

MEMORANDUM

State of Alaska

Department of Law

TO: The Honorable Michele Brown
Commissioner
Department of Environmental
Conservation
TELEPHONE NO.:

DATE: December 31, 1996

FILE NO.: 663-97-0169

465-3600

SUBJECT: Impact of Municipal Utility Sale on Construction Grants

FROM:
Assistant Attorney General
Natural Resources Section - Juneau

Marie Sansone

The City of Fairbanks (city) recently agreed to sell its water and wastewater utilities to a private for-profit corporation. The Department of Environmental Conservation (DEC) asked our office for advice concerning the impact of this sale on DEC-administered construction grants.

Under AS 46.03.030, DEC may grant money to •a municipality• for public water supply and wastewater systems. The DEC construction grant regulations in 18 AAC 73.010(a) also limit grant eligibility to Alaska municipalities and combinations of municipalities, and the term •grantee• is defined in 18 AAC 73.060(8) to mean a municipality or combination of municipalities that has received a DEC construction grant offer. A private for-profit corporation is thus ineligible to receive a DEC-administered construction grant. *See* 1981 Inf. Op. Att’y Gen. (Apr. 7; J-66-183-81). As a result, several questions have come up concerning past, ongoing, and future grants to the city. Our analysis follows.

BACKGROUND

The City of Fairbanks is a home rule city and unless restricted by law or charter, may sell or lease its municipal utilities. *See Lien v. City of Ketchikan*, 383 P.2d 721, 723 (Alaska 1963); 1990 Inf. Op. Att’y Gen. (Mar. 15; 663-90-0197). On October 8, 1996, the city voters ratified the sale of the Fairbanks Municipal Utility System, an integrated utility that includes the city’s public water supply and wastewater systems.

Before the election, on August 20, 1996, the city entered into a stock purchase agreement with Fairbanks Sewer and Water, Inc. (FSW), relating to the sale and leasing of the water and wastewater systems. The agreement calls for the city to form a corporation called Golden Heart Utilities, Inc. (GHU), and to transfer the water system and part of the wastewater system to GHU in exchange for GHU stock. The city will then sell the GHU stock to FSW for \$2 million. The city will also lease the wastewater treatment plant¹ to GHU, with an option in

¹ The •wastewater treatment plant• is defined in paragraph 1 of the agreement as •those certain

GHU to purchase the plant at any time. An August 1, 1996, draft summary of the agreement indicates that the transaction was structured to insulate FSW from wastewater system liabilities and to obtain favorable tax treatments. The city and FSW anticipate closing will occur in mid-1997.

As indicated in the August 1, 1996, draft summary, the transaction will result in an immediate \$2 million payment to the city, with additional lease payments with a net present value of \$5 million spread over 30 years, for a total payment value of \$7 million. Paragraph 5.3 of the agreement provides that the lease payments will be secured by a commercially reasonable perfected first priority security interest in GHU assets and stock, subject to a commercially reasonable subordination agreement to facilitate GHU's ability to obtain financing to rehabilitate and improve the water and wastewater systems.

Before offering the utilities for sale, the city obtained an independent appraisal of the Fairbanks Municipal Utility System from Frederick & Warinner, certified public accountants. While the city received only one bid, that bid fell within the value range established by the appraisal. •Group offers city \$153 million to buy utilities system,• *Fairbanks News-Miner*, May 16, 1996, at A-1. As of December 31, 1995, the appraisal establishes a net plant value between \$5 million and \$7.6 million for the water system and zero economic value for the wastewater system. Upon formal presentation of the offer, the Fairbanks City Council established a negotiating team to work out the terms of the sale and held lengthy public hearings on the sale. •Fairbanks Utility Sale Goes to Voters,• *Anchorage Daily News*, Aug. 14, 1996, at D-4. Following the city council's approval of the sale on August 12, 1996, the mayor signed the contracts on August 20 to sell the components of the Fairbanks Municipal Utilities System. *Id.*; •Fairbanks Mayor Inks Utility Deal,• *Anchorage Daily News*, Aug. 22, 1996, at D-4. In paragraph 8.4(b) of the stock purchase agreement for the water and wastewater utilities, the city and FSW agree that the purchase price and lease payments are fair and adequate.

facilities owned by Seller and constructed with federal grants, including Seller's wastewater treatment plant, the Peger Road Interceptor, the Van Horn Interceptor (original), Lift Stations 39, 40, 41, and 42, and outfall structures. •

Paragraph 5.3 of the agreement indicates that the systems require over \$10 million in rehabilitation and improvement. Paragraph 12.1 of the agreement requires GHU, during the first five years after closing, to spend at least \$1 million each year on improvements, for a total of \$5 million. During that period of time, GHU will not make any distributions of dividends or of current or retained earnings in any form to FSW or any subsequent shareholder. In addition, under paragraph 8.6, GHU will assume all known and disclosed or unknown environmental compliance obligations. To protect consumer interests, paragraph 12.2 includes a rate containment provision that during the first three years after execution of the agreement, GHU will not seek more than a 15 percent total increase in the rates in effect as of closing, except as may be required by legislation, regulatory action, or judicial order.

