MEMORANDUM OF LAW

DATE: June 18, 1996

TO: Ed Ryan, City Auditor and Comptroller

FROM: City Attorney

SUBJECT: Water and Sewer Fund Transfers for Use of City Rights-of-Way

Question Presented

Pursuant to a memorandum dated March 8, 1996, you have asked our office to examine whether the Fiscal Year ("FY") 1996 Right-of-Way Assessment proposed by the City Manager for the Sewer and Water Revenue Funds (the "Funds") of the Metropolitan Wastewater Department and the Water Utilities Department (the "Utilities") is a justifiable charge given the restrictive use of water and sewer utility funds.

Short Answer

The FY 1996 Right-of-Way Assessment proposed by the City Manager appears to be a justifiable charge for the use of the public

rights-of-way, based on the data provided by the City Manager, as more fully discussed below. The method, and components, of the calculation appear to be comparable to those used in calculating amounts charged to other entities for similar rights.

Background

In response to an inquiry from Deputy City Manager Coleman Conrad, our office opined by memoranda dated June 22, 1993, and January 24, 1994, that the Utilities may be charged for use of the City's rights-of-way. See Attachments 1 and 2, respectively. Such charge is transferred from the Funds to the City's General Fund. According to the memoranda, a right-of-way assessment may be charged against the Funds as an operation and maintenance expense. The assessment must be based upon the benefits conferred on the Utilities by the General Fund for use of the public rights-of-way, and must be necessary and reasonable as discussed below. Those memoranda did not address the appropriateness of any given methodology for calculating the appropriate charge but,

rather, indicated that the appropriate ("reasonable") charge is a matter left in large degree to managerial or policy discretion. See Attachment 1, p. 1.

In FY 1994, the General Fund charged the Funds a Right-of-Way Assessment of $6.6 million; in FY 1995, $11.1 million. The proposed assessment in FY 1996 is $15.8 million. In a memorandum dated June 14, 1996, from City Manager Jack McGrory to Financial Management Department Director Patricia Frazier (see Attachment 3), the City Manager set forth the basis for the increase in the FY 1996 Right-of-Way Assessment. According to the memo, the Assessments have been increasing each year so that there would not be a "shock" to the Funds from an immediate assessment, beginning in FY 1994, of the full amount properly charged for each fiscal year. In other words, the appropriate assessment was to be phased in over time.

Analysis

Pursuant to San Diego City Charter section 53, all revenues of the Water Utilities Department must be deposited in the Water Utility Fund. This fund is then annually appropriated, based on estimates provided by

the City Manager, for several purposes, the first of which are operations and maintenance expenses. As we have repeatedly opined, however, these expenditures must confer a direct benefit on the water utility. S.D. City Att'y Opinion No. 80-8 (1980).

The Sewer Revenue Fund does not have any similar limitations under the City Charter but the use and expenditures of the Fund are limited by the San Diego Municipal Code. In addition, expenditures from the Sewer Revenue Fund are limited by covenants in both Series 1993 and 1995 Sewer Revenue Bonds (the "Bonds") each issued by the Public Facilities Financing Authority. In accordance with Municipal Code section 64.0403, all revenues derived from the operation of the wastewater system shall be paid into the Sewer Revenue Fund. The revenues are then appropriated for a variety of purposes, including maintenance and operation costs of the City's wastewater system. Pursuant to Section 5.02 of the Master Installment Purchase Agreement concerning the Bonds, the City covenants to pay "directly or as otherwise required all Maintenance and Operation Costs of the Wastewater System." The same document carries its own limiting definitional sections regarding maintenance and operation costs. Section 1.01 defines in two (2) places "Maintenance and Operations Costs of the Municipal System" and "Maintenance and Operations Costs of the Wastewater System." Both limit expenditures to "the reasonable and necessary costs spent or incurred by the City ...." Hence both the bond covenants and definitions limit the charges for right-of-way use to those that are demonstrably "reasonable and necessary."

