

**PLANNING AND IMPLEMENTING
UTILITY INFRASTRUCTURE INVESTMENTS
IN AN ERA OF WIDENING CHOICES**

**Kenneth R. Myers, Esquire
High, Swartz, Roberts & Seidel LLP
Norristown, PA**

March 2007

PLANNING AND IMPLEMENTING UTILITY INFRASTRUCTURE INVESTMENTS IN AN ERA OF WIDENING CHOICES

Municipal officials face the periodic need to evaluate their utility infrastructure, to decide whether and how to address the future needs of their public for water, wastewater and stormwater services. In certain instances, such a periodic review is required to meet specific statutory obligations.^[1]

Today municipalities often have a wide range of choice: they may establish or add to publicly owned facilities, directly or through a municipal authority; they may seek to establish a regional authority to address needs on a broader geographic basis; or they may attract a private for-profit utility to provide service or to take over existing service. These alternatives may exist even if the project or need entails a major obligation to add to or upgrade infrastructure investment.

This paper identifies key factors that distinguish public (municipal or regional) and private (investor owned) utilities, and the significant information that should be assembled in order to choose and execute the most favorable course of action.

I. PRIVATE VERSUS MUNICIPAL UTILITY COMPARISON

When a decision is needed between establishing or continuing a municipality or municipal authority to provide a utility service, and inviting an investor owned utility to do so, a number of considerations arise. Where a real choice exists, there can be advantages of selecting an investor utility to render a desired service, but disadvantages as well.

A. Finance and Management: If an investor utility provides the capital and renders the service, the municipality avoids utilizing its credit and incurring the costs of borrowing.

In marginal instances the investor utility may not intend to invest significantly, but may expect developers and even the municipality to provide the bulk of the necessary capital. Investor utilities (not unlike municipal utilities) want developers to provide collection and distribution lines, laterals, and in some instances, the central utility plant. An investor utility may be agreeable to purchase an existing municipal or private small system, but only at a token price that does not involve a significant capital commitment. Such proposals generate their own legal issues, however.

Municipalities have better tools than investor utilities for achieving a sufficient customer base to sustain a utility operation. Municipalities may require connection of all customers accessible to the municipal public water or sewer. See e.g. 53 P.S. §§47051, 47461 (Boroughs). Investor utilities do not have such a tool. Although the Pennsylvania Department of Environmental Protection (DEP) could presumably order residential, commercial or industrial properties to connect to water or sewer lines, a proper factual basis would be needed to support that action. In practice,

DEP is not quick to order a connection if a substantial cost must be borne by non-culpable residents.

Can a municipality use its better tools to assemble customers and a collection/distribution system, and then turn it over to private investor utility hands? Public property may not be donated to a private profit making entity. Transferring an existing municipal system to private hands will require advertising and public bidding. See, e.g., 53 P.S. §§36901, 36917 (Cities), 56802 (First Class Townships). Municipalities cannot give away their real or personal property; if any significant value is involved, competitive bidding procedures are usually needed to transfer the asset.^[2]

Municipalities commonly require developers, as a condition of granting land use approval or allowing attachment to utility service lines, to provide or pay for customer facilities such as local piping and appurtenances, and even mains to connect to existing municipal utility facilities. See 53 P.S. §10507-A(b), incorporating 53 Pa.C.S. §5607(d)(24). Typically, if the developer is charged the cost of a main extension, he is entitled to a partial refund if other users subsequently attach to the same main. See, e.g. 53 P.S. §47463 (Boroughs), incorporating 53 Pa.C.S. §5607(d)(24). The refund provision (but not the scope or amount of the contribution that may lawfully be required) is parallel to Pennsylvania Public Utility Commission (PUC) requirements (see below).

Municipalities also may require any developer or prospective customer to pay a tapping fee designed to collect any part or even the totality of the applicable cost of backbone plant, such as treatment facilities, from the customers to be served. See 53 P.S. §10507-A, incorporating 53 Pa.C.S. §5607(d)(24).

