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MEMORANDUM OF LAW

DATE: March 16, 2006

TO: Council President Scott Peters

FROM: Mark Blake, Chief Deputy City Attorney

SUBJECT: Allocation of Costs to Enterprise Funds

QUESTIONS PRESENTED

You have asked the following questions:

1. By what standard may the City allocate overhead expenses to the general fund and to enterprise funds?

2. By what standard may the City allocate Audit Committee expenses to the general fund and to enterprise funds?

3. Under what standards is it legal for City of San Diego taxpayers to subsidize enterprise funds, and by extension, ratepayers who are outside the City of San Diego?

SHORT ANSWERS

1. City overhead expenses (i.e., administrative and other common charges) are chargeable to only the general fund as a cost of operating City government when the only benefit is to the core government. By their nature, these situations will be limited and rare. Overhead expenses, by their definition, are common to and a benefit of all departments and enterprises of the City. The accounting question is the methodology by which such charges are allocated to the various departments, including the enterprise funds. Cost allocation methodologies are numerous, including, for example, an allocation based upon the number of employees within a department, square footage used, consumption of the costed activity, etc. It is permissible under the City Charter and under Proposition 218 to charge City overhead expenses to the enterprise funds provided (i) such costs are reasonable and (ii) reflect a proportionate and equitable charge to the enterprise funds of common services provided by the City. In order to comply with the provisions of Proposition 218, any apportionment of general overhead expenses to the enterprise funds should be supported by a cost of service study or other rigorous accounting treatment to

buttress the cost allocation methodology and to show that the costs imposed upon the enterprise funds are proportionate and reasonable.

2. The City can allocate the Audit Committee expenses to the general fund and to the enterprise funds as a direct cost. It would be necessary, however, to trace such costs or to establish a nexus of the work of the Audit Committee to specific tasks performed in respect of the enterprise funds. This could easily be done with appropriate billing statements submitted by the Audit Committee to the Auditor/Comptroller and the City Attorney for their review and approval. It is not clear that it would be permissible to charge the Audit Committee expenses as an "indirect cost" given that the means to provide direct cost allocation is readily available. It is noted that arguments have been made that Audit Committee expenses have been incurred for a common purpose in accordance with the guidance provided by Circular A-87 (to wit, to perform an investigation for the City's outside independent auditor, KPMG, to enable the City's outside independent auditors to complete and release their financial audits for the 2003 fiscal year), and as such, such costs represent an indirect cost chargeable to all City departments since such costs arguably benefit the entire City. But these arguments are unpersuasive given that direct billing can be readily assigned to the cost objectives specifically benefited, without effort disproportionate to the results achieved. And this, quite simply, could be done with the receipt by the City of satisfactory billing statements from the Audit Committee. Moreover it is unlikely that the City would be able to comply with the provisions of Proposition 218 to apportion Audit Committee expenses to the enterprise funds with the necessary evidentiary support to show that the costs are proportionate and reasonable.

3. Rates and charges imposed by the enterprise funds (i.e., water and sewer) should be designed to recover from each class of customers the proportionate cost of providing such service, including ratepayers located outside of the City. Presumably a properly designed rate structure would involve no subsidy by the general fund to, in effect, enable ratepayers outside of the City to pay less than their proportionate share for water or sewer service, as applicable. Absent a conclusion that the City was deriving some public benefit from such a subsidy, and no such conclusion is assumed in the question, the provision of a subsidy by the general fund to the ratepayers located outside the City could run afoul of both Proposition 218, the City Charter and provisions of the State Constitution respecting the gift of public funds.

DISCUSSION

At the January 17, 2006, meeting of the City Council, Councilman Maienschein asked whether a proposed cost allocation methodology with respect to the payment of Audit Committee expenses were "legal." [See R-2006-632, attached hereto as Exhibit 1] In the course of these discussions the City Attorney raised objections to an allocation methodology that attempted, without adequate documentation, to allocate Audit Committee costs, including the costs of its legal counsel, to the enterprise funds. After an extended discussion regarding this matter, it was decided by the Council that the funding request for the Audit Committee, and its counsel, would be paid from the City's General Fund pending a determination about the legality of allocating such costs to the City's enterprise funds. [R-2006-632 (COR COPY), attached

hereto as Exhibit 2]. Subsequent to the City Council discussion Council President Scott Peters submitted the questions indicated above to the City Attorney for his review.

