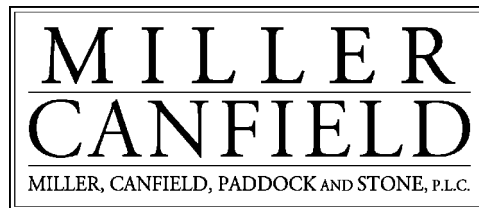


**LEGAL ANALYSIS OF
PROPOSED REGIONAL UTILITY AUTHORITY
AS OUTLINED IN
KALAMAZOO COUNTY GROWTH PLAN**

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EXECUTIVE SUMMARY

This report examines the principal legal aspects of a proposed sale of water and sewer utilities currently owned by local units of government in Kalamazoo County to a regional authority, as outlined in the Kalamazoo County Growth Plan dated June 2005. For purposes of simplicity the seller of the utilities is assumed to be the City of Kalamazoo. The proposed sale is evaluated against various requirements of law as detailed in the full report. The report's summary conclusions are as follows:

1. In light of *Bolt v Lansing*, will the Growth Plan's proposed rate model be upheld if challenged?

- No. There is a substantial likelihood that the proposed rate model will fail at least two parts of the three-part *Bolt* test: The rates 1) appear to be designed to raise revenue, which in turn is envisioned to provide general fund relief to the City, and 2) do not appear to be proportional because the asset price has not been established based upon objective measures of value. We recommend revising the proposed rate model.

2. What State and local law limitations might interfere with the proposed sale?

To answer this question, we reviewed provisions of the Michigan Constitution, the Home Rule Cities Act (1909 PA 279), the Revenue Bond Act (1933 PA 94), the Kalamazoo City Charter, the Kalamazoo Code of Ordinances, and various City bond ordinances. We identified three areas of significant concern:

- Section 4e(3) of PA 279 contains a provision which on its face limits the use of proceeds from the sale of a municipally-owned utility to two purposes only: procuring similar capital assets or retiring debt. This would prevent the City from using sale proceeds for general fund purposes. We recommend pursuing an amendment to Section 4e(3) of PA 279.
- Code Section 28-5 presently does not permit a sale of the City's wastewater utility. Although the City Commission can amend Sec. 28-5 to permit the sale, the amendment may be subject to referendum under City Charter Sec. 63. Section 4i(g) of PA 279 and Charter Sec. 63 provide that City ordinances generally are subject to referendum. Although an ordinance amending Code Sec. 28-5 would likely be considered an "administrative act" and not subject to referendum, that result cannot be assured. We recommend pursuing an amendment to Section 4i(g) of PA 279.

- The City, in the Bond Ordinances, has covenanted to bondholders that the City will not sell the systems until the bonded indebtedness is repaid or an escrow sufficient for defeasing the bonds has been fully funded. This is a contractual right enforceable by bondholders. We recommend that the final transaction provide either for retirement or defeasance of the current debt.

3. What other limitations could interfere with the proposed sale, such as requirements arising from federal grant financing of the wastewater system or from the prior rate litigation, and how should the regional authority be created?

- We do not find any material impairment of the proposed transaction arising from the rate settlement agreements. The City of Portage's prior equity contribution, however, should be reflected in the final terms of the transaction.
- The EPA will be required to approve of the wastewater utility sale because of the \$92 million in grant funding received by the City for utility improvements. Under current EPA regulations and policies, either the EPA grant percentage of the original project cost must be repaid from sale proceeds upon conveyance or, in the alternative, the grant will be considered fully depreciated but EPA is unlikely to approve of a meaningful compensation payment to the City. We recommend seeking Congressional assistance in respect of the regulation, and continued dialogue with EPA to consider additional alternatives.
- The appropriate statute to use for the purpose of creating the regional authority is 1955 PA 233, as amended, commonly used by Michigan local governments to create regional water and sewer authorities.

I. INTRODUCTION

This report describes the principal legal issues presented by the proposed conveyance of water and sewer utilities owned by the City of Kalamazoo (the “City”) to a regional water and wastewater authority to be comprised of all or substantially all of the governmental units within Kalamazoo County. The report addresses three specific subject matter areas, as generally described in our letter dated January 6, 2006, to Southwest Michigan First. The subject matter areas are:

A) Will the rate model assumed in the Kalamazoo County Growth Plan dated June 2005 (the “Growth Plan”) survive a legal challenge grounded in the theory announced by the Michigan Supreme Court in *Bolt v City of Lansing*, especially in light of the Growth Plan’s assumed raising of rates on City utility customers while simultaneously giving property tax relief to City taxpayers?

B) What are the State law limitations upon the City’s legal authority, as owner and prospective seller of the utilities, to sell such assets under (i) the Michigan Constitution, (ii) state statute (primarily the Home Rule Cities Act, 1909 PA 279, and the Revenue Bond Act, 1933 PA 94), (iii) the City Charter, (iv) the City’s utility ordinances, and (v) relevant bond ordinances under which current utility indebtedness was issued?

C) What other limitations constrain either the seller (the City) or the prospective purchaser (the regional authority) from concluding the transaction as contemplated by the Growth Plan, especially limitations imposed by (i) the United States, as a consequence of having grant-funded a material portion of the utilities, (ii) constitutional “lending of credit” constraints, (iii) the prior rate settlement agreements and the like, and (iv) the regional authority’s enabling legislation.

