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June 16, 2010

Source:

INTEROFFICE MEMORANDUM

TO: Alexandra Fercak
Auditor's Office

FROM: Peter Kasting
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City Attorney's Office

SUBJECT: Constraints applicable to expenditure of sewer and water utility funds

You have requested a description of the legal constraints applicable to expenditure sewer and water utility funds. The following outline describes the constraints we discuss with City officials when this issue arises.

1. Constraints on use of sewer utility funds.

A. Framework for the analysis

In analyzing the lawful expenditures of sewer utility funds, it is necessary to review laws governing how sewer funds are raised as well as laws specifically governing how sewer funds are expended. This is because the authority to raise funds is limited to raising funds for certain purposes. That is, since the authority to raise sewer utility funds is limited to raising funds for specified purposes, expending those funds (once raised) for other purposes would mean the funds were raised outside the scope of the City's authority. a

Relevant constraints on raising and expending sewer utility funds include:

- B-3/1-8 (1) Statutory – ORS 454.225 grants authority to set “just and equitable” charges for sewer service. b
- B-3/1-15 (2) Cost of service requirements – ORS 454.375 requires that certain sewer charges be based on reasonable cost-of-service sewer utility ratemaking principles. c

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- (3) Charter – contains a grant of authority to impose charges for specified sewer services, which includes both sanitary and storm sewers. The Charter also contains a parallel statement regarding expenditure of sewer utility funds.
- (4) Bond covenants.
- (5) Tax vs. fee issue – if charges do not reflect cost-of-service principles, courts could decide the charge is really a tax.

B. Charter Authority to Impose Sewer Charges

Determining the allowable form of a charge imposed by government should begin with an examination of the source of authority for imposing it. Portland's authority to impose charges for sewer service arises from the Charter and from state statute. Section 11-302 of the Charter requires collection of fees and charges when properties receive benefits from the City's sewer system, and imposes restrictions on use of those charges.¹

a The Charter authorizes sewer user fees "for purposes relating to design, construction, acquisition, operation, maintenance and contract requirements of sewage treatment or purification facilities and related facilities." This limited authorization to raise money is matched by a limited authorization to spend money "for any matter connected with the sewer or sewage

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Charter section 11-302 provides:

For all purposes relating to design, construction, acquisition, operation, maintenance and contract requirements of sewage treatment or purification facilities and related facilities, the City may fix fees and charges for connection or use or both of sewers and sewage purification or disposal systems to be paid by property which is served or is capable of being served for use of the sewage-disposal system. Sewer user service charges may be collected by the Water Bureau which shall be compensated for such service as determined by the Council. The City may establish procedures for collection and may provide for penalties, interest and costs. The City may establish requirements and impose regulations as it finds appropriate. Sewer user service charges shall be paid for all premises connected with City sewers, directly or indirectly, notwithstanding that such premises may have been assessed or may in the future be assessed for construction of sewers under local improvement assessment procedures or may have otherwise paid for sewers.

The City may enter into contracts relating to sewage disposal, treatment or purification or all such functions. The City may impose charges for sewage transportation, disposal, treatment or purification or any or all such functions, on property outside the City served through City facilities, at rates no less than those imposed for similar service inside the City to similar classifications.

Proceeds of such charges shall be placed in the Sewage Disposal Fund, and may be expended for any matter connected with the sewer or sewage disposal or treatment system of the City, and bonded debt and debt service related thereto.

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disposal or treatment system of the City, and bonded debt and debt service related thereto." Taken together, these provisions authorize collection and expenditure of money for purposes directly related to operation of the sewer utility. ^a

C. Statutory Authority to Impose Sewer Charges

Additional authority to impose charges for sewer service (including stormwater drainage) is found in ORS 454.225. This statute contains a requirement that sewer charges imposed under the statute's authority be "just and equitable."²

D. Regulatory and Contractual Constraints Affecting Sewer Ratemaking Methodology

Both state and federal law impose constraints on sewer ratemaking methodology, though the federal constraints address proportional allocation of costs among customers or customer classes and do not appear to be directly relevant to your question. Ratemaking methodology is relevant to your question because the methodology identifies costs that can be recovered through charges. Bond covenants, though they arise from contract rather than regulation, also impose mandates on sewer utility ratemaking.