As a brief background for question 2, the Audit Committee was retained on or about February 10, 2005, as an Independent Investigator to review and evaluate (i) the findings of the investigations by V&E and the City Attorney (i.e., matters relating to the under funding of the City's retirement system), and (ii) errors discovered in footnotes of the City's audited financial statements for the fiscal year ending 2003. This work was required to enable KPMG to review additional competent evidential matter necessary for it to complete its audit in accordance with applicable accounting, auditing and professional standards. The work of the Audit Committee is ongoing, and the breadth and scope of their engagement is not precisely clear. Certainly is has expanded to take in matters beyond a AU 317 analysis that was the intended original purpose of their engagement. To date, the City has spent or committed to spend approximately $17 million on the Audit Committee, and its counsel. The question to be addressed here is by what methodology should the City allocate the expenses of the Audit Committee and its counsel.

Cost accounting is defined as "a technique or method for determining the cost of a project, process, or thing . . . This cost is determined by direct measurement, arbitrary assignment, or systematic and rational allocation." Barfield, Raiborn, Kinney, *Cost Accounting, Traditions and Innovations*, 2nd Ed. (1994), p. 12, *citing* Institute of Management Accountants (formerly National Association of Accountants), Statement Management Accounting: Management Accounting Terminology, Statement Number 2. Cost information is needed for planning, control and decision-making. Cost allocation is primarily, although not exclusively, information used for internal organizational purposes.

Cost allocation determinations are necessarily decisions of auditing and comptroller department of an organization. The comptroller function is basically concerned with internal matters (e.g., financial accounting, budgeting, cost allocation, and control functions). Under section 39 of the City Charter, the auditor and comptroller "is the chief fiscal officer of the City . . . [and] shall exercise supervision over all accounts." The auditor and comptroller "performs the duties imposed upon City Auditors and Comptrollers by the laws of the State, and such other duties as imposed upon him by ordinances of the Council . . ."

There are three basic types of funds that are used in municipal accounting: (i) governmental, (ii) proprietary, and (iii) fiduciary.

General funds are those funds consisting of general revenue sources, such as taxes, fines, licenses and fees. The general fund is generally the largest municipal fund.

Proprietary funds generally contain funds of self-supporting operations, for example, water and sewer funds.

Fiduciary funds are funds that are held or caused to be held by the City for restricted purposes (e.g., bond funds).

As an elemental notion, costs can be characterized as either "direct" or "indirect". A direct cost is a cost that can be readily assigned to a particular cost objective (anything to which costs attach or are related---which can be a service, a department or a product) with a high degree of accuracy. Indirect costs, on the other hand, cannot be traced to a specific cost objective. As a rule of thumb, a cost that cannot be specifically traceable to a specific cost objective and must be allocated on some formulaic basis are typically referred to as indirect costs. The most common of indirect cost is City overhead expenses (e.g. City administrative expenses, centralized computing expense, etc).

A. Office of Management and Budget Circular A-87

Municipal governments, such as the City, refer for guidance to cost accounting principles set forth under a publication by the federal Office of Management and Budget Circular A-87, *Cost Principles For State, Local and Indian Tribal Governments* [Circular A-87]. While Circular 87 provides cost allocation principles with respect to federal agencies and the recipients of federal grants, the principles set forth therein are instructive. The Office of the State Comptroller has also made available a publication entitled, *Handbook for Cost Plan Procedures for California Counties* (March 2001) to interpret Circular A-87 for county governments.

The following cost allocation principles are set forth under Circular A-87, and will be set forth below as relevant for our discussion:

Allowable Costs

a. Must be necessary and reasonable . . .;

b. authorized or not prohibited under State or local laws;

c. accorded consistent treatment. A cost may not be awarded as a direct cost if any other cost incurred for the same purpose in like circumstance has been allocated as an indirect cost; and

d. determined in accordance with generally accepted accounting principles.

Reasonable Costs

A cost will be treated as "reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost." To determine whether costs are reasonable consideration should be given to the following factors:

a. whether the cost is recognized as ordinary and necessary for the operation . . .;

b. market price for comparable goods and services; and

c. whether individuals involved acted with prudence (e.g., sound business practices, arm's length bargaining, etc).

