MEMORANDUM OF LAW

DATE: October 19, 1992

TO: Richard Enriquez, Clean Water Program, Grants Administrator

FROM: City Attorney

SUBJECT: State Revolving Loan Fund and Debt Limitations

By memorandum dated September 12, 1992, you raised two questions regarding a revolving loan fund program offered by the State Water Resources Control Board ("Board") to assist wastewater discharge permit holders in financing construction of treatment facilities. Included as factual background was a copy of the Board's policy manual ("policy") which itself contained a sample loan agreement form ("loan terms") as an appendix. The policy basically incorporates funding require-ments of the Environmental Protection Agency as set forth in the Code of Federal Regulations. In conversations regarding this subject, you have informed us that up to $20 million in loan proceeds may be available to the City through this program, and the loans may be amortized over a period of up to 20 years. Interest rates would be favorable as compared to prevailing commercial rates.

QUESTIONS

1. Based on San Diego City Charter section 80, can the City enter into a loan agreement with the state?

2. What amounts would have to be initially encumbered through the budget process, i.e., the full amount of the loan or just the amount required for repayment within the year the payment is due?

ANALYSIS

Although your first question references Charter section 80, the concern for municipal debt limitations more properly implicates Charter section 99 and California Constitution Article XI, section 18. Charter section 80 addresses the yearly appropriations of the City Council, and provides in substance that contracts, agreements, or other obligations involving expenditures for any one fiscal year may not be entered unless the City Auditor has first certified that the money required for the entire obligation is in the treasury to the credit of the

appropriation from which it is to be drawn. In essence, this means that before any agreement is entered, the Auditor must certify that not only has the City Council made an appropriation for that entire agreement, but that the money has been actually encumbered for the purpose of funding it. While not entirely irrelevant to your questions, the provisions of Charter section 80 apply only incidentally to the debt limitation provisions of the state Constitution and Charter section 99.

Charter section 99 is a very close reflection of the debt limitation provisions of California Constitution Article XI, section 18. Since the two laws are nearly identical in language, purpose, and effect, we refer here only to the content of Charter section 99, as the analysis would be the same for the Constitutional provision. Charter section 99 states:

> SECTION 99. CONTINUING CONTRACTS
>
> The City shall not incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year unless the qualified electors of the City, voting at an election to be held for that purpose, have indicated their assent as then required by the Constitution of the State of California, nor unless before or at the time of incurring such indebtedness provision shall be made for the collection of an annual tax sufficient to pay the interest on such indebtedness as it falls due, and also provision to constitute a sinking fund for the payment of the principal thereof, on or before maturity, which shall not exceed forty years from the time of contracting the same; provided, however, anything to the contrary herein notwithstanding, when two or more propositions for incurring any indebtedness or liability are submitted at the same election, the votes cast for and against each proposition shall be counted separately, and when the qualified electors of the City, voting at an

> election for that purpose have indicated their assent as then required by the Constitution of the State of California, such proposition shall be deemed adopted. No contract, agreement or obligation extending for a period of more than five years may be authorized except by ordinance adopted by a two-thirds majority vote of the members elected to the Council after holding a public hearing which has been duly noticed in the official City newspaper at least ten days in advance.

As is evident, this Charter section is intended to regulate the incurrence of long term continuing indebtedness. And the Constitutional provision upon which it is modeled likewise was enacted to prevent improvident creation of inordinate debts that might be charged against taxpayers, and to ensure that taxpayers have the opportunity to express their approval or disapproval of a long term indebtedness. Lagiss v. County of Contra Costa, 223 Cal. App. 2d 77, 85 (1963); Redondo Beach v. Taxpayers, Property Owners, Citizens and Electors, 54 Cal. 2d 126, 131 (1960). It means that indebtedness cannot be lawfully incurred (except in the manner provided, i.e., election with supermajority vote) which exceeds in any one year the revenue actually received by the City for that year. Each years's income must pay each year's liability, and no part of such liability may be paid out of the income of any future year. San Francisco Gas Co. v. Brickwedel, 62 Cal. 641, 642 (1882); Higgins v. City of San Diego, 131 Cal. 294, 298 (1901); Fresno Canal and Irrigation Co. v. McKenzie, 135 Cal. 497, 500-501 (1902).