Each of these subject matter areas is discussed in turn below.

As noted in our January 6, 2006, letter, in preparing our report we limited our analysis to the specific legal questions set forth above.¹ We also reviewed the Growth Plan, and in particular Strategy No. 3 therein entitled “*Unlock Value of Water and Sewer Systems.*” In

¹ For purposes of presentation the order and grouping of the subject matter areas differs slightly from our January 6, 2006, letter, but the topics analyzed have not changed.

applying the relevant law to the facts, we relied upon the specific factual assumptions presented in the Growth Plan. In answering the questions, we indicate approaches offering promise in resolving the legal issues requiring attention.

As a means of limiting the report's complexity and length, we address only the legal limitations that apply to the City. This is a simplifying assumption. The Growth Plan anticipates that each of the public-entity utility owners will convey its respective utility assets to the regional authority. Many of the limitations we discuss below will be of equal applicability to each public-sector utility owner: United States Environmental Protection Agency ("EPA") grant limitations, for example, will be of uniform applicability as will State constitutional and some statutory provisions. Certain limitations, however, will be specific to each public-sector entity. These include the Home Rule Cities Act and relevant charter provisions for cities, as well as ordinance and bond limitations for entities having outstanding utility bonded indebtedness. Limitations specific to public entities other than the City are beyond the scope of this report.

The Growth Plan scenario resembles a leveraged buy-out of the existing utility systems. Our report identifies the major public law legal issues that will be present in any such scenario. While we conclude by recommending strategies for addressing the issues, we have not exhaustively developed those strategies pending further discussions among the regional stakeholders as to which combination of strategies is best suited to achieve the stakeholders' objectives. Our report therefore should be viewed as a general road map to the legal issues presented by the leveraged buy-out. As the stakeholders determine which particular course of action they wish to pursue, detailed review of the alternatives selected for implementation will be appropriate.

We acknowledge and appreciate the cooperation and effort of the Southwest Michigan First staff in collecting materials for our review, and in coordinating a discussion with Mr. Bart Foster regarding the assumptions supporting the proposed Growth Plan rate model.

Summary of the Growth Plan, Strategy 3: Unlock Value of Water and Sewer Systems

The Growth Plan proposes that the City and other units of government within Kalamazoo County form a regional water and wastewater authority. Each local unit, including the City, will convey its water or wastewater system to the authority. The authority will then operate and manage one combined regional system serving all of the units that constitute the authority.² By consolidating the local units' systems into one, the total costs of system operation and capital financing are projected to decrease by 19.5%.

The rates charged to users, however, will increase under the Growth Plan. The rate increase results from a Utility Purchase Surcharge (the "Surcharge")³ that is charged to all users. The Surcharge is derived from the authority paying a price to purchase the separate systems from its constituent local units. The purchase price of the consolidated system is based on the system's Net Operating Cash Flow rather than on a predetermined value. Net Operating Cash Flow is defined as all revenues (including the Surcharge) less operation and maintenance expense. The rates charged to all users will be equalized over time, which in practice means that out-City users will pay 110% of what they currently pay, while in-City users, who currently pay less than out-City users, will see an increase in rates to the level of out-City users.

² Other units both within and without Kalamazoo County would be permitted to contract with the authority for utility service. Currently the City serves wastewater customers in Barry and Van Buren Counties, for example.

³ See The Foster Group, *Review of Kalamazoo County Growth Plan Strategy 3: "Unlock Value of Water and Sewer Systems,"* September 15, 2005.

Finally, significant general fund relief is projected to occur because of the transfer of utility assets from the local units to the regional authority in exchange for cash flow. The general fund relief is especially significant in the City’s case, owing to the size and capacity of the City’s systems. The Growth Plan projects a consequent reduction in City property tax rates.⁴

Through the combination of regional utility ownership, equalization of rates, and City property tax relief, the Growth Plan envisions “a substantial advantage for economic development.”⁵

II. DISCUSSION AND ANALYSIS

A. Will the rate model survive a legal challenge grounded in *Bolt*?

The foundation of the Growth Plan’s “Unlock Value” strategy is the proposed rate model.

The rate model assumes that:

- System acquisition can be “priced” by establishing a 30-year revenue stream equal to 90% of Net Operating Cash Flow in lieu of using asset value;
- Over time rates can be equalized between in-City and out-City customers;
- Reserves can be kept by the City; and
- Property tax relief will result, reflecting the removal of a burden from the City’s general fund.

⁴ See Growth Plan, p. 7; The Foster Group, *Review of Kalamazoo County Growth Plan Strategy 3: “Unlock Value of Water and Sewer Systems,”* September 14, 2005 (preliminary review).

⁵ Growth Plan, p. 7.