Paragraph 11.9 specifically addresses the treatment of grant funds:

Grants. To the extent that Seller is entitled to any grant funds which are designated for water/wastewater projects and to the extent that Seller's entitlement to such grant funds (or the funds) is transferable to a private entity at no cost or liability to Seller, then, to the extent that such grant funds are either dedicated to an existing approved capital project or are not transferable to other City of Fairbanks projects, such funds shall be transferrable to GHU with GHU's agreement to apply said funds in conformance with the grant.

This provision reflects that the city and FSW were aware that the continued availability of public grants for a privately owned utility was uncertain and that they took that into account in their negotiations. *See also* Letter from James C. Hayes, Mayor, City of Fairbanks, to Michele Brown, Commissioner, DEC (Sept. 13, 1996) (confirming that the issue of grant eligibility was addressed in the negotiations). This issue was also addressed in the Frederick & Warinner appraisal.

DISCUSSION

The following discussion is based on our understanding that the city's charter does not prohibit this utilities sale and lease transaction. Also, it does not appear that any of the statutory limitations in AS 29.10.200 on home rule powers prohibit this transaction. *See Lien*, 383 P.2d at 722-23; 1990 Inf. Op. Att'y Gen. (Mar. 15; 663-90-0197).

1. What impact is created on projects that have been funded and constructed, in part, with DEC construction grant funds? Is reimbursement of the grant funds required as a result of the sale?

In general, a home rule city may sell or lease public facilities constructed with state grant funds to a private entity, provided the city's charter does not restrict the exercise of such powers and provided the requirements of the public purpose clause of the Alaska Constitution² are met. *See Lien*, 383 P.2d at 722-23; 1990 Inf. Op. Att'y Gen. (Mar. 15; 663 -90-0197); 1987 Inf. Op. Att'y Gen. (Feb. 26; 663-87-0357); 1982 Inf. Op. Att'y Gen. (Feb. 26; J66-403-82). A municipality may thus attach conditions to a sale or lease agreement designed to assure that the facility's public purpose will continue to be met. *See 12 McQuillan Municipal Corporations* • 35.36 at 605 (3d ed. 1986).

There are two aspects of the transaction that must be addressed. First, the city must receive fair market value for the water and wastewater systems in an arms-length free market transaction. *See* 1982 Inf. Op. Att'y Gen. (Feb. 26; J66-403-82). This requirement assures that city does not serve as a mere conduit to pass DEC construction grant funds through to a private entity. Such a pass-through would constitute a diversion of public funds to an unauthorized purpose and contravene the DEC construction grants statute, regulations, and grant agreements. *See* 1982 Inf. Op. Att'y Gen. (Feb. 26; J66-403-82).

² Article IX, • 6, of the Alaska Constitution provides:

Public Purpose. No tax shall be levied, or appropriation of public money made, or public property transferred, nor shall the public credit be used, except for a public purpose.

The phrase •public purpose• encompasses •The basic objective of government . . . to protect and promote the health, safety, and general welfare of the people.• *Suber v. Alaska State Bond Comm*, 414 P.2d 546, 551-52 (Alaska 1966).

It appears that this first condition has been met. The city obtained an independent appraisal of the utilities before offering them for sale, and the agreed-upon price fell within the value range established by the appraisal. The city council conducted lengthy negotiations and held public hearings on the proposed sale. The sale was approved by the city council, the contracts executed by the mayor, and the sale ratified by the voters. These facts, along with the terms and conditions of the stock purchase agreement reviewed above, would support finding that this was an arms-length transaction and that the city received fair market value.