These principles will apply to general fund loan contract obligations. Thus, when a loan obligating the general fund is contracted, the City as borrower incurs a present obligation to make future payments, and the result is the seemingly anomalous requirement that all money required to meet that liability must be within the year's income, unless an exception to the debt limitation law fits the situation at issue. The anomaly exists because a long term loan contract is an unusual type of contract for a municipality to enter, for long term municipal financing has more commonly been accomplished through other security arrangements (bonds) governed by distinct Charter provisions or general law. Still, a loan contract is nonetheless a contract, and the debt limitation laws must therefore be considered as to whether exception applies.

Turning to the Board's policy and the loan terms which are the basis of your questions, we believe that an exception does indeed apply. The Board's policy calls for the development of a Revenue Program in section VII.C. (more thoroughly described in Appendix C), which is to be based upon a sewer use ordinance. It states in pertinent part that . . .

> the loan recipient will be required to demonstrate, at the time of the actual loan application at the approval to award stage that a "dedicated" source of revenue is available to repay the loan. Revenue will be considered dedicated when the local community passes an ordinance or a resolution committing a source or sources of funds for repayment.

The Revenue Program Guidelines contemplate a "system of charges based on actual use." It thus clearly appears that what is intended as the revenue source are revenues derived from sewer users.F

The Guidelines also make provision for a municipality's dedication to ad valorem property taxation as a supplemental aspect of the Revenue Program, but this appears to be only incidental and optional. In our City's case, sewer revenues are based entirely on use, and this is generally what the Guidelines require. This discussion will therefore assume that taxation will not be an element of the expected Revenue Program.

San Diego Municipal Code ("SDMC") section 64.0403 provides for a Sewer Revenue Fund for paying for development, construction, operation, and maintenance of sewerage facilities, as well as for funding of revenue bonds issued according to Charter section 90.2. This Sewer Revenue Fund is to be distinguished from the City's General Fund, as it is a special fund with a specifically limited purpose, and its assets are derived entirely from pursuit of that purpose.

The constitutional debt limitation (and hence the Charter debt limitation) is generally inapplicable where indebtedness in excess of ordinary annual revenue is to be paid out of a special fund. Shelton v. City of Los Angeles, 206 Cal. 544, 551-52 (1929); Department of Water and Power v. Vroman, 218 Cal. 206, 217-20 (1933); City of Oxnard v. Dale, 45 Cal. 2d 729, 733-37 (1955); City of Walnut Creek v. Silveira, 47 Cal. 2d 804, 813 (1957); City of Palm Springs v. Ringwald, 52 Cal. 2d 620, 624 (1959).

We therefore believe that if, as the loan terms generally

imply, the Sewer Revenue Fund is to be the exclusive source of revenue for repayment of the loan, the loan would fall within a recognized exception to the debt limitation provisions of the state Constitution and City Charter. Thus, regarding Charter section 80, the City Auditor would be in lawful position to certify partial payments to be made from annual appropriations of the City Council, and the Council would be in lawful position to make such periodic appropriations from the special Sewer Revenue Fund notwithstanding the limitation provisions of Charter section 99. Under Charter section 99, the only remaining stricture would be the necessity of a two thirds affirmative vote of the City Council to approve a loan contract which exceeds five years.

