

Municipal Water and Sewer Authorities: When Wall Street Comes Knocking

Kevin Kent, Esq.,
Conrad O'Brien

Frank Catania, Esq.,
Catania & Parker

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**Conrad
O'Brien**

Overview

- Municipalities across Pennsylvania are facing budgetary deficits as a result of:
 - Aging infrastructure
 - Increased healthcare costs
 - Underfunded pension plans
- Recent changes in laws have made selling a public asset – such as a municipal water authority – to a private entity an attractive short-term option to manage these deficits.

Overview (Cont.)

- There are a number of legal risks that may result from privatization proposals for both a municipal authority and an investor-owned utility (IOU).
 - Civil or administrative litigation challenging the transaction.
 - Litigation over use of funds.
 - Risk of criminal exposure.

Overview (Cont.)

- This presentation will use case studies to:
 - Describe the legal landscape surrounding efforts at water privatization and risks IOUs, water authorities, and municipalities may face.
 - Address legal obligations and ethical concerns for a water authority considering a privatization proposal.
 - Red flags.

Privatization Landscape

- Across the country, IOUs currently serve about 10-15% of the population that is served by a community water system.
- In Pennsylvania, IOUs serve approximately 30% of the population.

Privatization Landscape (Cont.)

- In recent years, IOUs have embarked on “growth through acquisition” strategies.
 - Municipal water authorities across the country have faced both solicited and unsolicited bids from IOUs to purchase all or substantially all of the utility’s assets.
- IOUs base privatization proposals on ability to finance necessary infrastructure upgrades and operating costs.

Privatization - Legal Landscape

- Increasingly stringent standards for water and wastewater utilities under the Safe Drinking Water Act and Clean Water Act.
- Water crisis in Flint, MI highlights the dangers of aging infrastructure and costs associated with safe water operations.
- Fair Value Legislation.

Fair Value Legislation

- California, Missouri, Illinois, Indiana, Pennsylvania, New Jersey, North Carolina, and Ohio have passed fair value legislation.
- This legislation makes it easier for private utilities to acquire public water authorities, because it allows private utilities to offer higher prices for water system assets.
- In June 2016, Pennsylvania's fair value legislation, 66 Pa.C.S. 1329 ("Act 12"), went into effect.

Pennsylvania's Fair Value Legislation

- Act 12 permits entities regulated by state utility commissions, such as investor-owned utilities (“IOUs”), to value municipal water authorities’ assets for rate-making purposes at the lesser of the fair market value or the negotiated purchase price.
- “Essentially the purchase price as rate base in many cases.” – Aqua America, CEO, February 2019.
- Prior to Act 12, the value of a municipal water system for rate-making purposes was based on a depreciated original cost, which would generally result in a lower sale price than fair market value.
- Fair value laws have been touted as a way for municipal water authorities facing mounting infrastructure upgrades to sell their assets to a private utility better equipped to finance and oversee necessary upgrades.

Fair Value Legislation (Cont.)

“The importance of this [fair value] legislation is evident when we look at the numbers . . . Nearly 97 percent of the customers [from deals] we have closed or pending are from one of these ‘fair market value’ states.”

-- Chief Operating Officer, American Water, August 2017

Privatization Risks and Legal Considerations

- Privatization in some form may be an attractive and necessary option for municipal authorities struggling to operate and/or provide safe and clean drinking water.
- Privatization may also be attractive to viable water utilities that need little infrastructure upgrades or are well-equipped to finance them, but are looking to use proceeds from a sale in the municipality's general fund.
- So what is there to worry about?

Legal Considerations

- Fiduciary duties.
- Mission?
- The Pennsylvania Constitution.
- The Pennsylvania Sunshine Act.
- The Pennsylvania Public Official and Employee Ethics Act.
- Local regulations.

Fiduciary Duties

- In Pennsylvania, public office is considered a public trust.
- Public officials, such as municipal authority board members, have fiduciary duties.
- Municipal utilities are distinct from the municipalities in which they operate and owe fiduciary duties that are separate and distinct.
 - Example: Pennsylvania's Auditor General filed a 2017 Audit Report of the Pittsburgh Water and Sewer Authority (PWSA). The Report took issue with the fact that "all board members have direct or indirect ties to the City's Mayor." Indeed, the City required that one PWSA board member be a City Council member and the remaining board members be appointed by the Mayor.
 - The AG stated that the PWSA board members -- a City Councilperson and City employees -- who all received compensation from the City, could be influenced by the wishes of their employer, in violation of the "specific fiduciary duty to the entity (PWSA) they serve and its customers."