The Michigan Constitution, particularly the provisions of Article IX, Section 31 (commonly referred to as the “Headlee Tax-Limitation Amendment” or “Headlee”), requires that any fee charged by a governmental entity must meet certain criteria in order to be deemed to be a “true fee” rather than a tax.⁶ The Michigan Supreme Court in its landmark 1998 decision, *Bolt v City of Lansing*,⁷ announced these criteria. Failing to adhere to the criteria set forth in *Bolt* and interpreted in subsequent cases will result in a fee being held to be an unlawful tax, with consequent potential liability to refund the moneys unlawfully collected.⁸

Bolt and its progeny require that to be found valid, a user fee for an enterprise system must 1) serve a *regulatory*, rather than *revenue-raising* purpose; 2) be *proportional* to the cost of operating the system; and 3) be *voluntary* in that users may refuse or limit system service. The rate model’s assumptions are vulnerable to challenge under this test, and especially under the

⁶ The Headlee Tax-Limitation Amendment provides:

Units of Local Government are hereby prohibited from levying any tax not authorized by law or charter when this section is ratified or from increasing the rate of an existing tax above that rate authorized by law or charter when this section is ratified, without the approval of a majority of the qualified electors of that unit of Local Government voting thereon. . . . The limitations of this section shall not apply to taxes imposed for the payment of principal and interest on bonds or other evidence of indebtedness or for the payment of assessments on contract obligations in anticipation of which bonds are issued which were authorized prior to the effective date of this amendment.

1963 Mich Const, art IX § 31.

⁷ 459 Mich 152 (1998).

⁸ See *Bolt v City of Lansing*, 238 Mich App 37, 51 (1999) (on remand).

first and second parts. *Bolt* therefore presents a significant obstacle to the Growth Plan’s “Unlock Value” objective.⁹

1. The “Unlock Value” strategy is expressly intended to raise revenue.

The rate model’s vulnerability is manifest by its express terms: The model’s stated purpose is to raise revenue. The Growth Plan calls for “unlocking the value” of each local unit’s utility system and channeling that value into the general fund. In most *Bolt* cases, courts must work through some analysis to determine whether a fee’s predominant purpose is to regulate or to raise revenue. To state it differently, a local unit seeking to sustain a fee from *Bolt* attack typically will argue that the challenged fee’s purpose is regulatory in nature, and that any revenue generation is ancillary to its regulatory purpose. Here, the Growth Plan expressly admits to the revenue-raising purpose with the stated objective of “develop[ing] a structure that will allow the cities to unleash the value of their assets and have the proceeds flow into their general fund.” Reducing City property taxes also may be viewed as an admission that fees are disguised taxes, and the application of proceeds of the sale of the City’s system to the City’s general fund will be a red flag to a reviewing court.¹⁰ Thus the rate model is very likely to fail the first element of the *Bolt* test.

⁹ We have considered, but rejected, a potential argument that the rates charged as described under the Growth Plan would not be subject to *Bolt* on the theory that a regional authority charging those rates is not a “local unit” with taxing power within Headlee’s terms, and thus that Headlee, and *Bolt*, does not apply. While it is true that *Bolt* was decided in the context of a Headlee challenge, the reasoning in *Bolt* and subsequent cases interpreting it has been extended beyond Headlee claims; see *Lakeland Neuro-Care Center v State of Michigan*, Ingham County Circuit Court, 02-1326 CZ at 3 (2003). Headlee presents only one type of tax limitation in Michigan, namely a constitutional limit. An entity’s lack of statutory authority to levy a tax represents another, even more absolute, limitation on taxation. A regional authority, presumably created under 1955 PA 233 as discussed below, is subject to such a statutory limitation: it has no power to levy taxes. Thus there are alternative theories—one constitutional and one statutory, each grounded in *Bolt*—which could operate to nullify the rate structure.

¹⁰ That the Lansing general fund was relieved of the burden of stormwater costs previously borne by the general fund was an important element in finding the stormwater fee there to be a tax. See 459 Mich at 168.

2. The proposed rates are not demonstrably proportionate to the cost of providing service.

Under the proposed rate model, user rates are designed to pay for acquisition of the system at a price that is not related to the system's actual value; indeed, the difficulty in establishing a system value is given as a reason for using the Net Operating Cash Flow approach. This runs contrary to *Bolt*'s requirement that rates be based upon the actual cost of providing service,¹¹ thus creating a significant vulnerability that rates can not be shown to be proportionate to the necessary cost of operating (or, in this case, acquiring) the system.

Under the Growth Plan, equalized rates will generate significantly more revenue than necessary to operate the system. In fact, system consolidation is projected to confer a 19.5% decrease in costs, while rates to in-City users increase 93%. The cost increase comes from the Surcharge being added into rates. Proponents of the Growth Plan may argue that the authority has the power to acquire a system in a bargained-for exchange for fair value and set rates sufficient to recover the purchase price—a true statement on its face. The problem here is that the Growth Plan makes no effort to determine actual fair value “in accordance with available technology,” instead setting an arbitrary purchase price.¹² Under the Growth Plan, the Utility Purchase Price is not one fixed amount, but rather a 30-year stream of payments equal to 90% of Net Operating Cash Flow. Revenues are equal to the sum of (1) those revenues actually required to operate and finance the system (fair value under *Bolt*) plus (2) the Surcharge, which is simply the prorated Utility Purchase Price. The stated purchase price formula is circular, since one variable is the purchase price itself. In reality, the actual Surcharge amount comes from the 93% increase in rates paid by in-City users to equalize the rates to current out-City users. This

¹¹ The *Bolt* court held that in order for a user charge to be valid, it must “reflect[] the *actual costs of use*, metered with relative precision in accordance with available technology.” *Id* at 164 (emphasis added).

¹² It would be difficult to demonstrate a true arms-length market price to a reviewing court, since the municipal sellers individually also constitute the municipal purchaser—the authority—collectively.

decision to equalize at current out-City rates is not linked to any calculation of actual system value. Rather, this manner of equalization simply provides a “profit” to the City in the form of a 30-year cash flow. In the absence of any demonstrable valuation of system assets forming the basis of the purchase price, the rate model likely will fail the second element of the *Bolt* test.