The state limitation is found in ORS 454.375(1), which provides:

Before any property owner is required to pay for construction of or connection to treatment works constructed pursuant to ORS 454.275 to 454.380, the local governing body shall file with the Environmental Quality Commission documentation that connection charges and user charges levied for sewer service are

² ORS 454.225 provides:

454.225 Rates and charges; collection. The governing body of the municipality may establish just and equitable rates or charges to be paid for the use of the disposal system by each person, firm or corporation whose premises are served thereby, or upon subsequent service thereto. If the service charges so established are not paid when due, the amounts thereof, together with such penalties, interests and costs as may be provided by the governing body of the municipality may be recovered in an action at law, or if the municipality does not have the ability to collect sewerage disposal charges in connection with or as part of the charge for another service or utility that can be curtailed to secure collection, the charge may be certified and presented after July 15 and on or before the following July 15 to the tax assessor of the county in which the municipality is situated and be by the assessor assessed against the premises serviced on the next assessment and tax roll prepared after July 15. Once the service charges are certified and presented to the assessor, the payment for the service charges must be made to the tax collector pursuant to ORS 311.370. Such payment shall be made by the person responsible for the delinquent service charge or by the municipality who has received payment for the delinquent service charge. These charges shall thereupon be collected and paid over in the same manner as other taxes are certified, assessed, collected and paid over.

based upon the cost of providing sewer service, according to reasonable cost-of-service sewer utility ratemaking principles. The existence of a city boundary shall not be used as a basis for imposing a sewer user rate or connection fee differential unless there are documented cost causative factors to justify the differential.

While this statute is phrased in terms of rates and charges imposed on customers located within areas described in ORS 454.275 to 454.380,³ as a practical matter it results in a mandate that sewer charges imposed throughout Portland be based upon reasonable cost-of-service sewer utility ratemaking principles. For our purposes, those principles require that customers only pay rates that can be tied to some sewer "service" actually provided in return. Put otherwise, sewer rates can only be collected to pay for activities or projects related to the City sewer system.

Bond covenants also impose constraints on the City's management of the sewer utility, including some general guidance on imposition of charges. See Section L (4) of the Master Ordinance (Ordinance No. 160276, adopted 11/18/87, as amended by Ordinance No. 167740, adopted 6/8/94).⁴ The bond covenant could, for example, lead to questions whether particular expenditures would be viewed by bondholders as "sound, efficient and economic" costs for a municipal sewer utility to incur.

E. Avoiding classification as a tax

As described above, the Charter and state statute provide authority for the City to impose fees and charges for sewer service. There is a distinction between 'fees and charges' and 'taxes.' A fee is compensation for a particular act or service and is to be paid by the party obtaining the benefit. *Landis v. Lincoln Co.*, 31 Or 424, 426, 50 P 530 (1897). The theory is that those who

³ These statutes refer to areas where the EQC has determined that on-site sewage disposal has resulted in a threat to drinking water.

⁴ The bond covenant provides:

Operation and Maintenance. The City shall cause the System to be operated at all times in a safe, sound, efficient and economic manner in compliance with all health, safety and environmental laws, regulatory body rules, regulatory body orders and court orders applicable to the City's operation and ownership of the System, and shall cause the System to be maintained, preserved, reconstructed, expanded and kept, with all appurtenances and every part and parcel thereof, in good repair, working order and condition, and shall from time to time cause to be made, without undue deferral, all necessary or proper repairs, replacements and renewals so that at all times the operation of the System shall be properly and advantageously conducted. The City shall not enter into any agreement to provide free service or services at a discount from published rate schedules except in case of emergency.

