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**Michael J. Aguirre**  
CITY ATTORNEY

**MEMORANDUM OF LAW**

**DATE:** April 3, 2006

**TO:** Michael J. Aguirre, City Attorney

**FROM:** Mark D. Blake, Chief Deputy City Attorney

**SUBJECT:** Legality of Service Level Agreements for City Attorney Services to Enterprise Fund Departments

**QUESTION PRESENTED**

May the City Attorney's office use Service Level Agreements to charge Enterprise Funds for legal support services incurred during a fiscal year?

**SHORT ANSWER**

Yes. The San Diego Charter, Municipal Code, and bond covenant provisions all allow water and sewer revenues to be used for reasonable and necessary operation and maintenance expenses. Attorneys' services, attorney support staff services provide a direct benefit to the Enterprise Funds, and as such are proper operation and maintenance expenses Water Department and the Metropolitan Wastewater Department (collectively, the Enterprise Funds). Expenses for attorney services are proper operation and maintenance expenses of the departments. While a more rigorous time-keeping system would be preferable, SLAs are a legally permissible and reasonable method to recoup the cost of legal services to the enterprise funds provided the methodology utilized to estimate the services to be needed is reasonable and consistently applied. Nonetheless attorneys with the legal department should, particularly attorneys who do not perform services exclusively for the enterprise funds, keep a record of tasks performed for the enterprises to ensure that an appropriate audit of the services provided could be undertaken.

**DISCUSSION**

Under full cost recovery accounting principles supplies and services provided to an enterprise fund should be paid for by that fund to ensure that the full cost of those supplies and services are accounted for. Enterprise funds in the City of San Diego pay for the supplies and services provided to them by General Fund activities in two ways:

1. General Government Overhead/Indirect Cost Recovery Rate – General services such as accounting, management, employee services and similar general functions which provide services to all City departments are funded through the General Fund and proportionately billed to enterprise funds as a rate based on actual costs which are adjusted two years in arrears.

2. Memorandums of Understanding (MOU)/Service Level Agreements (SLA) – When an enterprise fund desires/requires a specific service or level of service in excess of the general services provided by the General Fund, the enterprise funds enter into a contract with the General Fund activity providing the service. Based on the agreed upon anticipated need during the term of the contract (fiscal year), the General Fund activity budgets the resources necessary to meet the contractual level of service and the enterprise fund pays for that anticipated service level. Actual services provided are reviewed and serve as part of the formula in determining contract levels in succeeding years.

The City Attorney's Office provides legal support to certain enterprise fund departments within the City pursuant to service level agreements or memoranda of understanding [collectively, SLAs]. In accordance with the SLAs, the enterprise fund departments agree to include moneys in their budgets to fund a certain number of attorney and support staff positions within the City Attorney's office, as well as non-personnel and overhead expenses believed to be necessary for the upcoming legal work of such enterprise. The City Attorney's Office commits to provide the requisite attorneys and other personnel necessary to provide such legal services, and the scope of these services is set forth in the form of SLAs. An SLA defines the level of legal services to be provided to a contracting department within a given fiscal year. There are a number of enterprise funds that have been created by San Diego Charter or San Diego Municipal Code provisions, or by ordinance. The most restrictive of the enterprise funds are the Water Utility Fund and Sewer Revenue Fund. This memorandum addresses whether billing the enterprise fund departments for legal support services in accordance with the SLAs is legally permissible. Given that the most significant constraints are placed on the Water Utility Fund and the Sewer Revenue Fund, this memorandum will analyze the use of SLAs for providing legal services to such departments [collectively referred to herein as the "Enterprise Fund"]. The analysis, however, would be similarly applicable to the use of SLAs with other enterprise fund departments.

#### **A. OMB Circular 87---Governing Cost Allocation Principles**

Relevant principles for cost allocation are set forth under a publication by the Office of Management and Budget in a document commonly referred to as Circular A-87 (Revised 5/10/04) [Circular 87]. Circular 87 addresses cost allocation methodology associated with the administration of federal grants. Nonetheless Circular 87's principles and standards are useful for our purposes, particularly as the endeavor undertaken under Circular 87 is the same as ours: to ensure that the funding allocation decisions assure that cost objectives (in our case the enterprise funds) bear a fair and proportionate costs of services provided to them. Note that the Office of the State Controller has a publication entitled, *Handbook for Cost Plan Procedures for California Counties* (March 2001) to provide guidance to county governments regarding the

application of cost allocation principals under Circular 87. The following principles will be useful for our exercise:

Cost allocation principles under Circular 87 are, in pertinent part, as follows:

**Allowable Costs**

- a. be necessary and reasonable . . .;
- b. be authorized or not prohibited under State or local laws;
- c. be 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;
- d. be 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 (i.e., sound business practices, arm’s length bargaining, etc).

**Allocable Cost**

- a. 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 . . .
  3. equipment and other capital expenditures
- b. 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 rate 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 (3<sup>rd</sup> ed. 1995) (footnotes omitted).

In the City of San Diego there are a number of enterprise funds that have been established by San Diego Charter or San Diego Municipal Code provisions, or by ordinance. Most notably, the Water Utility Fund was established by San Diego City Charter section 53 and the Sewer Revenue Fund was established by San Diego Municipal Code section 64.0403. 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**

### **Proposition 218**

Proposition 218, the “Right to Vote on Taxes Act” was enacted November 5, 1996. Proposition 218 added Articles XIIC and XIID 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 XIID) 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 XIID, 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 costs 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.

### **San Diego City Charter**

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.

### **Contract Restrictions**

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],<sup>1</sup> 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

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<sup>1</sup> 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.