3. Users’ ability to refuse or limit service does not eliminate the *Bolt* problem.

Although use of the system (and therefore payment of the rates) arguably is voluntary in the sense that users can control their level of use, water and sewer utilities, and especially sewer utilities in urbanized areas because of mandatory connection, are vulnerable to voluntariness objections.¹³ Thus a favorable finding on the third *Bolt* element cannot be assured. Even if the utility rates are found to be voluntary, courts interpreting *Bolt* have indicated that voluntariness alone will not save a rate plan that fails on the other prongs of *Bolt*.¹⁴ Here, the rate model’s failure to satisfy the regulatory purpose and proportionality prongs of the *Bolt* test is sufficiently overwhelming to render the voluntariness prong inconsequential.

Bolt Conclusion and Recommendation

We conclude that the proposed rate model, if challenged on *Bolt* grounds as being a tax rather than a true fee, stands very little chance of survival. The economic result of the Growth Plan, which generates revenues well in excess of the true cost of service, creates significant potential liability. We cannot recommend its implementation.

In light of the potential refund liability which could arise from an adverse *Bolt* finding, we recommend that an alternative rate model be developed if the regional authority approach is

¹³ *Tobin Group, LLP v Genesee County*, 2004 WL 2875634 (Mich App).

¹⁴ *Grunow v Township of Frankenmuth*, 2002 WL 31376376 (Mich App) (holding that a water connection fee was a tax on the grounds that the charge served no regulatory purpose and was not proportionate to the cost of service, even though voluntariness was uncontested in the case).

followed. The model should resemble the traditional municipal ratemaking model: First, a value for the systems to be sold should be established by a valuation consultant applying a consistent methodology. The courts have not yet considered how to implement *Bolt's* requirement of basing proportionality on “the actual cost of use, [measured] in accordance with available technology”¹⁵ in an asset purchase context. In the absence of guidance from the courts, no particular method of valuation is yet favored; some observers have noted that the most common valuation model for public infrastructure assets is book value including depreciation.¹⁶ In any case the valuation methodology should be reasonable, objectively applied and explainable to a court. Second, the system’s revenue requirements, including amounts covering the value-based acquisition price, should be spread among system users on a cost-of-service basis. The cost-of-service basis means that systems users may be classified based upon differing characteristics of their respective use, and the rates payable by any particular class of system users should reflect the cost of facilities required to provide the service to that class of users. We would recommend the engagement of a professional rate consultant for advice respecting rate-setting methodologies.

¹⁵ 459 Mich at 164.

¹⁶ *Tapping Public Assets: Frequently Asked Questions About Selling or Leasing Infrastructure Assets*, Reason Public Policy Institute, March 2003, pp. 2-3. Compare valuation approved in *Tobin*, 2004 WL 2875634 at 2-3; GASB 34.

B. What are the constitutional, State law, charter, ordinance, and bond limitations upon the City’s legal authority to sell the utilities?

There are five principal sources of law which, taken together, govern the City’s ownership and control of the utilities: The State Constitution,¹⁷ certain State statutes, the City Charter, the City’s Code of Ordinances, and the ordinances authorizing the bonded indebtedness for the utility systems (as defined more fully below, the “Bond Ordinances”). We reviewed each source and discovered three material limitations to the proposed transaction:

- Section 4e(3) of the Home Rule Cities Act provides that money received from the sale of any capital asset of a municipally-owned utility shall either be used for procuring a similar capital asset or retiring bonded indebtedness, i.e., not for general governmental purposes. Although there is case law holding that this limitation does not apply to a municipally-owned waterworks utility operated as a “business,” recent cases blur the distinction between a business and governmental operation. Moreover, the words of the statute do not make any business/governmental distinction. The resulting ambiguity raises the specter of potential litigation on this point and puts at risk the City’s ability to use any sale proceeds for general fund purposes.
- Code of Ordinances Section 28-5 as presently written prohibits the wastewater system sale, because it provides that the system shall remain under City Commission management, supervision and control. Although the City Commission can amend Section 28-5 to permit the sale, the amendment may be subject to a public referendum.

¹⁷ The *Bolt* limitation is a constitutional limitation, but because it is separately treated in Part A of the report, it is not included within the constitutional review discussed in Part B.

- The Bond Ordinances provide that the City shall not sell, lease or dispose of the systems or any material part of the systems unless and until the outstanding bonded indebtedness is paid or defeased.

1. State Constitutional Limitations

We do not find any material State constitutional limitation on the transaction as proposed. The principal applicable provision is Article VII, Section 25, of the 1963 Michigan Constitution, which provides: "No city or village may sell any public utility unless the proposition shall first have been approved by a majority of the electors voting thereon." While Article VII, Section 25, prohibits a city from selling a "public utility" without a vote of its electors, the courts have held that public utilities providing water and sewer are not included in the constitutional prohibition. The provision instead has been held to apply only to public utilities furnishing light, heat or power.¹⁸

The constitution at Article VII, Section 26, also generally prohibits cities from "lending their credit" (which includes donating or transferring assets without adequate consideration) for any private or, except as provided by law, public purpose. Michigan courts have also held that an unlawful lending of credit arises when a municipal corporation attempts to donate or transfer public assets without adequate consideration or attempts to guarantee a debt or obligation of another.¹⁹ The courts further have held, however, that the transfer of property between governmental entities even without monetary consideration does not constitute a lending of

¹⁸ *White v City of Ann Arbor*, 406 Mich 554 (1979); *Holland v City of Garden City*, 299 Mich 465 (1941).