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benefit should pay. The fee should not materially exceed the cost of providing the service.^h
Hickey v. Riley, 177 Or 321, 334, 162 P2d 371 (1945). The money collected must be used to
finance the service. *Haugen v. Gleason*, 226 Or 99, 105, 359 P2d 108 (1961). Raising money
under the authority granted for utility fees and then spending it for non-utility purposes could
result in the revenue being classified as an unauthorized tax. This could trigger a requirement for
repayment. a

2. Constraints on use of water utility funds.

There are a number of constraints on the raising and spending money for the Water
Bureau. First, the City Charter, §11-104, declares that "the funds and accounts of the Water
Bureau relating to water plant and works shall be separate from other accounts and funds of the
City and treated as a separate municipal operation." (emphasis added). It goes on to say that b
"money in the Water Fund or Water Construction Fund shall not be transferred to the General
Fund of the City, nor to special funds unrelated to the water works, water system and the sinking
funds for water bond debt service." (emphasis added). B-2/2-2

While on its face this Charter language refers only to transfers among various City funds,
the City Attorney's Office has for decades interpreted the words also to constrain indirect c
transfers of Water Bureau monies to serve non-water purposes. According to an oft-cited
opinion, the Charter limitation is intended to "prevent the City Council from using the City's
water revenues to carry out General Fund projects." (Christopher Thomas memorandum to Carl d
Goebel, Sept. 21, 1983).⁵ As a consequence, the City Attorney's Office has repeatedly held that
Water Bureau money cannot be spent on matters "unrelated" to the Water System. The Office f
has established the following test to judge such expenditures:

"Expenditures that are "related" to the water works and system are
expenditures: (1) whose primary purpose is to promote the
objectives of the water ... services of the City, and (2) are
reasonably calculated to promote those objectives." (City Attorney
Opinion 88-615). >g

On the other hand, just as it could with any other separate utility, the Council may charge
the Water Bureau for the cost of "municipal services [provided by] . . . other bureaus" and it may

⁵ For instance, this part of the Charter prohibits the transfer of Water Bureau capital assets to other parts of the City
without payment, unless the transfer can be shown to accomplish water system objectives. (City Attorney Opinion
90-26). The City Attorney's Office has also said that the Charter limits the ability of the Council to direct the Water
Bureau to contribute money to support general fund art projects, (City Attorney Opinion 88-165), and prevents the
provision of free water to the Parks Bureau, (Jeffrey Rogers memorandum to Mike Rosenberger, Jan. 26, 1988), or
a particular class of citizens. Christopher Thomas memorandum to Carl Goebel, Sept. 21, 1983.

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impose "fees of the same character as for public utilities." Council has implemented the latter authority, of course, by imposing on the Water Bureau a utility license fee calculated at 7.5% of the Bureau's revenues.

Each year, the Council is to set rates to raise enough money to meet Water Bureau "expenses and debt service relating to water bonds." Charter § 11-105. Since Water Bureau expenses can only be incurred if they "relate" to the water works, the limit on expenditures also effectively constrains Council discretion to raise rates for purposes unrelated to the water system. In addition, the Water Bureau earns substantial revenues annually from its wholesale customers. Under the long-term water sales contracts, the City must set its wholesale rates using recognized "cost of service" principles. As we explained in discussing those principles as applied to the sewer system, essentially they require that customers only pay rates that can be tied to some water "service" actually provided in return.

Finally, in selling Water Bureau revenue bonds, the City typically makes certain representations and contractual commitments to the bond purchasers. For instance, the disclosure statement for water bonds to be sold this spring declares that proceeds will be used to "fund various capital improvements to the Water System, including additions, improvements, and capital equipment that facilitate supply, treatment, transmission, storage, pumping, distribution, regulatory compliance, customer service and support." Our bond counsel advises us that this announcement represents the City's commitment to use the proceeds only for projects "related to" the water system. The relationship must be "clear and direct." A less conservative interpretation could adversely affect the credit rating of Water Bureau revenue bonds. In addition, the City covenants in selling bonds that it "will operate the Water System in a sound, efficient, and economic manner. . . ." One way to meet that covenant is to insure that water funds are spent only for water related purposes.

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