The second condition that must be met is that the city may not divest itself of its duty to assure that the facilities being transferred remain throughout their practical life dedicated to a public use. The grant funds were spent to construct public water and wastewater systems, basic infrastructure essential to the community's health and welfare. That purpose does not necessarily become non-public when the facilities are transferred to a private corporation. Rather, the test of whether a public purpose is being served depends upon the character of the use to which the facilities will be put. *See Lien*, 383 P.2d at 722; 1981 Inf. Op. Att'y Gen. (Apr. 7; J-66-183-81). The use of the facilities as public water and wastewater systems will not change as a result of the sale and lease transaction. And, while FSW and, once formed, GHU are private for-profit corporations, GHU's ability to increase rates is subject to approval by the Alaska Public Utilities Commission and the statutory restriction that such rates be "just and reasonable." *See* AS 42.05.381(a).

The city, however, must ensure throughout the practical life of the facilities that FSW and GHU adequately recognize and protect the public interest. *Lien*, 383 P.2d at 723; 1987 Inf. Op. Att'y Gen. at 1-2 (Feb. 26; 663-87-0357); 1986 Inf. Op. Att'y Gen. (Sept. 22; 663-87-0114) (redated for printing, Jan. 1, 1991); 1985 Inf. Op. Att'y Gen. (July 11; 366-512-85). The DEC construction grant regulations thus provide that

The grantee, by accepting grant assistance under this chapter, agrees *to construct and operate* a system . . . awarded a grant under this chapter in accordance with the approved plans and specifications. Failure to meet the requirements of this subsection may result in withdrawal of grant assistance.

18 AAC 73.020(j) (emphasis added). The regulations also provide that "the municipality must agree to accept responsibility *to operate and maintain* the proposed system and must agree to the terms of the grant offer. 18 AAC 73.030(d) (emphasis added). Moreover, the grant offer and acceptance form letter used by DEC includes the condition that "The Grantee agrees *to operate and maintain* the completed project." *See, e.g.*, Letter from Keith Kelton, Director, Facility Construction & Operation, DEC, to Mark Boyer, Manager, City of Fairbanks (Jan. 11, 1994) (emphasis added) (Sewer Rehabilitation Phase X).

By accepting the DEC-administered construction grants for the water and wastewater systems, the city undertook a continuing obligation to operate and maintain the systems for their practical life. We previously opined that where there has been an arms-length free market transaction for value, a municipality may meet its obligation to operate and maintain a water or wastewater system by requiring as a condition of the sale that the system continue to be operated according to the terms of the grant agreement. 1982 Inf. Op. Att’y Gen. (Feb. 26; J66-403-82). It appears that the city, by virtue of the terms of the stock purchase agreement and lease agreement, has met these conditions.

At this time, there is no indication that the city has failed to meet the terms and conditions of those grant agreements where construction has been completed or that reimbursement is required. Under paragraph 22.4 of the stock purchase agreement, the city may enforce the agreement through any and all remedies provided by law. In the future, if during the practical life of the systems built with DEC construction grant funds, the city fails to enforce the stock purchase agreement and the lease agreement such that the continued public use of the water or wastewater systems is jeopardized, then DEC has the responsibility of enforcing the grant agreements. If informal efforts to enforce the grant conditions are unsuccessful, then DEC may seek enforcement by injunctive relief, reimbursement, or other remedies appropriate to the circumstances. *See* 1986 Inf. Op. Att’y Gen. (Sept. 22; 663-87-0114) (redated for printing, Jan. 1, 1991).

2. How is grant eligibility affected for systems where construction has not been completed by the date of the sale? To whom can we make payments, and at what point do we no longer make payments?

There are two appropriation items that are potentially affected by the utility sale. The legislature, in ch. 79, SLA 1993, appropriated \$475,000 through the DEC construction grant program for the •Sewer Rehabilitation Phase X• project and \$850,000 for the •Ft. Wainwright Interceptor Rehabilitation Phase IIA• project. In ch. 123, SLA 1996, the legislature amended the Ft. Wainwright interceptor appropriation to include •other water and wastewater projects.•

The DEC has made only one grant from these appropriations, \$335,000 for the Sewer Rehabilitation Phase X project. However, DEC indicates this project has not been designed to date and may not be designed or constructed by the closing date of the utility sale. Also, DEC has asked how to handle grant applications from the city for the remaining funds from these appropriations.

First, with respect to the Sewer Rehabilitation Phase X project, which is started but will not be completed by the closing date, DEC should adhere to the provisions in the grant offer and acceptance letter relating to grant cancellation. If the city does not intend to proceed with the project, or if DEC has reason to believe that the grant conditions would be violated or that the

city will not receive fair market value for the project, then DEC may decline to make further grant payments or to extend further grant offers to the city. The DEC may also require reimbursement of any grant monies that have not been spent on the project.