While the "reasonable and necessary" test is the principal standard against which the appropriateness of a right-of-way charge is to be

measured, we must be mindful that portions of the metropolitan sewer system have been financed through grant funds from the State of California which require the grantee (City) to provide all sewer service on a "fair and equitable" basis. Accordingly, the State has adopted "Revenue Program Guidelines for Wastewater Agencies" to ensure fairness in the costs assessed to certain users.F

The Guidelines provide, in relevant part:

Intent. The intent of the "fair and equitable"

requireme

agencies which are required to join regional systems as a

Board planning decisions, from undue financial burdens or

treatment by the regional agencies. These guidelines are areas of concern:

1. The cost assessed to incoming agencies or are
2. The appropriateness of conditions imposed by agency.

Revenue Program Guidelines for Wastewater Agencies, Appendix B. Assum of the methodology discussed in this memorandum, the Guidelines would charge to other users would be uniformly assessed and would not exceed incurred.

While we have been assured that no charge for right-of-way fees has been assessed against any participating agency (except for the City) in the metropolitan system, we must be mindful of these restrictions in the event that future payments for right-of-way fees impact these funds. Because of the assurances we have received from the City Auditor's Office, however, this memorandum does not directly address that issue.

A right-of-way is the privilege of passing over another's land in some particular way, and is equivalent to an easement. Highland Realty Co. v. City of San Rafael, 46 Cal. 2d 669, 677 n. 1 (1956); Miro v. Superior Court, 5 Cal. App. 3d 87, 96 (1976). With respect to the Utilities, they are paying for the privilege of placing their water and sewer pipes and mains on property owned or controlled by the City (property general acquired and maintained with the General Funds of the City), and for the ability to access those pipes and mains as necessary to undertake maintenance and repairs. Such pipes and mains are necessary for the operation of the water and wastewater systems. Thus, the Right-of-Way Assessment, being the cost of paying for the right to be on, and have unlimited access to, the City's property, may be properly classified as a "necessary" operation and maintenance expense since it is a necessary component of the ability to place and access pipes and mains.

In addition, the assessment must meet the reasonableness test. Here the reasonableness of the assessment must not be based on conjecture, but rather on some objective standards of comparable

charges, or a qualified opinion to that effect. Hence, to the extent that the figures and calculations in Attachment 3 are substantiated by confirmed comparables, the assessment would satisfy the reasonableness test.

At this point we offer some thoughts on the appropriateness of the methodology set forth in Attachment 3. We first note that the assessment may be based on a variety of methodologies or formulas, subject to our discussion above. In this case, the City Manager has chosen to use a formula that multiplies the operating revenues of the Utilities by a certain percentage. This method is identical to that used in calculating the fee collected from certain cable TV companies and SDG&E for identical privileges, i.e., the right to utilize the public rights-of-way, and appears to us to be an apt comparable. We are of this opinion because the City Auditor and his staff inform us that "franchise fees" (as these charges are denominated because those companies have received franchises from the City) are kept on the books as operations and maintenance expenses, pursuant to generally accepted accounting principles. See Attachment 4. While the Utilities do not have "franchises" with the City, we are of the opinion that the label attached to the assessment is not determinative, it is the reason or purpose for the charge that makes it a comparable methodology.

Our advice herein does not conflict with advice previously rendered by this office in two memoranda issued in 1966 and 1967. The 1966 memorandum (Attachment 5) analyzed the legality of an "in lieu tax" proposed to be assessed against the then existing Utilities Department of the City, calculated as a percentage of gross revenues. The memorandum discussed City Charter section 53 but focused on the disposition of "surplus" monies of the Department, once all of the other authorized appropriations were met. As discussed above, the first authorized expenditure is for operation and maintenance expenses, which in our view can properly include a right-of-way charge. Those memoranda explicitly assume that this authorized appropriation has been met. See Attachment 5 at p. 2. The 1967 memorandum goes on to conclude that an in lieu franchise tax or fee is not properly charged against the surplus.F

In its discussion of this issue, the memorandum confirms that a "franc functional equivalent of the right-of-way charge, as it is payment "fo avenues and highways occupied . . . ." Attachment 5 at p. 2, quoting of Dinuba, 188 Cal. 664, 670 (1922).