Investor utilities can also require developer assistance, but not to the same degree. Investor utilities are required by rules of the PUC to bear a reasonable portion of the cost of line extensions to new customers. 52 Pa.C. §§65.1, 65.20, 65.21. The minimum contribution that the investor utility must make toward necessary local facilities is derived in a formula based on the net revenue expected from the prospective customers. Popowsky v. Pa.P.U.C., 853 A.2d 1097 (Cmwlth. Ct. 2004). If the cost of extending to and attaching the new development exceeds the formula amount, the utility can require the developer to pay the excess cost.^[3] Implicitly, investor utilities are expected to bear the cost of “backbone plant.”

Municipal entities have the benefit of income tax exemption and the ability to issue tax exempt financing. Municipal entities are burdened with the cost of satisfying the Prevailing Wage Act, which may have a greater impact on rates than the avoided tax costs. See 43 P.S. §165-1 et seq. Which entity (public or private)

may have the economic advantage thus varies from case to case, and must be examined on the individual facts.

The scale of operation can significantly affect cost to the ultimate customer. The entity (either public or private) that is able to assemble the largest customer base, whether within a municipality or by serving several communities in reasonable juxtaposition, may have a significant advantage over a small system.

- B. “Non-Viable” Utilities:** The PUC has observed that very small water or wastewater utilities often become “nonviable” and unable to render safe and adequate service to the public. Primary immediate causes of this eventuality include the deterioration of existing facilities, or the need to add costly new facilities to meet environmental and other regulatory requirements. But the salient factor in each instance is usually the difficulty a small utility faces attracting capital if its customer base is not adequate to support its operation. The know-how to operate efficiently, particularly in an increasingly technical environment, may also be unaffordable for the small system.

The PUC has adopted policies to discourage the creation of small systems and to encourage the restructuring or incorporation of those systems into larger, successful utility operations. See policy statements entitled *Small Drinking Water System – Statement of Policy*, 52 Pa.C. § 69.701; and *Small Nonviable Water and Wastewater Systems – Statement of Policy*, 52 Pa.C. § 69.711. The PUC holds out the promise of the reward of an increase in rates through an adjustment in the allowable rate of return for a utility that absorbs non-viable systems.

Municipal officials also will wish to consider the differences in their relationship to an investor utility, or to a municipal utility that is either a municipal department or a municipal authority. Immediately or over a period of time, municipal officials can control the policies and the practices of municipal utilities of either kind. This is much less true of the relationship with an investor utility. However, the municipality that chooses an investor owned utility avoids the administrative burden of operating a utility department.

- C. Service and Rates:** Both municipal and investor utilities are obligated to provide safe and adequate service to the public at just and reasonable rates within their service territories. See 66 Pa.C.S. §1501; 53 P.S. §5703; 53 Pa.C.S. §5607(d)(9) (Authorities); *Hopewell Township v. Municipal Water Authority of Borough of Aliquippa*, 475 A.2d 878 (Pa.Cmwlt. 134).¹⁴¹ Municipal utilities bear the service obligation as a matter of common law and various statutory provisions. *Yeziore v. North Fayette County Municipal Authority*, 193 Pa. Super. 276, 104 A.2d 129 (Pa. Super. Ct. 1960).

An investor utility must justify its rates with detailed cost of service data (studies seeking to show the cost of serving each individual class of customer). Increasing attention is being paid to eliminating discrimination between customer classes. The Public Utility Code proscribes unsupported geographical differences in rates. Today utilities that have different rate zones, without any important demonstrable difference in the cost to serve, are required to gradually eliminate the differentials over a period of years. Lloyd, Small Business Advocate, v. Pa.P.U.C., 904 A.2d 1010 (Cmwlth. Ct. 2006).

In judging municipal rate and service practices, courts have commonly looked for guidance to PUC decisions and appeals from PUC decisions. However, the standard of judicial review of municipal decisions accepts municipal judgment unless there is a violation of a specific requirement of law or the municipal body has committed an abuse of discretion (generally taken to mean that the municipal body has reached a decision that is not supported by any logical view of the facts and law). Judicial supervision of municipal utilities is therefore much less strict than PUC supervision of investor utilities.

Each investor utility is required to establish and publish its service territory. Within the described service territory, an investor utility has an affirmative obligation to serve the public. Per contra, outside its service territory, the investor utility has almost no obligations. Its decision not to extend its territory is rarely subject to disturbance from the PUC.

