NACWA
A CLEAR COMMITMENT TO AMERICA'S WATERS

To: NACWA Members
From: NACWA National Office
Date: July 15, 2020
Subject: LIMITS TO DIVERSION OF PUBLIC CLEAN WATER UTILITY FUNDS FOR OTHER PROGRAMS

The COVID-19 pandemic has caused an issue that public clean water utilities periodically face to resurface for several of NACWA's members: the potential diversion of utility ratepayer funds to fill gaps in other areas of a city (or other governmental body's) budget. In light of the increased pressures on city budgets being caused by the coronavirus, NACWA was recently asked by several members to look at whether there is any national guidance, precedent, or even individual federal court decisions addressing whether such diversions of utility revenue for purposes other than the provision of clean/safe water services are permissible.

NACWA's brief legal review did not find any consistent national precedent on utility revenue diversion. Rather, the issue differs from state to state. News articles from across the country appear to indicate that it is a common practice in many places despite often being viewed unfavorably by the public, but state laws differ as to whether and when it is legal.

For some utilities diversions are prohibited by statute, particularly for those organized as a separate political entity or subdivision of the state, and these clear cases are not the focus of this memo. For others where the prohibition on diversion is not clearly established in statute, NACWA did find that language in bond covenants and, to a lesser extent, consent decrees may not only provide public wastewater utilities some protection against revenue diversion generally, but may also be helpful to utilities seeking to access city stimulus funds related to the coronavirus pandemic.

Because the issue may arise for other NACWA members as the economic ramifications of the pandemic continue to reverberate across the country – or at any time in the future for myriad reasons – we wanted to share our findings with NACWA's membership to review, provide input on, and discuss.

The information NACWA found is outlined below. In light of the many other pressing issues currently facing NACWA's members and to be judicious with our resources, we kept both the geographic and substantive scope of our review limited. We are asking that you review and ground-truth our findings with what you know to be the case in your city/state. Our hope is that this memo will provide useful information to NACWA public agency members as you move forward in addressing the economic fallout from the pandemic, and begin a longer-term productive dialogue on a topic that has the potential to continue to impact wastewater utilities in the future.

I. Bond Covenants and Consent Decrees

Language contained in municipal bond covenants and consent decrees may directly impact a city's ability to divert clean water utility revenues for purposes other than the provision of clean/safe water services. Such language may also prove useful as utilities continue to negotiate access to funds made available to cities through recently passed government stimulus packages.

If a utility has issued debt obligations, the documents from each financing will include contractual covenants that are intended to preserve the security of the investors in such obligations. While these covenants can vary, unlike with state law regimes there is a significant amount of uniformity nationwide in bond covenant language.

Bond covenants are intended to ensure that rates are established at a sufficient level to provide for timely payments of principal and interest on all obligations of the utility. Additionally, if the debt obligations are tax advantaged for the investors thereof under the federal income tax code, they will include certain covenants designed to maintain that tax status.

Importantly, bond covenants will typically set forth a required coverage ratio (net revenue over maximum annual debt service), a requirement to maintain sufficient rates, restrictions on the use of revenues if required coverages aren't met, a waterfall priority on how net revenues may flow through an indenture or other security document to ensure proper funding levels in funds and accounts (debt service reserve, capital maintenance, or operating accounts), and other contractual provisions negotiated as a part of the issuance of the debt obligations.

Debt obligations are often secured by a lien on the net revenues of a system or a dedicated property tax levy. Failing to comply with these bond covenants and maintain the required coverage ratio – such as through the diversion of clean water utility revenue to other city services or failure to compensate for lost revenues related to the pandemic – could result in a lower bond rating (and corresponding lack of access to debt markets). If too much revenue is diverted to other purposes or lost and not otherwise compensated for, and the utility fails to maintain the required ratio, the utility may also be required to raise rates to comply with the bond covenants.

Notably, whether bond covenant language prohibits the diversion of ratepayer funds to other municipal purposes will also depend in part on state law. For example, while Arkansas permits diversion of surplus ratepayer funds, state law provides that if any utility revenue is pledged to pay off bonds, surplus funds may only be used for certain purposes enumerated in the statute. *See* A.C.A. § 14-199-101(a). Such state laws vary, but some also contain other permissible mechanisms to transfer revenues to other political subdivisions (for example, in the form of a Payment In Lieu of Taxes (PILOT)), or for revenues of the utility to flow directly to the political subdivision's balance sheet to supplement its operating budget.