Fiduciary Duties (Cont.)

- Duty of Care
 - There is an obligation to discharge duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.
- Duty of Loyalty
 - There is an obligation to put the public's interest before own personal interests.

Fiduciary Duties (Cont.)

- Privatization of a municipal water authority may result in a permanent loss of local control over a valuable public resource.
- Whether the decision is to sell or not to sell, fiduciaries should balance and clearly articulate the pros and cons of any decision.

Fiduciary Duties – Key Takeaways

- Anticipate potential legal challenges.
- Consider long-term effects.
- Engage in due diligence of the entity you are negotiating with.
- Whether decision is to-sell or not-to-sell, consider all alternatives and clearly articulate how the decision is in the public interest.

Constitutional Issues

- Municipalities or government officials should consider whether proposed asset sale could have disparate impact on rate payers.
- Following the Flint water crisis, Flint residents brought claims against state and city officials alleging violations of substantive due process and equal protection under 42 U.S.C. § 1983 arising out of the contamination of drinking water.

Constitutional Issues (Cont.)

- Sixth Circuit held the claims against the state and city were permitted to go forward.
- Sixth Circuit noted that a state-appointed commission investigating the crisis determined that the response to the Flint water crisis was “the result of systemic racism.” *Boler v. Earley*, 2017 WL 3202778, at *3 (6th Cir. July 28, 2017).
- Query whether a challenge under a similar theory to a decision about whether to enter an asset sale could prevail, or at least survive pleadings stage.

Pennsylvania Constitution

- There is no US Constitutional right to environmental protection, but Pennsylvania has built into its state Constitution a protection for natural resources such as water.
- Article I, Section 27 of the Pennsylvania Constitution, also known as the Environmental Rights Amendment, states:

The people have a right to clean air, pure water, and to the preservation of the natural, scenic, historic and esthetic values of the environment. Pennsylvania's public natural resources are the common property of all the people, including generations yet to come. As trustee of these resources, the Commonwealth shall conserve and maintain them for the benefit of the people.

Pennsylvania Constitution (Cont.)

- Municipalities and municipal authorities are considered Commonwealth entities in Pennsylvania. As a result, municipal authorities, municipalities, and their board members must keep Article I, Section 27 in mind above and beyond the fiduciary duties discussed.
- In Pennsylvania, this right to pure water is on par with free speech, the right to bear arms, and due process. It trumps any inconsistent statutes and regulations, and it codifies that Commonwealth entities hold natural resources such as water in trust for the people. See *Pennsylvania Environmental Defense Foundation v. Commonwealth* ("PEDF"), 161 A.3d 911 (Pa. 2017).

Litigation based on Article I, Section 27 of the Pennsylvania Constitution

- In July 2018, two environmental groups sued seeking to stop Allegheny County from using money in the County's Clean Air Fund -- set aside for air pollution regulation and reduction projects -- to pay for a \$9.4 million office renovation, on the basis that the use of Clean Air Funds for an office renovation violates Article I, Section 27 of the Pennsylvania Constitution.
- On November 2, 2018, this case was assigned to the commerce and complex litigation center. Parties are briefing on preliminary objections.

Litigation based on Article I, Section 27 of the Pennsylvania Constitution (Cont.)

- The Complaint states: "The use of money from the Clean Air Fund . . . to finance [a] building renovation project does not serve the purpose of the trust — clean air for the benefit of all people."
- The environmental groups seek a prohibition on future draining of the Clean Air Funds.
- The case remains pending.

Pennsylvania Public Official and Employee Ethics Act, 65 Pa. C.S. § 1101, et seq.

- Prohibits public officials from voting in a proceeding that may involve a personal or pecuniary interest.
- Example: A municipal water authority receives a privatization proposal where the private entity promises that all authority employees, including board members voting on the proposal, will have continued employment with the private entity after a sale.
- Such a promise could be perceived to confer a benefit upon municipality board members in exchange for votes.