Second, for the Fort Wainwright Interceptor Rehabilitation Phase X and the other unspecified water and wastewater projects, to the extent the projects are included in the •wastewater treatment plant• as defined in paragraph 1 of the agreement and will continue under the city's ownership, then DEC may extend grant offers to the city. If the project will not continue under the city's ownership, then, before DEC may extend a grant offer to the city, the city must demonstrate that it will receive fair market value for the project and that the public purpose of the project will continue to be met during the practical life of the project. Again, for any grant offers that are made, if it becomes apparent that the city does not intend to proceed with the project, that the grant conditions will be violated, or that the city will not receive fair market value for the project, then DEC should follow the procedures indicated in the grant offer and acceptance letter concerning the revocation of grant offers and grant cancellation.

Finally, since FSW and GHU are not grant-eligible, all grant payments should be made to the city. As discussed above, regardless of any transfer, which must be for fair market value, the city remains responsible for ensuring that the new construction remains dedicated to the public use and that the grant conditions are met.

3. Should DEC continue to accept and rank project funding requests from the City of Fairbanks for inclusion in the FY 98 capital budget?

The city and FSW anticipate that closing will occur in mid-1997, while the state's FY 98 begins on July 1, 1997. We advised DEC in an earlier memorandum that since a private utility cannot receive a construction grant directly, it may not do so indirectly by using a municipality as a mere conduit for the grant funds. *See* 1982 Inf. Op. Att'y (Feb. 26; J66-403-82). Therefore, for FY 98, for the water system and those parts of the wastewater system that will be owned outright by GHU and FSW, the DEC may not provide the city with construction grant funds.

However, the city may lease a facility constructed with state grant funds to another entity, provided the city assures the public purpose of the facility will be met. *See* 1987 Inf. Op. Att'y Gen. at 2 (Feb. 26; 663-87-0357). Therefore, DEC may accept applications from the city with respect to the wastewater treatment plant to be leased to GHU. If GHU exercises its option to purchase the treatment plant, it must pay the city fair market value for any improvements made by the city with construction grant funds.

4. Can the City of Fairbanks use private funds from Fairbanks Water and Sewer, Inc., as a match for the grant to construct improvements to the wastewater treatment facility?

The wastewater treatment plant requires substantial improvements to ensure continued public health protection and compliance with environmental regulations. The city would like to apply for a construction grant to fund the improvements, using private funds received from FSW as a match.

Under AS 46.03.030(g), a match for the DEC construction grants may include federal funds and state funds, other than grant funds received under AS 43.03.030 or capital project matching grant funds received under AS 37.06. The word include when used in a state law is construed as though followed by the phrase but not limited to. See AS 01.10.040(b). Therefore, funds derived from sources other than DEC construction grants or capital project matching grants, including funds derived from private sources, may be used to provide the local match.

The DEC has also promulgated a regulation, 18 AAC 73.040(c), concerning the local match. This regulation provides that [A] grantee may match the state grant share with any combination of (1) local money; (2) federal money; and (3) state money other than money received under this chapter or AS 37.06. The regulations do not define the term local money; however, as a general rule, unless restricted by its charter, a municipality may derive revenues from private sources such as gifts, bequests, and donations. See 10 *McQuillan Law of Municipal Corporations* 28.16 at 50 (3d ed. 1990); *id.*, vol. 15, 39.03 at 9 (3rd ed. 1985). The term local money in the DEC regulations can be interpreted to allow the city to use revenues derived from FSW as a match. This interpretation is consistent with AS 46.03.030(g), which does not restrict the use of local money derived from private sources, and fulfills the purposes of both the statute and the regulation in assuring that DEC construction grant funds and capital project matching grant funds are not used to provide the local match. This interpretation is also consistent with the local share provisions in the capital project matching grant statute, since under AS 37.06.030(a)(3)(C), the local share can include money from another nonstate source.

However, for purposes of ensuring that the construction grant is made to a municipality for a public purpose and that upon sale the city receives fair market value for the wastewater treatment plant, the proposed improvements must be treated as improvements made by the city, and not by GHU or FSW. This requirement derives from paragraph 5.4 of the stock purchase agreement and paragraph 5 of the lease agreement which provide that the option purchase price shall be fair market value less improvements performed by GHU or FSW.

CONCLUSION

The Honorable Michele Brown, Commissioner
Department of Environmental Conservation
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We hope this memorandum has been helpful. Please do not hesitate to contact us if you require further assistance.

MS:prm

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