Certain jurisdictions may also permit interfund or other types of loans between a utility and a political subdivision, but this may place other utility obligations at risk if those loans are not repaid. One example of this situation occurred where a formerly large city had a drastic population decline over the past fifty years due to the restructuring of a key industry and the resulting loss of jobs in the city. However, the sanitary district failed to follow its population decline with a necessary corresponding increase in rates/fees and continued to make large loans to the city in the process.

The city ultimately entered into a consent decree with EPA and the state requiring it to repay all loans that had been extended by the sanitary district, and stipulating that no further loans can be made, regardless of whether funds are collected through taxes, ratepayer fees, or municipal bonds.

Even where not directly prohibited by bond covenants or state law, a major risk of the diversion of utility funds is the potential to negatively impact the utility's bond rating. If a utility's funds are regularly being "raided," and the utility is barely meeting its obligations as a result, rating agencies could "ding" the utility by lowering their municipal bond rating. Notably, rating agencies will scrutinize a utility's balance sheet and determine how funds are being used and if they are being diverted from core utility purposes; all of this can be used to determine the bond's rating. So, even when nothing in state law or a bond's language specifically prohibits funds from being diverted, future bond ratings and a utility's access to the bond market may be impacted by wastewater revenue diversion.

Additionally, some utilities carefully maintain surplus funds in reserve as part of their long-term financial plans designed to meet the utility's costs and debt obligations. These reserves and advanced planning mechanisms allow clean water utilities to keep rate increases consistent and less frequent. Any diversion of funds would therefore increase unpredictability while decreasing the sustainability such financial plans are designed to foster, all to the detriment of the communities being served.

II. State Laws

While NACWA has not conducted a review of all state legal requirements regarding the use of wastewater utility funds, an overview of just a few states demonstrates the divergent ways states address the issue. Below is information from New York, South Carolina, Arkansas, California, and North Carolina, each of whom treats the question of whether ratepayer fees may be diverted to other funds differently.

A. New York

Except where otherwise prohibited by statute, New York allows the transfer of *some* municipal utility funds to other municipal purposes, so long as operating revenues in the fund exceed expenditures and the surplus funds are used for the payment of expenses or obligations for "municipal purposes." New York's General Municipal Law § 453 expressly limits the use of wastewater ratepayer funds to three purposes: (1) operation, maintenance and repair costs; (2) debt service; and (3) construction of sewage treatment and disposal works and related appurtenances.

The Office of the State Comptroller has opined that sewer rates cannot be used to provide funds for general municipal purposes, and that § 453 expressly prohibits the setting of rates "at an amount that would generate revenues in excess of costs attributable to the sewer system in order to provide funds for general [municipal] purposes."

But at least one court has held that General Municipal Law § 94 (GML § 94), which allows local government to use profits from utilities "for any other lawful purpose," to mean that where water and sewer rates are combined, § 94 governs the use of the rates. *See Heritage Co. v. Massena*, 151 Misc.2d 587 (S.C. St. Lawrence Cnty, 1992) (city's water and sewer revenues were considered a "fair return" and appropriate under GML § 94).

GML § 94 further allows profits from public utility services to be used "for the payment of expenses or obligations incurred by such municipal corporation for municipal purposes or for the payment of refunds to consumers." At least one state court has interpreted this law to give municipalities the right to use profits from utility funds for any general purpose. *Langdon v. Town of Webster*, 182 Misc.2d 603, 610 (S.C. of N.Y., Monroe Cnty., 1999) ("Under these provisions, the right of a municipality which operates a water utility service to use profits therefrom for any lawful purpose is protected, and section 94 of the General Municipal Law clearly permits use of such profits for general municipal purposes"). And the Office of the State Comptroller has noted that "profits" in the context of GML § 94 only exist where operating revenues in the fund exceed expenditures, and that this must occur before surplus fund moneys may be transferred and used for any lawful municipal purpose.

Additionally, public utility authorities, including the New York City Municipal Water Finance Authority, operate pursuant to specific statutes that may supersede provisions of the General Municipal Law. Pursuant to Public Authorities Law § 1045-j, for example, the New York City Water Board may assess funds only "for the use of, or services furnished by the sewerage system, water system, or both, as the case may be..."

