

The Honorable Thomas C. Petrone
Democratic Chairman
House Urban Affairs Committee
179 Steuben Street
P.O. Box 8557
Pittsburgh, Pa. 15220

October 31, 1997

RE: Operating Authority Vs. Lease-Back
House Resolution 84

Dear Mr. Petrone:

The following is written to possibly help you and the Urban Affairs Committee to better understand the above two different types of authorities under Pennsylvania law and my preference as to the better type of authority operation:

Of all the institutions England has lent to America, from the language to the law, perhaps the least well known and most under-appreciated is the municipal authority.

In the late 19th century, London's port was doing a brisk business. So brisk, in fact, that its need for expansion outpaced the government's ability to oversee and approve the port's growth. Rather than forego the commerce and the revenues derived from increased port activities, the City granted the port the "authority" to exercise certain powers usually reserved for government. (America's first municipal authority, The Port Authority of New York, came into being for similar reasons.)

Although the scope and particulars of authorities have been refined over the years, London's original port authority still defines the three basic characteristics of a modern authority. One is that an authority runs a business that provides an essential service or aids in local economic development. To run that business successfully, an authority must have the latitude to make decisions faster than a government bureaucracy and to make them with a minimum of political influence. Second, like the London port, authorities often need the powers of government. Those powers typically include the ability to condemn property and the ability to raise large amounts of money through the issue of revenue bonds, a financial instrument created by government. Finally, in return for their independence and power, authorities are accountable to the popular will through a political process. In Pennsylvania, that process is the nomination and confirmation of authority board members by the incorporating municipality.

What are the main benefits of authorities ?

Municipal authorities combine the best aspects of city- and investor-owned businesses. Authorities offer municipalities a way of controlling long-term debt, while allowing them to undertake important projects that further economic development and enhance the local quality of life. Typically an authority shoulders the responsibility for building, managing, maintaining or improving large, expensive businesses (such as airports, parking facilities or water and sewer systems).

How do authorities finance capital programs ?

Generally through a financial instrument called a revenue (or revenue anticipation) bond, a tax-free municipal debt issue with very favorable interest rates. When a municipality creates an authority it creates a corporation with its own balance sheet and credit rating. Banks and other lending sources understand financing needs of capitol-intensive businesses (the kind authorities tend to operate) with predictable future revenue streams. Because authorities generally operate well-defined businesses and can assure the adequacy of rates for their services, lenders are very willing to finance municipal authorities' construction and improvement programs. So a municipality with several authorities can do more for its residents than a comparable municipality without authorities.

What purpose do authorities serve ?

From their beginnings in 19th-century England, authorities have been government's way of running a business. They are based on two explicit observations. First, bureaucracies often make decisions too slowly for effective business management. Second, political organizations often make decisions on grounds that don't pertain to business. Thus the major strength of municipal authorities is their ability to run businesses as businesses, seeing to the gritty, daily details of commerce. Authorities excel at providing service, responding to a community's needs, resolving customer complaints and making the endless invisible improvements, small and large, that don't make headlines but do make a difference.

Haven't municipal authorities outlived their usefulness ?

To the contrary, the trend toward forming authorities is accelerating. That's because authorities are really solutions looking for problems to solve and public officials are finding more ways to use authorities each year.

In 1994, the latest year for which statistics are available, municipal authorities:

- ☞ Collected more than \$1.2 billion in user charges
- ☞ Extended almost \$200 million in capital advances to lessees
- ☞ Supervised and financed \$71 million in construction and system extensions
- ☞ Made major equipment purchases worth \$7.8 million.

Operating Authority Vs. Lease-Back Comparisons

Operating Authority

1. Bonds - sold on basis of repayment by authority
2. Property and income - tax exempt
3. Municipality appoints board members
4. Meetings - monthly at least; responsible for any additions or improvements to system
5. Board members operate plant by employees and manager
6. Debt Service - paid by authority and chargeable to its users
7. Operates and maintains system by its charges to users
8. Plant run by employees of authority
9. Raising rates - up to board members
10. Political control by municipality limited
11. Responsive to public opinion - up to board members

Lease-Back

1. Bonds -sold on basis of municipality taxing power
2. Property and income - tax exempt
3. Municipality appoints board members
4. Meetings - once or twice per year to transfer funds for payment of bonds or more often if new construction or capital addition is needed
5. Municipality operates plant by its employees
6. Debt Service - included in rental payment by municipalities and backed by taxing power
7. Municipality operates and maintains system and paid by users
8. Plant run by employees of municipality
9. Raising rates - up to municipality
10. Political control by municipality
11. Responsive to public opinion - up to municipality

CONVERSION OF LEASE-BACK AUTHORITY TO OPERATING AUTHORITY:

1. Reasons to Consider Conversion

Many authorities organized in the years before the enactment of the Local Government Unit Debt Act in 1972 were organized as lease-back authorities. The utility system, of course, was constructed and owned by the authority, but it was leased to the municipality at a rental equal to the debt service payable on the authority bonds. This mechanism was developed in order to provide an indirect guaranty of the authority's bonds at a time when no other form of guaranty was available under applicable law. The effect, however, was to impose upon the incorporating municipality the duty of operating the system, setting the rates and charges and handling administrative matters related to the system. In addition to those created under the indenture of the authority.

In some of these lease-back situations, the municipality's governing body wanted to maintain control of the operation, but in other cases, they were happy to have the authority board manage the operation as well as construction of the system. In the latter type of case, a management agreement was sometimes executed under which the municipality employed the authority as its agent to operate the system.