Allocable Cost

A cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with the benefits received.

Composition of Costs

Allocable costs will be composed of direct costs, plus an allocable portion of indirect costs. For purposes of this paragraph:

a. Direct costs. Those costs that can be identified specifically with a particular final cost objective. Typical direct costs are:

    1. compensation of employees for the time devoted and identified specifically. . . ;

    2. cost of materials acquired, consumed, or expended . . . ; and

    3. equipment and other capital expenditures.

c. Indirect costs. Those costs (a) incurred for a common or joint purpose benefiting more than one cost objective, *and* (b) not readily assignable to the cost objectives specifically benefited, without effort disproportionate to the results achieved.

Interagency Service

The cost of services provided by one agency to another within the governmental unit may include allowable direct costs of the service plus a pro rata share of indirect costs. A standard indirect cost allowance equal to ten percent of the direct salary and wage cost of providing the service may be used in lieu of determining the actual indirect cost of service.

B. City Enterprise Funds

Enterprise funds are a form of special account created and restricted by statute (or city charter) where the governing body has decided to impose specified limitations on the deposit or expenditure of funds.

> "Special funds are often created for the payment of a particular class of claims, or for a particular class of expenditures or for a particular purpose, and in such case the general rule is that they cannot be used for any other purpose, unless a special provision is made. Claims payable out of a special fund are usually not payable

> out of any other fund, and therefore the municipality is ordinarily not liable outside of such fund. Whether municipal officers are personally liable for use of funds for a purpose other than for which they are designated is a matter of conflict. Undoubtedly, the circumstances as well as local statutes or laws must be taken into account. Irrespective of statute, a fund raised by a municipality for a special purpose is a trust fund, and equity will, in a proper case, interfere to prevent its diversion, or will entertain an action for an accounting."

15 Eugene McQuillin, The Law of Municipal Corporations, § 39.45 (3rd ed. 1995) (footnotes omitted).

The City has established a number of enterprise funds under the Charter, Municipal Code or ordinance. Most notably, the Water Utility Fund was established by Charter section 53 (and further provided for under section 90.1 of the Charter) and the Sewer Revenue Fund was established under section 64.0403 of the Municipal Code. Historically, this office has followed the "trust fund" concept posited by McQuillin when asked to interpret whether the expenditure of moneys from these funds is proper. *See, e.g.,* 1991 City Att'y MOL 13 (denying the use of water revenue funds for the installation of water backflow devices in park facilities); 1992 City Att'y MOL 648 (approving the expenditure of sewer revenue funds for General Fund managerial salary charges); 1992 City Att'y MOL 849 (approving the use of water revenue funds for water fixtures used in City parks); 1994 City Att'y MOL 635 (denying the transfer of sewer revenues to a maintenance assessment district for impacts caused by the installation of sewer facilities). Generally, the determination of whether the use of these moneys is proper turns on whether the departments receive a benefit from the expenditure of the moneys.

I. Water Utility Fund and Sewer Revenue Fund Restrictions

The City Charter reflects a concern that the provision of water and water utility services to City residents is of primary importance. The Charter contains unique provisions designed to guarantee the availability of funds for water services. The City's Municipal Code codifies restrictions on the use of wastewater revenues to similarly guarantee the provision of wastewater collection and treatment services. The following analysis will generalize the relevant City Charter provisions which restrict the use of moneys in the Water Utility Fund. Following this analysis is a discussion of the relevant provisions of the City's Municipal Code pertaining to the use of moneys in the Sewer Revenue Fund and the relevant bond covenant restrictions relating to moneys in the Water Utility Fund and the Sewer Revenue Fund.

San Diego Charter section 53 sets forth the permissible uses of the revenues deposited into the Water Utility Fund. The City Attorney has written numerous opinions and memoranda of law on this particular San Diego Charter provision. The recurring conclusion embodied in these opinions and memoranda is that the Water Department must remain a self-sustaining, financially independent water utility; and that the moneys deposited into the Water Utility Fund are held in trust to guarantee sufficient revenues for the provision of water and water utility

services. 1932 Op. City Att'y 177; 1932 Op. City Att'y 362; 1933 Op. City Att'y 526; 1965 Op. City Att'y 23; 1966 Op. City Att'y 157; 1967 Op. City Att'y 37; 1980 Op. City Att'y 69; 1980 Op. City Att'y 83.