Although larger investor utilities usually observe their obligations scrupulously, smaller private utilities are sometimes strapped for capital and may interpose any number of objections to making investments to reach new customers.

The municipality has no “command and control” tool to force an investor owned utility to fulfill its obligations, but usually must accept the costly, long and uncertain remedy of filing a complaint to the PUC. The PUC provides virtually automatic admission to interested municipalities seeking to participate in investor utility service and rate cases.

- D. Planning and Development:** The municipality has significant control over the development and extension of sewer facilities, however owned, through the planning function under Act 537, the Sewage Facilities Act, and the requirement that all sewer installations and connections be submitted to the municipality. 35 P.S. §750.1 et seq. There is no parallel provision for water utility service or facilities. The municipality also has very limited authority over the design and timing of utility development through its control of street rights.

The municipal land use planning function provides an opportunity to require new developments to use piped water and sewer service. Municipalities are authorized by law to require existing residents to attach to public water and sewer lines. The language of the statute suggests that a municipality may not require a resident to attach to an investor owned utility. If few residences or businesses agree to connect to the water or sewer system, the extension of investor utility service may be unaffordable.

The DEP exercises significant authority over investor and municipal water utilities under the state and federal Safe Drinking Water Acts,^[5] and over investor and municipal sewer utilities under the Clean Streams Law and Federal Water Pollution Control Act,^[6] as well as through its reviewing power as to sewage facilities under Act 537.

These regulatory programs also provide opportunity for the municipality to argue for its developmental and operational preferences at DEP. However, the decisions of the DEP (like those of the PUC) are typically driven by the policies of the particular statute they administer, rather than the policies of the municipality. The DEP occasionally may require a business that is responsible for pollution to pay for an extension of service required to relieve the condition, but DEP does not usually require a utility to extend service or residential property to connect to a utility.

II. Selling a Municipal Utility

Among the more exciting developments in Pennsylvania has been the emergence of a market for well positioned municipal water utilities and even some sewer utilities to be acquired by investor entities. Where this is under consideration, a number of considerations need be examined in each individual case.

- A. How do you value a functioning utility? This consideration has several elements;
 - (i) The selling municipality will want to be sure that it is securing a fair and adequate price for the utility system. Competitive bidding may not be a sufficient answer, because in any locale there may be just one investor utility positioned to acquire the municipal utility and operate it efficiently.
 - (ii) The buying investor utility will want to determine a value in order to substantiate its purchase price at the PUC. (Recognize that the amount of the purchase price plus any assumed debt may influence, although conceptually should not control, the beginning rate base set by the PUC for the property in the hands of the acquiring utility.)

- (iii) Setting the value of an operating utility has a circular element: if the PUC sets a value at least equal to the purchase price, the acquiring utility will have an opportunity to earn a fair rate of return on that sum. But this does not mean that the sky is the limit. The PUC may look to the assets to determine if a price is justifiable. Common methods of valuation include original cost when first devoted to public service less depreciation, trended cost or reproduction cost less depreciation, and capitalization of income (as noted above, income calculations tend to be circular in these circumstances). An original cost valuation study may therefore be necessary.
 - (iv) Note that the ratemaking formula applied by the PUC sets rates designed to produce a fair rate of return on a rate base equal to the depreciated original cost of the utility plant less depreciation. If the valuation used to justify a sale price is seriously out of balance with the net original cost rate base, the financial future of the utility is likely to be compromised.
- B. What conditions does the municipal utility's outstanding debt impose on such a sale? Can any of the debt be continued in private hands (such as PennVest loans)? Are there penalties for early retirement of outstanding instruments such as bonds, debentures or bank loans?
- C. What arrangements will be made for the work force – will it continue? If there is a labor contract with a union, or individual contracts with any employees, is there a duty to negotiate terms for the change of ownership?
- D. Will the acquiring utility make any commitment regarding future rates, and what changes will the PUC impose on such plans?
- (i) An investor utility may commit to a cap on rates for a period of time, but it should be recognized that the PUC has the power to disapprove such arrangements at the outset, and even if it does not do so, probably will be called upon to override them in the future.
 - (ii) If the investor utility has other service in the region, over a period of time differences in rates between service areas are likely to be eliminated. Different rates charged in different geographical areas, in order to survive, must be justified by cost of service or some other demonstrable facts. *Lloyd v. Pa.P.U.C., supra.*
 - (iii) Municipalities need to be particularly aware of some rates, such as water rates for hydrants, which most materially affect their budgets.