Local Regulations

- Section 5612(a.1) of the Pennsylvania Municipality Authorities Act precludes money of an authority from being used for any purpose not directly related to the mission or purpose of that authority, and provides ratepayers with a cause of action against the recipient of that money to seek the return of any funds expended in violation of Section 5612(a.1). *See* 53 Pa.C.S. § 5612(a.1).

Case Study - Scranton Sewer Authority

- In 2003, the EPA ordered Scranton to make over \$140 million upgrades over two decades to its water and sewer system.
- SSA's assets were valued at \$106.5 million.
- SSA determined the sale of its assets was in ratepayers' best interests due to the amount of infrastructure upgrades that were required.
- Proceeds from the sale were earmarked for the City's general fund.

Scranton Sewer Authority (Cont.)

- Following the sale, the SSA and the City have been embroiled in litigation.
- October 2017: Lawsuit filed by Scranton ratepayers alleging that the SSA asset sale proceeds cannot be used in City's general fund.
- Lawsuit seeks the return of all money, with proceeds placed in trust during litigation.
- Oral Argument on Preliminary Objections to Plaintiff's Amended Complaint is scheduled for March 19, 2019.

Alternatives to a Sale – P3 Agreements

- Public private partnership (P3) agreements enable an authority to retain ownership of its water system, while bringing in the expertise of a private entity.
- These agreements encourage competition and permit a utility to have more oversight and control over the private entity than in an outright sale.

Alternatives to a Sale – P3 Agreements (Cont.)

- A P3 agreement may permit the authority to require that the private company meet certain milestones in order for the private entity to continue to provide services to the authority ratepayers.
- In the event there are necessary infrastructure upgrades, the private entity may be better equipped to finance and handle them.
- Ratepayers are more likely to see the results of infrastructure upgrades and less likely to subsidize infrastructure for an IOU's assets elsewhere in the state, as cost-spreading is less likely under the terms of a P3 agreement.

Alternatives to a Sale – Lease Agreements

- Lease agreements permit municipalities to contract with either public or private entities for the operation of the authority's water system.
- Under a lease agreement, the water system is leased to an entity that runs the operations of the water system, makes necessary improvements, collect payments from ratepayers, and then makes yearly payments back to the authority.

Erie Lease Agreement

- Erie, PA signed a lease agreement with the Erie City Water Authority, which in turn oversees the Erie Water Works, for operation of the water system in and around Erie in 1991.
- At the time the lease agreement was signed, the system was in need of expensive infrastructure upgrades. Over the last 20 years, the utility has spent \$180 million to upgrade its systems.
- Erie Water Works continues to run the water system. In 2016, it made annual lease payments to the City of approximately \$3.6 million.

Erie Lease Agreement

- The Authority may use these lease payments for purposes as it sees fit.
- Note however that this agreement was entered into before the *PEDF* case discussed previously, which governs how funds from public trust assets such as water may be used – as a result, an agreement today would have to be analyzed under the lens of *PEDF*'s requirements.

Takeaways

- Municipal authorities act as fiduciaries of a public trust and may owe duties to ratepayers, both present and future, in considering the disposition of natural resources and related revenues.
- Litigation affects rate payers and private entities, as it can tie up or deplete funds from a sale.
- These duties could be considered at the forefront of any negotiations, and parties should clearly articulate the public benefits and detriments of whether or not to sell.

Takeaways (Cont.)

- Be wary of promises of long-term (i.e., ten year) rate freezes.
 - IOUs in Pennsylvania are governed by the Pennsylvania Public Utility Commission (“PUC”). The PUC is responsible for setting rates.
- Consider how promised rate-freezes affect an IOU’s existing customer base, and how revenue lost from rate-freezes will be recouped in the future.

Takeaways (Cont.)

- Municipal utilities may consider training board members on applicable duties.
- Municipal utilities may consider appointing a special committee of board members to consider proposals and make recommendations.
- Vet alternatives to an outright sale.

Takeaways (Cont.)

- Make inquiries of potential acquirers, particularly if transaction involves distressed municipalities that may be subject to state oversight.
- Consider use of FOIA/Right-to-Know Law Requests.

QUESTIONS?

**Conrad
O'Brien**