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,<sup>2</sup> 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. . .”<sup>3</sup> 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 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

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<sup>2</sup> The General Accounting and Standards Board Statement 34, paragraph 112 a (2), governing “reciprocal interfund activity,” contemplates that “[i]nterfund 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.”

<sup>3</sup>*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).



in the Water Utility Fund and the Sewer Revenue Fund shall be used for related operation and maintenance costs of the utilities. Moreover, operation and maintenance costs include reasonable and necessary costs incurred or spent for attorneys' services related to the operation and maintenance 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 (2002).

## II. SLA's and the Budget Process

San Diego Charter section 69 requires the City Manager to "prepare and submit to the Council a budget of the expense of conducting the affairs of the City for the ensuing fiscal year." The budget document reflects programs and projects which the City Council reviews as a checklist of projected governmental operations for the ensuing year. Upon receipt of the City Manager's estimate, the City Council is required to prepare an Annual Appropriation Ordinance using such estimate as a basis. San Diego Charter § 71.

With regard to the Water Utility Fund and the Sewer Revenue Fund, the Appropriation Ordinance appropriates all of the anticipated water and sewer revenues of the ensuing fiscal year for various purposes and projects, the first of which are operation and maintenance expenses. Attorneys' services and related expenses which are reasonable and necessary for the operation and maintenance of the utilities and are expressly included within the restrictive bond definition of "maintenance and operation costs," therefore are properly included in the Annual Appropriation Ordinance for the Water Department and the Metropolitan Wastewater Department.

One method by which the Water Department and the Metropolitan Wastewater Department may estimate the costs of attorneys' services and related expenses for the ensuing fiscal year, and to ensure sufficient staffing and budgetary certainty, is to enter into SLAs with the City Attorney's office. An SLA is a form of retainer agreement. There are various forms of retainer agreements. A "true" or "classic" retainer agreement is one in which the client pays a certain amount of money to the attorney solely to secure the availability of the attorney over a given period. *See Baranowski v. St. Bar of Calif.*, 24 Cal. 3d 153, 164 n.4 (1979). A true retainer is earned upon receipt (and therefore is non-refundable) because it takes the attorney out of the marketplace and precludes him or her from undertaking other legal work. It also requires that the attorney generally be available for consultation and legal services to the client as needed. Sometimes a true retainer will take the form of a single payment to guarantee the attorney's future availability for a specified period and other times as payments made on a recurring basis, such as monthly retainer, to assure the attorney's availability for that specified period.

The SLAs that have been entered into between the City Attorney's office and the Water Department and the Wastewater Department are similar in nature to a true retainer agreement. Each year the Enterprise Funds estimate the amount of attorney work, together with proportionate related personnel and non-personnel expenses, that will likely be required for the upcoming fiscal year. The Enterprise Funds agree to provide the necessary moneys in their budgets to fund such services and this is memorialized in an SLA. Thus legal services are procured by the Enterprise Funds for the given fiscal year; and the City Attorney's office agrees

to provide such requisite level of legal services. At or around the end of each fiscal year, the City Attorney's office and the Enterprise Funds review the work performed to make a needs assessment for the upcoming budget year.

The form of SLA currently in place is a permissible form of establishing a budgetary mechanism for work to be performed by the City Attorney's office for the Enterprise Funds. For the Enterprise Funds, it guarantees that when they have need of attorney services, attorneys are available upon demand to meet their needs. Additionally, the SLAs provide budgetary certainty to the Enterprise Funds for costs associated with attorney services and related expenses. Legal services provide a direct benefit to the Enterprise Funds and are entirely appropriate, if not legally required. City Att'y Report to Council, RC-2004-15, June 21, 2004. If such services were not provided by the City Attorney's office, they would have to be contracted for with outside counsel and similarly paid for by the Enterprise Funds. As has been the subject of numerous City Attorney opinions and memoranda of law, if the expenditures provide a benefit to the utilities, then the expenses are a proper use of the enterprise funds. *See* 1990 City Att'y MOL 761; 1992 City Att'y MOL 648; 1993 City Att'y MOL 137; 1994 City Att'y MOL 635; City Att'y MOL No. 2001-12 (July 12, 2001); *see also Howard Jarvis Taxpayers Ass'n v. City of Roseville*, 97 Cal. App. 4<sup>th</sup> 637, 647-648 (2002). For the City Attorney's office, this form of SLA is also beneficial as it permits the department to anticipate staffing needs for the fiscal year as well as anticipate revenues for its budget.

## CONCLUSION

The San Diego Charter, Municipal Code, and bond covenant provisions all allow water and sewer revenues to be used for reasonable and necessary operation and maintenance expenses. Moreover under Proposition 218 the ability to assess such enterprises with costs are circumscribed by the limitations that the ultimate fees charged to ratepayers must represent the proportionate and/or reasonable cost of delivering water or sewer service. In a word, costs cannot simply be imposed the Enterprise Funds that have nothing whatsoever to do with the cost of delivering water or sewer service . Legal services, including necessary support staff and reasonable related costs, provided by the City Attorney's office to the Enterprise Funds provide a direct benefit to the Enterprise Funds, and as such are proper operation and maintenance expenses of the Enterprise Funds. The Enterprise Funds would otherwise have to employ outside counsel to obtain legal services. Attorney's services, attorney support staff services, and non-personnel and overhead related expenses billed to the pursuant to the SLAs are a reasonable means of accounting for the costs incurred by the City Attorney's office. While a more rigorous time-keeping system would be preferable, SLAs are legally permissible and a reasonable method to recoup the cost of legal services to the enterprise funds provided the methodology utilized to estimate the services to be needed is reasonable and consistently applied. Nonetheless attorneys with the legal department should, particularly attorneys who do not perform services exclusively for the enterprise funds, keep a record of tasks performed for the enterprises to ensure that an appropriate audit of the services provided could be undertaken.

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