

**Office of
The City Attorney
City of San Diego**

**MEMORANDUM
MS 59**

619-533-5800

DATE: September 21, 2017

TO: John Helminski, Assistant Director, Public Utilities

FROM: Raymond C. Palmucci, Deputy City Attorney

SUBJECT: Sewer and Water Bond Covenants Related to Competing Enterprises

INTRODUCTION

You asked if potential projects by private entities to treat and recycle wastewater within the City of San Diego (City) could violate the City's bond covenants in the financing agreements of the Water Utility Fund (Water System),¹ the Sewer Revenue Fund (Wastewater System),² or both.

We evaluate two scenarios in this memorandum. In the first, a private entity captures off-site wastewater in the City's system, treats it to recycled water standards, and uses it for on-site irrigation. In the second, a private entity retains the wastewater generated on its site, treats it to recycled water standards, and uses it for on-site irrigation.

BACKGROUND

Mission Trails Golf Course (MTGC), a private entity, wants to construct an on-site satellite water recycling facility (Facility) to create a new, more-reliable, and drought-proof source of recycled water for its golf course. As proposed, MTGC's Facility would divert wastewater from a nearby City collection system, transport it to the Facility, and clean it to recycled water standards for use on the golf course. For purposes of analysis, we also discuss a contrasting project where the customer utilizes its own wastewater generated on-site rather than diverted wastewater from the City's Wastewater System.

¹ "Water System" means "facilities, properties, and improvements . . . owned, controlled, or operated by the City as part of the public utility system of the City for water purposes . . . including reclaimed or re-purified water." Water Master Installment Purchase Agreement (Water MIPA), Art. I, sec. 1.01.

² "Wastewater System" means "facilities, properties, and improvements . . . owned, controlled, or operated by the City as part of the Sewer Revenue Fund for the collection, treatment . . . disposal or reclamation of waste . . ." Wastewater Master Installment Purchase Agreement (Wastewater MIPA), Art. I, sec. 1.01.

QUESTIONS PRESENTED

1. May a private entity capture off-site wastewater in the City's Wastewater System, treat it to recycled water standards, and use it for on-site irrigation without violating the Water System or Wastewater System bond covenants?
2. May a private entity retain the wastewater generated on its site, treat it to recycled water standards, and use it for on-site irrigation without violating the Water System or Wastewater System bond covenants?

SHORT ANSWERS

1. No. A private entity may not capture off-site wastewater in the City's Wastewater System, treat it to recycled water standards, and use it for on-site irrigation without violating the Water System or Wastewater System bond covenants.
2. Yes. A private entity may retain the wastewater generated on its site, treat it to recycled water standards, and use it for on-site irrigation without violating the Water System or Wastewater System bond covenants.

ANALYSIS

A. The City's Financial Agreements Restrict Permissible Activities.

In order to fund the acquisition, construction, installation, and improvement of the Wastewater System, the City entered into a Wastewater MIPA³ with the Public Facilities Financing Authority of the City of San Diego (PFFA). The PFFA issues bonds and the City pledges "Net System Revenues" to pay the debt service on those bonds. Net System Revenues are all "System Revenues" less maintenance and operating costs.⁴ Wastewater MIPA section 1.01.

The City must set its rates and charges for Wastewater System service to ensure sufficient funds to pay the debt service on the bonds and other obligations under the Wastewater MIPA. Wastewater MIPA section 6.08. The City's ability to establish rates and charges to secure System Revenues is determined by the inflexible legal requirements of Article XIII D, section 6 of the California Constitution (Proposition 218). Therefore, due to the difficulty involved in adjusting rates and charges, any projects with the potential to impair Net System Revenues must be carefully analyzed.

As part of the City's obligation to protect Net System Revenues, the City cannot enter into any contract (such as a wastewater system access agreement) that impairs the ability to recover revenues derived from the operation of the Wastewater System:

³ <https://citynet.sandiego.gov/sites/default/files/mins-pur-srb1993.pdf>

⁴ System Revenues means, among other things, all income, rents, rates, fees, charges, and other moneys derived from the ownership or operation of the Wastewater System including all income, rents, rates, fees, charges, or other moneys derived by the City from the wastewater services sold, furnished, or supplied.

[T]he City will not . . . enter into any agreement or lease which impairs the operation of the Wastewater System or any part thereof necessary to secure adequate Net System Revenues for the payment of the [bonds] or which would otherwise impair the rights of the [PFFA] with respect to the System Revenues of the operation of the Wastewater System.

Wastewater MIPA section 6.04.

In addition, the Wastewater MIPA also has a specific covenant against competitive facilities, which states:

[T]he City will not, to the extent permitted by existing law, construct, acquire, maintain or operate and will not, to the extent permitted by existing law and within the scope of its powers, permit any other public or private agency, authority, district or political subdivision or any person whomsoever to acquire, construct, maintain or operate within the City any wastewater system competitive with the Wastewater System.

Wastewater MIPA section 6.05.