The relevant provisions of the San Diego Charter provide:

> "All revenues of the Water Utility shall be deposited in a Water Utility Fund. The Manager shall include in the annual budget the estimated expenditure and reserve requirements of the Water Utility Fund. The City Council using such estimates as a basis shall include in the annual appropriation ordinance for the Water Utility Fund provision for *operating and maintenance costs*; replacements, betterments, and expansion of facilities; payments necessary for obtaining water from the Colorado River; any other contractual obligations; reserves for future expansion of water utility plant; reserves for future water purchases." San Diego Charter § 53 (emphasis added).

The foregoing provisions of the City Charter ensure that sufficient moneys are deposited into the Water Utility Fund for the provision of water and water utility services and that these moneys are first used to fulfill the requirements of the Water Department, including the payment of operation and maintenance expenses.

The Sewer Revenue Fund is established pursuant to San Diego Municipal Code section 64.0403. All revenues from the operation of the wastewater system must be deposited into this fund. San Diego Municipal Code § 64.0403(a). These revenues are restricted to the following purposes:

1. Paying the *cost of maintenance and operation* of the City's wastewater system.

2. Paying all or any part of the costs and expense of extending, constructing, reconstructing, or improving the City's wastewater system or any part thereof.

3. Any purpose authorized by Section 90.2 of the City Charter.

4. Paying the cost of mitigation of fair share overburdens within any City Council district as more fully set forth in Section 64.0403(c).

San Diego Municipal Code § 64.0403(b) (emphasis added).

The City Attorney has previously opined that the restrictions contained in Section 64.0403(b) are similar in import to those contained in San Diego Charter section 53. Ultimately, these opinions conclude that sewer revenues may only be used for those purposes identified in Section 64.0403(b). 1993 City Att'y MOL 137; 1994 City Att'y MOL 635-39.

In addition to the Charter and Municipal Code provisions restricting the use of Water Utility Fund and Sewer Revenue Fund moneys, there are contractual requirements (i.e. bond covenants) that restrict the use of such funds. In June 1998, the City Council approved the issuance of $385 million of certificates of undivided interest [1998 COPs] for the capital improvement program of the Water Department. The 1998 COPs were issued by the San Diego Facilities and Equipment Leasing Corporation [Corporation], a non-profit public benefit corporation, of which the City is the only member.

A Master Installment Purchase Agreement by and between the City of San Diego and the San Diego Facilities and Equipment Leasing Corporation, dated August 1, 1998, relating to Installment Payments from Net System Revenues of the Water Utility Fund of the City of San Diego, California [Water IPA],[1] and a supplement thereto, were developed in conjunction with the 1998 COPs to provide for the acquisition of the improvements financed by the 1998 COPs. The City and the Corporation are parties to this agreement.

The Water IPA contains certain covenants respecting the use of the revenues deposited into the Water Utility Fund. Specifically, Section 5.02(a) of the Water IPA obligates the City to pay from the Water Utility Fund: (i) all maintenance and operation costs of the water system; (ii) the amounts specified in any indenture, trust agreement, or installment purchase agreement, including any supplement under which obligations are issued; and (iii) the amounts or payments due under a qualified swap agreement (as defined in the Water IPA) as parity obligations. The term "maintenance and operation costs of the water system" is defined in the Water IPA to include, among other things, "reasonable and necessary costs spent or incurred by the City for maintaining and operating the Water System, calculated in accordance with generally accepted accounting principles,[2] including . . . salaries and wages of employees, payments to employees retirement systems (to the extent paid from Water System Revenues), overhead, taxes (if any), fees of auditors, accountants, *attorneys* or engineers and insurance premiums. . ."[3] Water IPA § 1.01 (emphasis added).

