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Public Chapter 509 slaps cuffs on utility revenues

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Transferring surplus revenues from utility sales to a city's general fund is being phased out by Public Chapter 509, which says the extra cash must go toward reducing customer rates after 1998. This stipulation is among the stricter limits the new statute imposes on uses for revenues from utility sales, which can now only cover specific costs related to providing utility services. The comprehensive law, which went into effect July 1, 1993, amended *Tennessee Code Annotated* (*T.C.A.*) § 9-21-308 and *T.C.A.* § 7-34-105, also known as the Revenue Bond Law. It applies to all city utilities and other public works projects.

Amendment bans excessive transfers of utility funds

Preventing excessive transfers of utility revenues to the city's general fund is the heart of the amendment. This, the most important change caused by Public Chapter 509, results from the following language: "No public works shall operate for gain or profit or as a source of revenue to a government entity."

Public Chapter 509 states that, **after establishing proper reserves, any remaining surplus will be used solely for reducing rates.**

Previously, the courts allowed cities to transfer surplus utility revenues to the general fund if this wasn't prohibited by statute or bond covenants. Now, any revenues left over must stay in the utility fund and be used for reducing rates.

Interestingly, there is a five year phase-out period allowing cities to continue to recover surplus revenues. (A formula is provided in § 1 (g) of the amendment.) However, after five years, cities can only recover valid direct and indirect expenses.

Direct and indirect expenses defined

Direct and indirect expenses are accounting terms commonly used in manufacturing, cost accounting, and enterprise funds.

Direct expenses are expenditures *easily* identified with a specific job, such as material, equipment, and labor necessary to install water service. For direct expenses to be reimbursed, they must be incurred outside that public works operation. This is likely to occur with cities that have a common labor pool for all public works tasks.

Indirect expenses, or overhead, are expenditures that are necessary to provide services but aren't identified with any specific job. For instance, in many municipalities a central management group oversees all city functions. They may be managing supervisors and typically work "behind the scenes" administering policies. These administrative expenses are reimbursable and represent indirect costs incurred for the benefit of the public works service. Indirect costs are defined by the municipality and include other shared costs such as rent, depreciation, computer systems, telephones, and utilities.

This new statute requires cities to devise an indirect costs recovery plan by carefully considering all expenses associated with public works. (This is similar to the TVA-approved cost recovery plans done by cities operating electric systems.) Your auditor will have to accept or approve the indirect cost recovery plan of your city.

Uses for public works revenues under Public Chapter 509

The new statute requires cities to devote all public works revenues to:

- paying all operating expenses;
- bond interest and retirement and/or sinking fund payments;
- acquiring and improving public works;
- contingencies;
- paying other obligations incurred in public works operations and maintenance and furnishing services;
- redeeming and purchasing bonds, in which case they'll be cancelled;
- creating and maintaining a cash working fund;
- paying an amount to the municipality's general fund not exceeding a cumulative return of 6 percent per annum of any equity invested from the general fund, if any, of the municipality. Equity investment is any contribution or purchase made by the municipality from the general fund. As long as these contributions are reflected in the utility's financial statement, this includes, but isn't limited to, cash contributions, retiring debt service, and purchasing equipment; and
- payments to the municipality in lieu of ad valorem tax on the property of the public works within the municipality's corporate limits not exceeding the amount of taxes payable on privately owned property of similar nature, if requested in a resolution passed by the city's governing body.

Trouble may spring from amendment's vague terminology

There's a potential problem with the wording of Public Chapter 509 because the following important terms are not defined in the amendment.

Self-sufficient — This amendment requires all municipal utility systems to be operated "... as self-sufficient entities. User charges, rates, and fees shall reflect the actual cost of providing the services rendered." (*T.C.A.*, § 7-34-115 (a)).

Self-sufficiency, though, isn't a technical accounting term and it isn't specifically defined in *T.C.A.* It's a concept associated with long-term solvency, and it's a business principle describing successful operations. Self-sufficiency means that rates and fees should be high enough so that the utility doesn't need to be subsidized with general fund money.

Can a utility be self-sufficient and still accept contributions from the municipality's general fund? Apparently so. The amendment specifically says, "Nothing herein shall preclude a municipality from subsidizing in accordance with the adopted budget of the municipality a public works system with tax revenues." However, your bond covenants may be more restrictive than this state law, and they may prevent subsidies from the general fund to the utility.

Public works and municipal utilities — Another problem with the wording of Public Chapter 509 is that "public works" and "municipal utilities" are used interchangeably and nowhere is the term "municipal utility systems" specifically defined. However, in *T.C.A.* § 9-21-105, the definition of public works projects includes garbage collection and disposal systems, stormwater sewers, gas systems, parking facilities, and water operations.

Rates must balance between viability and profitability

Rates for public works must be high enough to cover all legitimate costs, but low enough to not produce a profit. The "demand for services" nature of utilities makes this difficult to accomplish every year. The amendment tries to incorporate sound business practices while protecting users from excessive rates. The amendment also lists the approved items that can be paid with any public works revenues, furthering the state's attempt to differentiate between utility customers and resident taxpayers.

Figuring in lieu of tax unchanged

Although there's no doubt that Public Chapter 509 places some constraints on how cities operate, it appears to provide statutory authority for computing an in lieu of tax for wastewater, water, solid waste, and other utilities. The in lieu of tax paid by municipal gas and electric systems continues to be figured under *T.C.A.* § 7-34-404 and *T.C.A.* 7-52-304, rather than the formula dictated by this act (*T.C.A.* § 7-34-115(h)).

Uncommonly stiff penalties result if fail to comply

The punitive enforcement established in Public Chapter 509 is unusual in a bond or utility finance statute. Violating provisions of the amendment:

- prohibits the state Division of Local Finance in the Comptroller of the Treasury Office from approving any issuance of debt until the violation is remedied;
- requires that any funds illegally transferred must be paid back;
- leaves any city official responsible for an illegal transfer subject to ouster under Title 8, Chapter 47 of *T.C.A.*

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