III. Acquiring an Investor Utility

Municipal authorities are precluded from rendering a service that is currently available from an alternative source. 53 Pa.C.S. §5607(b)(2) However, if an existing investor utility is not serving the needs of the public, nothing in the law ought to prevent the municipality or authority from providing service for the unmet needs. A municipality or a municipal authority should be able to acquire an investor utility in a voluntary negotiated transaction, if necessary to address unmet needs.

PUC approval will be required for a transfer of utility service, but ought to be readily forthcoming in regard to any of the small investor utilities that the PUC seeks to consolidate into larger entities. 66 Pa.C.S. §1102(a)(2)

The considerations in such a transaction include:

- A. Valuing a functioning utility.
 - (i) The buying municipality will want to be sure that it is paying no more than a fair price for the utility system.
 - (ii) A valuation study is usually needed. In this instance, engineering analysis must be provided to examine the condition of the facilities and to project what early replacements and retirements might be needed.
- B. The buying municipality will need an evaluation of the cost of improvements that are likely to be required over the next period of at least five years. This information will be important in order to obtain suitable financing for the acquisition and continued operation of the utility system.
- C. Revenue requirement and resulting rates should be projected for the period of at least five years, considering capital requirements and costs, in order to assure that the acquisition is viable without imposing serious economic disruptions on the public to be served.
- D. The considerations as to the work force are also pertinent: if there is a labor contract with a union, or individual contracts with any employees, is there a duty of seller to negotiate terms for the change of ownership? Will the acquiring municipality be bound by any such contract or arrangements?
- E. As noted above, a municipal authority is not authorized to provide a service that competes with a private enterprise. The few decisions under this provision do not answer the question whether a municipal authority can bid for the acquisition of a public utility if there are also private bidders.
- F. Where municipalities and investor utilities have fought over service territory, the precedent at the PUC appears to favor investor utilities. Municipal utilities may not receive recognition

of “pioneer rights” typically extended to investor utilities, and the lack of PUC supervision over rate and service matters may place the municipal utility at a disadvantage. *Chester Water Authority v. Pa.P.U.C.*, 868 A.2d 384 (Pa. 2005).

^[1] Municipalities are required to plan sewage facilities, and periodically to review their plans, under the Sewage Facilities Act, Act 537, Section 5. (35 P.S. §750.5) For the state water plan, now in preparation, regional committees have been established to carry out the primary functions “and coordinate with ... municipalities.” 27 Pa. C. S. §3103. Municipalities are responsible to implement plans for storm water management drafted by counties under the Storm Water Management Act, §11 (32 P.S. §680.11). Other obligations of municipalities to plan and implement infrastructure abound.

^[2] Compare 53 P.S. §56802(d)(1) permitting repairs or maintenance on municipal public works (including utility facilities) without following the advertising and competitive bidding procedures, but not an addition or extension of such facilities.

^[3] The developer pays an “advance in aid of construction” and is entitled to an agreement for a period of ten years to recoup a portion of the funds if other development occurs using the same facilities. 52 Pa.C. §65.22. After construction is complete and the period of such an agreement elapses, the advance becomes a contribution in aid of construction.

^[4] Municipal utilities are held to have an obligation to serve new customers, based on the common law obligation that predates the Public Utility Code. See 53 Pa.C.S. §5607(d)(9), authorizing a municipal authority to “to determine by itself exclusively the services and improvements required to provide adequate, safe and reasonable service, including extensions thereof, in the areas served.” There are very few cases on the subject. A municipal utility need not identify its “service territory” specifically, but may conclude that there is a benefit by doing so as a way of limiting any common law obligation to serve larger areas.

^[5] 42 U.S.C. §§ 300f et seq; 35 P.S. §§ 721.1 et seq.

^[6] 35 P.S. § 691 et seq; 33 U.S.C. § 1251 et seq.