¹⁹ For a lengthier discussion, see *In re Request for Advisory Opinion on Constitutionality of 1986 PA 281*, 430 Mich 93 (1988); *Kaplan v City of Huntington Woods*, 357 Mich 612 (1959). For example, in the absence of consideration, the transfer of a liability such as bonded indebtedness to an authority while a county remained obligated under a full faith and credit pledge can constitute a lending of credit by the county guaranteeing the authority's indebtedness. *Wayne County Bd. of Commissioners v Wayne County Airport Authority*, 253 Mich App 144 (2002).

credit because of the public purpose accomplished.²⁰ The transfer of utility assets among governmental entities therefore falls within this safe harbor and will be permitted.

2. Statutory Limitations

There are two principal State statutes which will have a material bearing on the proposed transaction: The Home Rule Cities Act, 1909 PA 279, as amended (“Act 279”), and the Revenue Bond Act, 1933 PA 94, as amended (“Act 94”). We discuss each in turn.

a. *Act 279, Section 4e(3)*

Act 279 is the fundamental enabling authority empowering cities to adopt charters and controlling what provisions may be included in a charter. Section 4e(3) of Act 279 authorizes a city to provide in its charter for the maintenance, development and operation of its property and to lease, sell or dispose of the property subject to any restrictions placed thereupon by the law. Section 4e(3) goes on to say that, “Provided, that on the sale of any capital asset of a municipally owned utility the money received shall be used in procuring a similar capital asset, or placed in the sinking fund to retire bonds issued for said utility.”

Section 4e(3) thus restricts the use of sale proceeds of any “municipally owned utility.” Act 279 does not define “municipally owned utility,” and although the expression is similar to that used in Art. VII, Sec. 25, of the constitution, the constitutional section is limited to utilities “furnishing light, heat or power.”²¹ Since similar words of limitation are not found in Section 4e(3), it is reasonable to infer that Section 4e(3)’s scope is broader, reaching additional utilities such as water and sewer.

²⁰ See *Sommers v City of Flint*, 355 Mich 655 (1959); *Sinas v City of Lansing*, 7 Mich App 464 (1967).

²¹ 1963 Mich Const, art VII § 25.

*Kalamazoo Municipal Utilities Assoc. v City of Kalamazoo*²² addressed this question. In that case, the Michigan Supreme Court concluded that there is an implied distinction within Section 4e(3) based upon whether the utility is operated for a *governmental* purpose or for a *business* (or “proprietary”) purpose, holding that the section only applies to the sale of property owned and operated by the city for governmental purposes. The *Kalamazoo* court noted that the electric plant at issue was owned by the city as proprietor and operated it for business purposes.²³ The court concluded that the restrictions contained in Section 4e of Act 279 did not apply to the sale of the electric utility, rationalizing that the practical effect of the opposite holding would require a city to perpetually maintain any utility that it was in the business of operating.

Although *Kalamazoo* has not been overruled, there is reason to doubt whether it would be followed today if reconsidered. First, there has been additional statutory and case law development since 1956 on the subject of which municipal activities are “governmental” and which are “proprietary.” These cases have not been brought or argued under Act 279; instead they frequently are brought in the context of determining the limit of governmental immunity from liability under 1964 PA 170 (“Act 170”).²⁴ The argument frequently turns on the question of whether the activity is conducted for the purpose of producing a “profit,” profit indicating a proprietary function. Since, following *Bolt*, a utility system arguably cannot be operated to

²² 345 Mich 318 (1956).

²³ *Id* at 330.

²⁴ State statute provides immunity from liability for governmental functions as opposed to proprietary functions. Section 13 of 1964 PA 170, provides in relevant part:

The immunity of the governmental agency shall not apply to actions to recover for bodily injury or property damage arising out of the performance of a proprietary function as defined in this section. *Proprietary function shall mean any activity which is conducted primarily for the purpose of producing a pecuniary profit for the governmental agency, excluding, however, any activity normally supported by taxes or fees.*

MCL 691.1413 (emphasis added). *See also* MCL 691.1401(f) (definition of “governmental function” for Act 170 purposes).

produce a “profit” (because a true fee’s primary purpose cannot be to “raise revenue”), it is possible to argue by analogy to Act 170 that the operation of water and sewer utilities therefore must be considered a governmental activity. Such arguments are being made in the Michigan courts,²⁵ and to the extent they take hold, *Kalamazoo*’s foundation will be undermined. Second, the current Michigan Supreme Court on several recent occasions has expressed its view that statutes should be construed narrowly, that is, the express language should control the court’s interpretation of a statute.²⁶ If this rule of construction is applied to Section 4e(3), the *Kalamazoo* court’s interpretation the section could well be challenged on the ground that the plain language of the section makes no reference whatsoever to an exception based upon the purpose for which the utility is operated. Amending Section 4e(3) would settle the issue.²⁷

b. Act 94, Sections 8 and 9

Act 94 is the fundamental enabling authority empowering Michigan public corporations to own and operate utility systems, to establish rates and charges for system use, and to issue bonded indebtedness payable from system revenues to finance system improvements. Section 8 of Act 94 creates a statutory lien in favor of bondholders on a utility’s net revenues pledged to the payment of revenue bonds issued under the Act. Section 9 of Act 94 goes on to provide that