The lease-back structure produced a substantial amount of documentation and rigidity in the financial operation, particularly in the flow of funds. Also, the lease usually contained covenants on such matters as insurance, engineers' duties and other requirements imposed on the lessee.

Even since the enactment of the Local Government Unit Debt Act, it has been possible for a municipality to guarantee the debt of an authority by simple guaranty agreement. This makes the security of the municipality's tax revenues available without the complexity of a lease. Administration simplicity is advanced by eliminating the lease.

There is a more important reason why it may be advantageous, depending on the circumstances, to convert a lease-back authority to an operating authority. Under the case law, if a system having the lease-back structure serves outside the boundaries of the municipality which incorporated the authority, the extent of service and the amount and structure of rates and charges become subject to the jurisdiction of the Pennsylvania Public Utility Commission. A municipality serving outside its boundaries, whether as owner or as lessee, is subject to PUC jurisdiction, while an operating authority is not. Obtaining even routine approvals of rate increases from PUC can be an administrative burden, and the cost escalates rapidly if a user objects to a rate increase, or if a potential user demands an extension of service to it. In that case, a PUC proceeding maybe commenced by a customer without cost to him and with substantial cost and delay to the municipality.

There are other advantages to eliminating the lease-back arrangement. It enables the municipal government to obtain greater involvement of its volunteer authority board, lightening the burden on itself. It is frequently helpful to have the rate setting function handled by an authority board, which can make decisions on the basis of businesslike considerations, rather than being unduly influenced by citizen pressure as sometime exists in the political arena.

The operating authority also eliminates several possibilities for conflict between the governmental body and the authority board. One example of this is the question about what expenses should be paid from operating revenues and which items are capital costs payable from capital funds.

A possible negative factor from the standpoint of municipalities, may be a loss of control by the municipality over certain aspects of the operation. In any event, the municipality would retain some control over system expansion within its boundaries because it must approve amendments to the Sewage Facilities Plan. Any additional controls desired by the municipality can be obtained by a long-term contract between it and the authority. The authority, however, must retain the ultimate control over service and rates in order to maintain the PUC exemption.

The above is simply stated as follows:

A. *Avoiding jurisdiction by Pennsylvania Public Utilities Commission.* Where a political subdivision entity provides utility services outside its boundaries, the result is that elected governmental officials impose the rates upon users who did not elect them. Under those circumstances, PUC jurisdiction applies covering the rates and service outside. However, an operating authority is not subject to PUC regulation, regardless of the extent of its service area. Proceedings before the PUC involve substantial cost and delay in obtaining necessary rate increases.

B. *Eliminating Cumbersome Legal and Administrative Structure.* The borrowing laws prior to 1972 required the use of a lease-back structure whenever an authority determined that its debt should be reinforced by the credit of a municipality. Guaranties can now be obtained more simply by a guaranty agreement. The use of a lease creates an additional lengthy legal document, and divides the functions between the municipality and its authority. It complicates the accounting and other practical details.

C. *Obtaining Full Benefit of Authority Device.* A significant advantage of the authority concept is the creation of an independent body to make decisions on a business-like basis, without political considerations. The lease-back structure maintains the rate-setting responsibility with the elected officials, which may lead to decisions based upon factors other than what will provide the best service at the lowest cost. Also, operating a utility system is a burden many elected officials are happy to pass along to a specialized body.

2. Steps in Accomplishing Conversion

- ❶ In connection with expert advisors, the authority determines the amount required to “defease” the existing indenture, and related financial details. If the authority needs new capital for improvements to the system, that money can be included in the bond issue.
- ❷ The structure of a new issue is determined, including the financial covenants, which usually can be more liberal than those typically found in the indentures 10 or 20 year’s old.
- ❸ A new bond issue is sold by the authority, and at the closing in that issue the escrow fund is established with the trustee, invested in U.S. Treasury obligations having maturities and interest rates sufficient to pay on the regular payment dates interest and principal on the old bonds.
- ❹ At the closing, the lease is canceled and the indenture “defeased.”
- ❺ Concurrently, the municipality rescinds its existing ordinance charging sewer rentals, but it maintains in force its mandatory connection ordinance.
- ❻ Concurrently, the authority adopts a resolution establishing rates, charges and regulations. This can be in essentially the same form as the prior municipal ordinance.
- ❼ Any desired restrictions on the authority are embodied in an agreement between it and the municipality.
- ❽ Notice of the defeasance may be published, but the old bonds are not redeemed.

If you have any questions on the above I would be happy to meet with you to discuss the above or you can call me at any time at your convenience. Also, I would like to answer any questions you might have as to the Bulltown/Remaley Road Sewer Project in the Municipality of Murrysville in which several residents of this community recently testified at your hearing on the above in Pittsburgh on October 15, 1997.

Thank-you for your consideration.

Franklin Township Municipal
Sanitary Authority

James C. Brucker
Manager

cc: FTMSA Board

Joyce Somers, Murrysville Council
Terry Van Horne, House of Representatives
Joseph Markosek, House of Representatives
David Mayernik, House of Representatives
Michael Moulds, Pa. Water Environment Association
Raymond Dami, Pa. Municipal Authorities Association

Note: The above main body of this letter is a compilation of several articles written in the Pennsylvania Municipal Authorities Association's magazine by its Solicitor, George M. Amon, 111 and the comparisons were written by Frank C. Carroll, Esq., from Binotto, Sweat, Johnson & Carroll at a Board Members' presentation held during P.M.A.A.'s 51st Annual Conference.