B. South Carolina

In South Carolina, the practice of transferring ratepayer fees to the general fund is allowable only if the transferred revenue is "surplus." S.C. Code Ann. § 6-1-330(B) states that the "revenue derived from a service or user fee imposed to finance the provision of public services must be used to pay costs related to the provision of the service of program for which the fee was paid." However, the South Carolina Supreme Court clarified that, reading § 6-1-330 in connection with the Revenue Bond Act for Utilities (S.C. Code Ann. §§ 6-21-5 – 6-21-570), cities must spend utility revenue solely on costs related to the utility unless the revenue is "surplus," as defined by S.C. Code Ann. § 6-21-440. *Azar v. City of Columbia*, 414 S.C. 307, 314-315 (S.C. 2015). "Surplus" revenue is defined in more detail in § 6-21-440, but is generally any revenue remaining "after the utility system's operating and maintenance expenses and bond principal and interest expenses have been paid and the statutorily required set-asides have been made in the depreciation and contingent funds." *Id.*

C. Arkansas

There is at least some precedent to suggest that wastewater utility ratepayer funds may be diverted to other municipal purposes in Arkansas. Arkansas Code § 14-235-223 requires that sewer rates be "just and equitable" and sufficient to pay for operation, repair, replacement, and maintenance of the sewer system, but there is no specific provision addressing how any surplus funds may be spent. By contrast, Arkansas Code § 14-234-214, governing waterworks, expressly permits diversion of surplus waterworks funds to other municipal purposes.

However, in *Maddow v. City of Fort Smith*, 369 Ark. 143 (2001), the Arkansas Supreme Court explained that because generally accepted accounting principles permitted the City's wastewater utility operating fund "to be operated as part of its general fund," and any transfer of funds "would

merely have been a transfer within the general fund," the Court upheld the City's practice on that basis.

Guidance from the Arkansas Municipal League confirms that the Court's holding "indicates that in general the use of surplus sanitation funds will be acceptable," but cautions that cities should consult with their accounting professional to ensure compliance with the Court's reference to "generally accepted accounting principles" (p. 19).

D. California

A 2004 opinion from the Office of the Legislative Counsel, issued in response to a financial crisis in 2004, stated that the California Legislature cannot lawfully enact a statute that would transfer to the State's General Fund money in a water district's reserve fund and allocate those monies for a purpose other than that for which the water district was created. California State Auditor, California's Independent Water Districts: Reserve Amounts Are Not Always Sufficiently Justified, and Some Expenses and Contract Decisions are Questionable, 1 (June 2004).

E. North Carolina

In North Carolina, local government entities can divert water and sewer ratepayer funds, so long as all of the budgeted expenses for the enterprise activity are covered for the fiscal year. Specifically, Section 159-13(b)(14) states that "[n]o appropriation may be made from a utility or public service enterprise fund to any other fund than the appropriate debt service fund unless the total of all other appropriations in the fund equal or exceed the amount that will be required during the fiscal year, as shown by the budget ordinance, to meeting operating expenses, capital outlay, and debt service on outstanding utility or enterprise bonds or notes."

There are also no explicit restrictions of the use of water or sewer revenue, other than those imposed in the previously referenced statute, bond covenant requirements, or local ordinances. *See, generally*, *General Textile Printing and Processing Corp. v. City of Rocky Mount*, 908 F. Supp. 1295 (E.D. N.C. 1995) (stating that the City of Rocky Mount "is among seventy . . . North Carolina municipalities which transfer revenue from a utility fund to a general operating or capital fund for governmental expenditure in an area unrelated to operation of the utility," and finding that the city's setting of rates for public enterprise services so as to generate revenues for unrelated activities did not violate operator's substantive due process rights).

Next Steps

As you can see, the laws concerning utility revenue diversion vary from state to state, and multiple other factors including bond covenants and long-term financial planning can be implicated by such diversions. We ask that you please send any feedback on this memo to Amanda Aspatore, NACWA's Chief Legal Counsel. Specifically, we would appreciate receiving any information you are willing to share concerning your experience with these issues, how they may be addressed in your city/state, and any other factors you feel may be relevant to this document and the broader discussion.