This is an appropriate conclusion because any charge for the privilege of being in the right-of-way can and should be properly accounted for in the authorized appropriations as an operation and

maintenance expense, not as a component of the surplus.

The 1967 memorandum (Attachment 6), by the same author of the 1966 memorandum, discusses the historical development of City Charter section 53. The memorandum responded to the Deputy Mayor by indicating that his "philosophical conclusion that the framers of the charter 'intended the waterworks to operate with the same obligations as a private waterworks' was basically correct . . . ." The memorandum, however, stresses that the waterworks was designed to be "self-sustaining" but goes on to conclude that "in-lieu tax payments and reasonable profit transfers to the General Fund . . . may not be made in the guise of a payment for Water Department purposes for no benefit inures to that department from such payment which is not already subject to a charge by the General Fund for services rendered to the Water Department." That conclusion is consistent with our analysis herein, to wit that a Right-of-Way Assessment is properly charged as an operation and maintenance expense in the first instance, and further charges may not be made for the same purpose from any surplus. It is thus clear to us that, as analyzed herein and in our previous memoranda, City Charter section 53 was designed to ensure that the General Fund was not to be at a disadvantage because the Utilities were municipally held rather than private. While the Utilities may not be subject to "all obligations" of private utilities, and may not be charged where no benefit exists or for which an account has already been made, a charge for the right to be in and use the public rights-of-way is authorized by the City Charter as an operation and maintenance expense, and serves to make the General Fund whole.

With regard to the components of the methodology, we note that the City's franchises with the cable TV companies charge against "Total Gross Receipts," as defined. The franchises with SDG&E charge against "gross receipts," as defined, which appear to be gross operating revenue, an amount somewhat less than the cable TV base. The City Manager uses "operating revenues" of the Utilities, which appears to us to be consistent with the SDG&E franchises. In addition, both the cable TV and SDG&E franchises charge three percent (3%) against the base. We note that the SDG&E franchises were entered into in 1970, and the cable TV franchises were also entered into some time ago. We are of the opinion that a decision as to what percentage to charge the base may be made considering not only these facts, but also a comparison of similar charges, for both public and private entities, that exist today. For example, the City Manager has provided data which show that many current

cable TV franchises throughout the state provide for a five percent (5%) assessment, the maximum allowed by state and federal law. Assessments for gas and electric utilities range from two percent (2%) to five percent (5%). The City Manager has also provided data which shows the range of assessments made by other cities in the state from funds comparable to the Funds discussed herein, to their respective general funds. A decision on the appropriate percentage to charge the Funds is properly made considering all these factors. We believe that a charge of five percent (5%) would not be unreasonable in light of this data. We are also of the opinion, however, that this percentage should be

reassessed at such time as the cable TV and SDG&E franchises are renegotiated, such that an up-to-date comparison of the City's practices can be made.

Finally, we offer some thoughts on the appropriateness of a charge for prior years. The Utilities were on notice beginning in FY 1994 that they would be charged a Right-of-Way Assessment. This fact has also been disclosed in the Bond indentures. While we noted above that the amount of the Right-of-Way Assessment may be calculated by a variety of methodologies, the previous methodology utilized in both FY 1994 and FY 1995 was calculated as a comparable linear foot charge and not as a percentage of operating revenues. Assuming substantiation, the City Manager is free to change the method of calculation prospectively, but he is not free to retroactively charge a right-of-way fee imposed and paid on an alternative methodology. To do so would invite reassessment of charges that user and investors alike correctly considered settled.

We are quick to caution that once the determination has been made to compensate the General Fund on the basis of the methodology provided in Attachment 3, the reasonableness test would be stretched to transparency by any supplemental assessments. Accordingly, the affirmation of the objectivity of the methodology necessarily excludes supplemental variations. In effect, objectivity freezes the methodology for assessing the charge, unless subsequent, similarly verifiable circumstances justify a change in that methodology.

Conclusion

A Right-of-Way Assessment charged to the Water and Sewer Funds for the privilege of placing utility pipes and mains in the public

rights-of-way is a valid operations and maintenance expense. The amount of the assessment, however, must be measured against uniform criteria confirmed by comparable references.

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By
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Attachments:6
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