In September 1993, the City Council approved the issuance of $250 million in sewer revenue bonds. Additional bonds were issued in 1995, 1997, 1999, and 2004 [collectively, the

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[1] The terms and conditions of the Water IPA for the 1998 COPs control with respect to all other bonds and securities secured by revenues of the Water Utility Fund, including the water revenue bonds issued by the Public Facilities Financing Authority of the City of San Diego in 2002.
[2] The Governmental Accounting Standards Board Statement 34, paragraph 112 a (2), governing "reciprocal interfund activity," contemplates that "[i]interfund services provided and used should be reported as revenues in seller funds and expenditures or expenses in purchaser funds. Unpaid amounts should be reported as interfund receivables and payables in the fund balance sheets or fund statements of net assets."
[3] *Howard Jarvis Taxpayers Ass'n v. City of Roseville*, 97 Cal. App. 4th 637, 647-648 (2002) (costs of providing a service by an enterprise fund include maintenance and operations expenses; transfers to the general fund from a special fund for general fund operations or assets that benefit the enterprise are permissible, provided the costs are reasonable).

five series of bonds are referred to herein as the Sewer Bonds]. The Sewer Bonds were issued by the Public Facilities Financing Authority of the City of San Diego [PFFA], a joint powers authority, of which the City and the Redevelopment Agency of the City of San Diego are members.

Similar to the 1998 COPs, a Master Installment Purchase Agreement by and between the City of San Diego and the Public Facilities Financing Authority of the City of San Diego, dated September 1, 1993, Relating to Installment Payments Secured by the Sewer Revenue Fund of the City of San Diego [Sewer IPA], and a supplement thereto, were entered into in conjunction with the 1993 Bonds. Separate supplements were entered into for the subsequent financings in 1995, 1997, 1999, and 2004. The Sewer IPA has nearly identical provisions to that contained in the Water IPA respecting the allocation of system revenues and the restrictions placed on the use of moneys deposited into the Sewer Revenue Fund. System revenues may be used for maintenance and operation expenses of the wastewater system, which are also defined to include expenses related to attorneys' services. Sewer IPA, §§ 5.02(a), 1.01.

The foregoing covenants for the 1998 COPs and the series 2002 water revenue bonds [collectively the Water Bonds], and the Sewer Bonds, as well as the relevant San Diego Charter and Municipal Code provisions, therefore contemplate that water and sewer revenues deposited in the Water Utility Fund and the Sewer Revenue Fund shall be used for related operation and maintenance costs of the utilities. *See* City Att'y Report to Council RC-2004-15, June 21, 2004; *Howard Jarvis Taxpayers Ass'n v. City of Roseville*, 97 Cal. App. 4th 637, 647-648 (2004).

C. Proposition 218

Proposition 218, the "Right to Vote on Taxes Act" was enacted November 5, 1996. Proposition 218 added Articles XIIIC and XIIID to the State Constitution, which contain a number of interrelation provisions affecting the ability of the City to levy and collect both existing and future taxes, assessments, fees and charges. Of relevance here, Proposition 218 (Article XIIID) adds several provisions affecting "fees" and "charges" to mean "any levy other than an ad valorem tax, a special tax, or an assessment, imposed by a [local government] upon a parcel or upon a person as an incident of property ownership, including a user fee or charge for a property related service." Among other things, Proposition 218 requires that fees and charges cannot:

(i) generate revenues exceeding the funds required to provide the property related service;

(ii) be used for any purpose other than those for which the fees and charges are imposed;

(iii) exceed the proportionate cost of the service attributable to the parcel;

(iv) be used for a service not actually used by, or immediately available to, the owner of the property in question; or

(v) be used for general governmental services, including police, fire or library services, where the service is available to the general public at substantially the same manner as property owners.

While there has been some debate about the applicability of Proposition 218 to charges for water and wastewater service, a [general consensus] has developed that such fees and charges must comply with the substantive requirements indicated above. Article XIIID, section 6(d) states quite clearly that "all fees and charges" must comply with Proposition 218 beginning July 1, 1997. See also Government Code Section 50076, adopted to implement Proposition 13, which provides that " . . . 'special tax' shall not include any fee which does not exceed the reasonable cost of providing the service or regulatory activity for which the fee is charged and which is not levied for general revenue purposes." As such, the ability to assess such enterprises with indirect costs or City overhead cost are circumscribed by the limitations that the ultimate fees must represent the proportionate and/or reasonable cost of delivering water or sewer service. In a word, the City cannot simply impose costs on the enterprises that have nothing whatsoever to do with the cost of delivering water or sewer service by the enterprises.