Similarly, in order to fund the acquisition, construction, installation, and improvement of the Water System, the City entered into a Water MIPA⁵ with the San Diego Facilities and Equipment Leasing Corporation (FELC).⁶ As under the Wastewater MIPA, Net System Revenues are all System Revenues less maintenance and operating costs. Water MIPA section 1.01. Water System Revenues include all income, rents, rates, fees, charges, or other moneys derived by the City from the water services sold, furnished, or supplied. Water MIPA section 1.01. The City fixes the rates and charges for Water System service so that there will be sufficient funds to pay the debt service on the bonds and other obligations under the Water MIPA. Water MIPA section 6.08.

The Water MIPA differs from the Wastewater MIPA because it lacks an explicit covenant against competitive facilities, but it does prohibit the City from entering into any agreements that would impair the Water System or the generation of system revenues:

⁵ <https://citynet.sandiego.gov/sites/default/files/master-installment-purchase-agreement.pdf>

⁶ The FELC issues bonds and the City pledges the Net System Revenues to pay the debt service on those bonds. By a separate agreement, the FELC assigns its payment rights under the Water MIPA to PFFA.

[T]he City will not . . . enter into any agreement or lease which impairs the operation of the Water System or any or any part thereof necessary to secure adequate Net System Revenues for the payment of the [bonds] or which would otherwise impair the rights of the [FELC] with respect to the System Revenues or operation of the Water System.

Water MIPA section 6.04.

B. Potential Projects May Not Financially Impair the City's System Revenues.

As proposed, MTGC's project impermissibly impairs City System Revenues. MTGC is exploring the option of diverting wastewater from the City's collection system into the MTGC Facility. The City is paid to provide wastewater treatment for its customers. To the extent wastewater is diverted and treated by MTGC, the City would not be providing that service. Under Proposition 218, the City cannot charge customers for services it does not provide. Therefore, when wastewater is diverted from the City's system, it results in a loss of revenue to the Wastewater System. In addition, as the Facility proportionally reduces the amount of wastewater in the Wastewater System, the City would experience a reduction in the amount of recycled water available to sell to other City customers.

An additional provision of the Wastewater MIPA would be violated by construction of the Facility itself. If the City were to allow MTGC to divert wastewater contained in the City's Wastewater System, an agreement or lease would be required to access the City's infrastructure. Execution of an agreement between the City and MTGC could impair the rights of the PFFA with respect to the System Revenues of the Wastewater System and the Water System in violation of the covenants in section 6.04 of both MIPAs. Further, this scenario involves MTGC transporting wastewater from the City's Wastewater System to the Facility and cleaning it to recycled water standards. An argument can be made that these actions compete with the Wastewater System in violation of the covenant in section 6.05.

The Facility also reduces the amount of potable water MTGC currently buys from the City for irrigation, which would further reduce System Revenues generated by the Water System. Under the Water MIPA, the definition of "Water System" also comprises incidental operations "including reclaimed or re-purified water." Allowing diversionary wastewater projects would likely violate section 6.04 of the Water MIPA as it could impair the FELC's rights to recycled water revenue paid to the Water System. Construction of a Facility that diverts wastewater would therefore impair Net System Revenues from both the Water and Wastewater Systems, because both systems receive revenue from the City's recycled water program.

C. Potential Permissible Water Reclamation Activities.

In contrast to the scenario proposed by MTGC, we believe an alternate project could be developed that would not violate any of the covenants or restrictions contained in either MIPA. A project does not appear to violate section 6.04 of the Wastewater MIPA or the Water MIPA when a customer recycles its own wastewater *before it enters* the City's Wastewater System. Although one could argue that such a project directly competes with the City's Water or Wastewater System because revenue-generating wastewater is prevented from entering the Wastewater System, there is no law or other regulation *requiring* it to go into the Wastewater System. Such a law or regulation would be wholly inconsistent with allowing potable water for any irrigation. Indeed, the City has a policy that encourages water users to capture graywater and rainwater to use for on-site irrigation. Council Policy 400-15.

Further, a customer who wishes to use graywater or treated wastewater on his or her own property is distinguishable from allowing a customer to "acquire, construct, maintain or operate within the City any wastewater system competitive with the Wastewater System." Wastewater MIPA section 6.05. This type of project does not compete with the Wastewater System because the wastewater never enters the City's system and is not being sold, and so the project cannot deprive the Wastewater System of revenue. Although it theoretically competes with the Water System because the customer would then be using less potable water on site, the Water MIPA has no provision preventing competition analogous to, the Wastewater MIPA. *Id.*

CONCLUSION

The bond covenants in the City's Water and Wastewater MIPAs preclude a customer from building a project that would divert wastewater from the City's Wastewater System. Such a project would impair the Wastewater System's ability to secure adequate Net System Revenues pledged to both MIPAs, and compete with the amount of wastewater entering the City's Wastewater System.

However, a customer may treat his or her own wastewater and use it before it enters the City's Wastewater System. In such a case, no agreement is required between the City and the customer since wastewater never enters the City's Wastewater System to generate recycled water revenue for the Water System. We look forward to providing further legal advice and guidance toward any water or wastewater reclamation projects.

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By /s/ Raymond C. Palmucci
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