²⁵ See *Commerce Center Partnership v City of Saginaw*, unpublished opinion *per curiam* of the Court of Appeals, issued February 23, 2006 (Docket No. 258137). See generally *Jenkins v City of Detroit*, 138 Mich App 800 (1984) (Detroit sewer system construction held to be governmental function for governmental immunity purposes because it was designed to serve six heavily-populated counties in southeast Michigan and enhance Great Lakes water quality); *Crosby v City of Detroit*, 123 Mich App 213 (1983), *lv den* 422 Mich 891(1985) (regional sewer system construction held to be governmental function for governmental immunity purposes).

²⁶ The Michigan Supreme Court recently overruled long lines of precedent in favor of the plain statutory language. See *Devillers v Auto Club Insurance Assoc*, 473 Mich 562 (2005) (overruling doctrine of equitable tolling in favor of plain language of no-fault statute); *People v Lively*, 470 Mich 248 (2004) (overruling long-standing materiality requirement for perjury in favor of plain language of perjury statute).

²⁷ The Legislature has amended Act 279 on at least two prior occasions to remove restrictions on the sale of city-owned property and a prohibition on the sale of land used for a public utility. 1911 PA 203 contained a prohibition on the sale of “any property of value in excess of ten cents [later \$2] per capita...or any real estate used in carrying on a public utility....” The section applicable to public utilities was deleted by 1923 PA 119 and the section restricting the sale of property of a value in excess of the limit was repealed by 1949 PA 207.

the lien remains in effect either until the bonds are paid in full or, if the bond authorizing ordinance so provides, other security is substituted providing for bond repayment.

The City has issued several series of water and sewer revenue bonds pursuant to Act 94, to which the net revenues of the systems are pledged. Bondholders therefore “own” the revenues pledged to the payment of the bonds, and that ownership right is second only to the systems’ operation and maintenance expenses.

We do not find any other material limitations on the transaction within Act 94. The Bond Ordinances incorporate and implement the lien and pledge provisions, with material impact upon system ownership, as discussed more fully below.

3. City Charter Limitations

We do not find any material City Charter limitations on the transaction as proposed. There are two relevant provisions: First, Charter Sec. 97, entitled “Power of City to Acquire and Dispose of Property,” grants the City Commission the power to convey or dispose of property. This action requires a majority vote of all elected members (not merely those present) and cannot be acted upon at the same meeting at which the conveyance or disposition is introduced. Second, Charter Sec. 157, entitled “Power of City to Acquire and Operate Utilities,” grants the City the power to sell and deliver the products or service of a utility. This section, however, does not authorize the city to sell the utility itself, nor does it contain any restriction on the sale of the utility.

4. Code of Ordinances Limitations

There is a material limitation on the proposed transaction arising from the City's Code of Ordinances (the “Code”). Code Section 28-5 provides that “the wastewater system shall be and remain under the management, supervision and control of the City Commission....” (emphasis

added). In order for any sale of the wastewater system to occur, this section of the Code will have to be amended to allow for a sale. There is no analogous requirement pertaining to the water system.²⁸

The City Commission may propose and enact ordinance amendments from time to time.²⁹ Ordinance amendments, however, are subject to the referendum provisions found in Charter Sec. 63.³⁰ While on its face Charter Sec. 63 grants a referendum right respecting any non-emergency ordinance, the Michigan Supreme Court in *Beach v City of Saline*³¹ held that a charter right of referendum only extends to “legislative” acts and not to “administrative” acts. Therefore whether an ordinance amending Code Sec. 28-5 is subject to the referendum right depends upon whether the amending ordinance is deemed a legislative act or an administrative act.

There is little definitive case law guidance on whether an action is legislative or administrative. Together with *Beach*, the leading Michigan case is *West v City of Portage*,³² in

²⁸ Code Section 38-7 provides that water service *connections* shall be “installed and maintained” under the direction and control of the City’s Director of Utilities, but we do not believe this rises to the level of requiring continued management, supervision and control of the system.

²⁹ See Kalamazoo City Charter, § 12(a), (b).

³⁰ Section 4i(g) of Act 279 authorizes cities to provide in their charters for initiative and referendum on all matters within the scope of the powers of the city. Charter Sec. 63 implements this power and provides:

If within twenty (20) days from the time of the enactment of any ordinance other than emergency measures by the City Commission or if at any time before the same shall have been published or posted and due notice of enactment given as provided in section 14 of this Charter, a petition shall be filed with the City Clerk protesting against such ordinance taking effect and signed by registered voters of the City in number of not less than fifteen percent (15%) of the number of total valid ballots cast for Commissioners at the last preceding regular election and verified as required in Section 32 of this Charter and certified by the Clerk as required in this Charter, the same shall thereupon be suspended from taking effect; and the City Commission shall at its next regular session reconsider such ordinance and act thereon; and if the same be not entirely repealed the City Commission shall submit such ordinance by the method hereinbefore provided for referendum or ordinances initiated by petition, to the vote of the qualified electors of the City, either at the next regular municipal election or at a special election which may be called for that purpose at the discretion of the City Commission and such ordinance shall take effect unless a majority of the qualified electors voting thereon at such election shall vote in favor thereof.