However, the City must make further considerations where the Sewer Revenue Fund is pledged as the sole source for repayment of the loan. This is because that same Sewer Revenue Fund has been pledged, and likely will be pledged in the near future, as the revenue source for redemption of Sewer Revenue Bonds issued pursuant to Charter section 90.2. Specifically, a concern arises for covenants made on bonds previously issued (1961 Bonds and 1966 Series A and Series B Bonds, as reported in the 1991 Annual Financial Report of the Water Utilities Department). An examination of the covenants for the 1966 Series A bonds discloses the following provision:

> Covenant 11. Limits on Additional Debt. The City covenants that (except for bonds issued to refund revenue bonds payable out of the Sewer Revenue Fund) no additional indebtedness evidenced by revenue bonds, revenue notes or other similar evidences of indebtedness payable out of the Sewer Revenue Fund and ranking on a parity with these bonds shall be created or incurred unless:

Two conditions are next set forth in the covenant, which due to verbosity we include as Attachment A. Those conditions may be generally summarized as follows: 1) All payments of principal and interest must be current and no late payments recorded; likewise for payments into the Bond Service Fund and Reserve Fund. 2) The sewerage system revenue accounts must have been

> independently audited within the year preceding incurrence of the new debt, and that accounting of revenue must amount to at least 1.3 times the maximum amount of annual debt service on all indebtedness that will be outstanding following incurrence of the new debt. For purposes of the accounting, two allowances for expected revenue are permitted to be added to actual revenue in applicable circumstances at the City's option, these allowances being equal to three-fourths of the estimated additional revenue that could have been expected a) from charges related to new improvements to the sewer system, and/or, b) from service charge rate increases, where such charges are imposed prior to the incurrence of the new debt but were not imposed during the full accounting year upon which the revenue calculation is based.

Similar covenants are contained in the 1961 and 1966 Series B bonds. The significance of this bond covenant to the prospect of obtaining a $20 million loan from the state is this: No indebtedness may be incurred on a parity with the previously issued bonds unless the aforementioned financial conditions are satisfied. Thus, absent fulfillment of those conditions, the state loan would by express terms have to recognize the priority of the bonds, and the Board would have to agree to be a creditor of second priority to the bondholders. The alternative would be to meet the conditions of the bond covenant by performing the necessary independent financial analyses and obtaining a conclusion that annual revenues will equal or exceed 1.3 times total annual debt service for all Sewer Fund obligations, including the state loan.

Aside from the bonds which have already been issued, the prospect of obtaining the state loan also raises questions regarding prospective future bond issues. The integrity of the Sewer Revenue Fund provides the basis upon which those future bonds will be rated and sold to investors, and a collateral obligation on a loan conceivably could affect the cost and terms of financing those bonds. Although the interest rate on the state loan may be a fraction of that prevailing generally in the

market, this cost incentive might be offset with corresponding increases in the cost of servicing bond debt. Our conclusions in this respect are purely theoretic, and bond counselors and financial advisors likely will be in a better position to give more particularized advice on the financial implications of these state loans. As state and federal grant programs are appearing to be supplanted by loan programs requiring municipalities to repay the funds, municipalities must evaluate how this trend will affect the more traditional methods of financing -- i.e., bonds -- and determine whether the loans are in their best interest. This evaluation ideally will require the advice of bond counsel and financial advisors, and it may well be that the loans are an excellent avenue of financing. Our point here is simply to suggest that the option of entering the state loans should be figured into the comprehensive programmatic financial plans of the sewerage utility, especially as to how this will impact other facets of the financial plans.

CONCLUSION

No debt limitation provision would preclude the City from executing the loan agreement with the state if the Sewer Revenue Fund is identified in that agreement as the exclusive source of funds for repayment. However, a pledge of the Sewer Revenue Fund on a loan agreement would implicate covenants in previously issued bonds, and might derogate marketability of future bonds. It is recommended that the plan to enter the state loan be thoroughly discussed with bond counsel and financial advisors.

JOHN W. WITT, City Attorney

By

Frederick M. Ortlieb

Deputy City Attorney

FMO:lc:mb:452.5(x043.2)

Attachment

ML-92-98

TOP

TOP