CONCLUSIONS

There is relatively little, if any, case law in this area. This is necessarily to be expected since cost allocation decisions are normally the province of accounting departments, and rarely do these decisions result in litigation. Moreover, cost allocation questions under Circular A-87 are necessarily decided by the federal government in its administration of grants to state and local governments, including Indian tribes. With that being said, the City's charter and Proposition 218 provide legal constraints to the ability of the City to allocate costs to the enterprise funds. In sum, the City cannot allocate costs to the enterprise funds without showing that such enterprise funds derive some benefit from the imposition of costs.

1. City overhead expenses (i.e., administrative and other common charges) are chargeable to the general fund as a cost of operating City government when the only benefit is to the core government. By their nature, these situations will be rare and infrequent. Overhead expenses, by definition, are common to and benefit all departments and enterprises of the City. The accounting question is the methodology by which such charges are allocated to the various departments, including the enterprise funds. The basis of allocation is necessarily dependent on the nature of the cost but the objective in any situation is to achieve equity and accountability. Frequently used methodologies are, for example, the number of full time equivalents, square footage, hours of use, etc. Accordingly, it would be permissible under the City Charter and under Proposition 218 to charge City overhead expenses to the enterprise funds provided (i) such costs are reasonable and (ii) reflect an equitable and proportionate charge to the enterprise funds of common services provided by the City. In order to comply with the provisions of Proposition 218, any apportionment of City overhead expenses to the enterprise funds should be supported by a cost of service study or other rigorous accounting treatment to fully support the analysis showing the benefits received by the enterprise funds.

2. Clearly, the City could allocate the Audit Committee expenses to the general fund and to the enterprise funds as a direct cost. It would be necessary, however, to trace such cost or to establish a nexus of the work of the Audit Committee to specific tasks performed in respect of the enterprise funds. This could easily be done with appropriate billing statements submitted by the Audit Committee to the Auditor/Comptroller and the City Attorney for their review and approval. The City Attorney has made numerous demands on the Audit Committee for appropriate billing statements. As well, the Auditor/Comptroller of the City has made a similar demand on the Audit Committee. To date, the Audit Committee has not provided invoices that would enable the Auditor/Comptroller to determine how to allocate costs on this basis. Should the Audit Committee provide such billing statements, it would be fairly mechanical to charge these costs directly. The effect of this approach would be to impose directly on the department the costs of the Audit Committee for which the Audit Committee has spent its time.

It is not clear that it would be permissible to charge the Audit Committee expenses as an indirect cost allocable to all City departments and divisions given that the means to provide direct cost allocation is readily available. It could be argued that such expenses were the result of decisions made by the City Council and Mayor with respect to the under funding of the pension plan and its description in the City's offering documents over the relevant period. As such, only the general fund should bear the consequences of those ill-fated decisions. It is noted that arguments have been made that Audit Committee expenses have been incurred for a common purpose under the guidance of Circular A-87 (to wit, to perform an investigation for the City's outside independent auditor, KPMG, to enable the City's outside auditors to complete and release their financial audits for the 2003 fiscal year), and as such, such costs represent an indirect cost chargeable to all City departments since such costs arguably benefit the entire City. But these arguments are unpersuasive given that direct billing can be readily assigned to the cost objectives specifically benefited, without effort disproportionate to the results achieved. And this, quite simply, could be done with the receipt by the City of satisfactory billing statements. Moreover it is unlikely that the City would be able to comply with the provisions of Proposition 218 to apportion Audit Committee expenses to the enterprise funds with the necessary evidentiary support to show that the costs are proportionate and reasonable.

3. Rates and charges imposed by the enterprise funds (i.e., water and sewer) should be designed to recover from each class of customers the proportionate cost of providing water and sewer service, and these costs should include the proportionate costs of providing water and sewer service to ratepayers located outside the City. Presumably, a properly designed rate under Proposition 218 would involve no subsidy by the general fund to, in effect, enable ratepayers outside of the City to pay less than their proportionate share for water or sewer service, as applicable. Absent a conclusion that the City was deriving some public benefit from such a

subsidy, and no such conclusion is assumed in the question, the provision of a subsidy by the general fund to the ratepayers located outside the City could run afoul of both Proposition 218, the City Charter and provisions of the State Constitution respecting the gift of public funds.

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By

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