³¹ 412 Mich 729 (1982). In *Beach*, the court examined a city's decision to purchase a plot of land, concluding that there is nothing inherently legislative about a decision to acquire real estate.

³² 392 Mich 458 (1974).

which the court decided that amending the zoning ordinance to effect a “change in the zoning of a particular property, although in form and in traditional analysis thought to be legislative action, is in substance an administrative, not legislative act.”³³ The *Beach* court examined numerous decisions from other states and relied on a Nebraska decision which “suggested as a test ... ‘whether the action taken was the one making a law, or executing or administering a law already in existence.’”³⁴

These cases are not particularly helpful in forecasting how a trial or appellate court would decide the question of whether an ordinance amending Code Sec. 28-5 would be considered “legislative” (and therefore subject to referendum) or “administrative” (and not subject to referendum). On the one hand, the *Beach* court found that the purchase of an asset—real estate—was administrative and not subject to referendum. This suggests that the sale of an asset similarly should be considered an administrative act. On the other hand, the proposed amendment to Code Sec. 28-5 is a material change, and arguably resembles the making of a new law rather than merely executing one already in existence. This ambiguity would provide an adequate basis to for an interested party to pursue a referendum on the amendment under Charter Sec. 63. Given the paucity of decided precedent, a court confronted by the question again would have wide discretion over how to decide. We therefore recommend this as a second area of legislative clarification by amendment to Act 279.³⁵

³³ *Id* at 461.

³⁴ *Id* at 470, quoting *Kelley v John*, 162 Neb 319; 75 NW2d 713, 714-15 (1956).

³⁵ The City further could assert, as an additional alternative, that the ordinance amending Code Section 28-5 was adopted pursuant to Act 94. Act 94 grants ordinance power in respect of revenue utilities, and ordinances adopted under Act 94 are not subject to referendum. This argument is weakened by Code Section 28-5, and the Code of Ordinances generally, having been adopted pursuant to the City’s ordinance power found in Act 279 and the City Charter. Thus while the argument may be worth asserting, we do not find it dispositive.

5. Bond Ordinance Limitations

There is a material limitation on the proposed transaction arising from the Bond Ordinances. The City has five outstanding revenue bond issues for the water system and one outstanding revenue bond issue for the sewer system.³⁶ The respective Bond Ordinances³⁷ create the statutory lien required by Act 94 discussed above. The Bond Ordinances in addition require that the operation, repair and management of the system remain under the control of the City Commission and further contain a covenant that the City will not sell, lease or dispose of the system or any substantial part of the system until all of the bonds are paid in full.³⁸ The Bond Ordinances constitute a contract with bondholders upon which bondholders are entitled to rely for so long as the bonds are outstanding.

Once the bonds are paid in full, the statutory lien on net revenues is extinguished, bondholders no longer have any rights in the Bond Ordinances, and covenants are inoperative. Full repayment may take the form of actual redemption of outstanding bonds, or in the alternative, the Bond Ordinances permit defeasance of the bonds and release of the lien and covenants under the Bond Ordinances if “sufficient cash or Sufficient Government Obligations have been deposited in trust for payment in full of the outstanding bonds.”³⁹ Repayment or defeasance of the bonds therefore will be a precondition to selling the systems.

³⁶ The 1999 Water Revenue Bonds, 1996 Water Revenue Bonds, Water Supply System Revenue Refunding Bonds, Series 2002, Water Supply System Revenue Refunding Bonds, Series 2002B, 2004 Water Revenue Bonds, and 2001 Wastewater Revenue Bonds.

³⁷ The water supply system bonds were issued pursuant to Ordinance Nos. 1541, 1583, 1616, 1731, 1744 and 1765. The wastewater system bonds were issued pursuant to Ordinance No. 1718.

³⁸ See Ordinance Nos. 1541 § 18; 1781 § 19.

³⁹ See Ordinance Nos. 1718 § 7; 1731 § 6, 1744 § 6.

C. What other limitations are imposed by receipt of federal grants for the wastewater system, by the rate settlement agreements, or by the regional authority enabling legislation?

Our final area of review covered the grant requirements in respect of the federal grants received by the City for the wastewater plant; the rate settlement agreements among the City and various of its municipal customers; and the regional authority's enabling legislation. We discovered a material limitation to the proposed transaction in respect of the federal grants:

- Current federal law and regulation could stymie the Growth Plan's objectives. EPA property disposition regulations either require a substantial repayment of federal grant dollars, or avoid the grant repayment while at the same time discouraging a meaningful compensation payment to the City. Under either alternative, EPA approval of the asset conveyance is required.

1. Federal Grant Restrictions

The City received approximately \$92,000,000 in federal grants to renovate and expand its wastewater treatment system in the 1970s and 1980s. There are numerous conditions attached to those grants. One of the conditions requires grant-funded property to be used for the originally-authorized purpose as long as needed for that purpose. It also restricts the grantee (the City) from disposing of or encumbering the title to the grant-funded property.⁴⁰ Another condition provides that when grant-funded property is no longer needed for the originally-authorized purpose, the grantee must obtain EPA approval before it may dispose of or convey its interest in the property.⁴¹

⁴⁰ 40 CFR 31.31(b).

⁴¹ 40 CFR 31.31(c).

According to our discussions with an EPA representative, EPA historically has considered two alternative methods by which public entities may sell grant-funded property. Each alternative requires EPA approval. First, the City may follow the standard EPA sale-of-property regulations, in which case the City would be required to refund to EPA a percentage of any compensation received for the sale equal to the federal grant share (approximately 75%) of the original project costs, less any actual and reasonable selling and fixing-up expenses.⁴²

Second, the City may seek EPA approval under Executive Order No. 12803 (“EO 12803”). EO 12803, issued in 1992, facilitates privatization of federally-funded public facilities. The EPA representative has informed us that even though the proposed transfer from the City to a regional authority would not involve a private entity, the EPA would consider EO 12803 to be applicable if the City receives any compensation (or “non-operational revenues” as the EPA describes it) for the transfer.

EO 12803 also includes a grant refund requirement. The refund, however, would be calculated using an accelerated depreciation schedule (MARCS 15-year, half-year depreciation schedule). According to the EPA representative, all of the City’s grants would be depreciated to zero under the MARCS accelerated depreciation schedule. Using the EO 12803 alternative therefore avoids in total the grant refund requirement.

Obtaining EPA approval under EO 12803, although not requiring a refund to EPA, would apparently be neither easy nor simple. The procedure is set forth in an EPA document entitled “Guidance on the Privatization of Federally Funded Wastewater Treatment Works.”⁴³ The approval process requires the City to submit a request for approval of a deviation from the EPA’s standard grant regulations regarding disposition of property. The request further includes a

⁴² 40 CFR 31.31(c)(2).

⁴³ EPA-832-B-00-002, August 2000.

request for EPA's review and approval of any transfer/disposition agreement. The submittal must include a substantial amount of information, including financial information, regarding the transfer's effect.

In evaluating the deviation request, EPA will consider, among other things: (1) the amount of public participation in the decision, such as public notices, meetings, news media coverage, etc, (2) the amount and use of any proposed compensation received by the City for the transfer, in both present worth dollars and total value, (3) oversight responsibility for the system, (4) employee status, and (5) the impact of the transfer on user fees, including projected user fees for residential users over the life of the agreement. The impact evaluation would include the total cost savings that will result from the transfer, in both present worth dollars and total value.

From our discussions with the EPA representative it is clear that the EPA is not enthused about compensation being paid for these types of transfers. It appears the EPA considers the payment of compensation to be an extra cost which ultimately is paid by the users of the system through increased rates. The EPA representative also indicated that the EPA has never approved a public-to-public transfer that included a payment of compensation for the facility. The representative also estimated that it would take four to six months to go through the EO 12803 review and approval process. The representative expressed willingness to assist if it was decided to proceed under EO 12803.

The EPA representative also suggested another approach under EO 12803: If the transfer was made without any compensation being paid to the City, the EPA approval process very likely would be easier and faster. It would consist of EPA's approval of the transfer of the title, assets, liabilities and permits of the facility to the regional authority. In effect, this would be just

a public-to-public “lock, stock, and barrel” transfer of the entire facility, without any compensation being exchanged.

Since the two approaches currently permitted under federal law are at odds with the Growth Plan’s objectives (either by requiring a substantial grant repayment or by precluding payment of compensation, in each case depriving the City of its anticipated consideration for the sale), we suggest an alternative approach. The regional stakeholders may wish to pursue a federal legislative amendment to secure (or eliminate the requirement for) EPA discretion and approval of this specific transfer. While the practical and political aspects of such an approach are beyond the scope of this legal analysis, it is offered as a possible option for further evaluation and consideration.

We believe there may be an additional method available under EPA regulations, not originally suggested or considered by the EPA representative, which could provide a basis for EPA to permit greater compensation. The method would involve transfer of title to the authority under 40 CFR 31.31(c)(3), which arguably allows the City to be paid a percentage of fair market value equaling the City’s percentage participation in the original project cost. To our knowledge the approach has never been considered previously by the EPA, but we believe it has merit and we have suggested it to the EPA representative. The EPA representative indicated tentatively a willingness to consider the new approach. He also indicated that whether the EPA might approve the approach could depend significantly on the final transaction terms, the amount of compensation, and the effect on user fees.

2. The Regional Authority

We recommend that the regional authority be created under the provisions of 1955 PA 233, as amended (“Act 233”). Act 233 has been used by a considerable number of Michigan

municipalities as a vehicle to collectively own and operate water supply and sanitary sewer utilities. We find no provisions in Act 233 which will place limitations on the transaction; to the contrary, a number of provisions are useful in achieving the Growth Plan's objectives. The following is a brief overview of the powers and structure of an Act 233 regional authority.

Creation and Powers. Act 233 authorities may be formed by two or more cities, townships, villages or counties to acquire, own, improve, enlarge, extend, and operate water supply and sewage disposal systems. The authority contracts with its member municipalities to provide the utility service. The authority is a separate public body corporate with power to sue and be sued in any court in the state and with the powers necessary to carry out its purposes.

An authority is created by the adoption of resolutions by the cooperating municipalities approving articles of incorporation for the authority. The articles of incorporation must include the authority's name, the names of its member municipalities, the authority's purpose, the authority's powers, duties and limitations (normally reflecting all powers available under State law), the method of selecting its governing body, officers and employees, the authority's effective date, and the person charged with the duty of completing the documentary formalities. After adoption, the articles of incorporation must be published in a newspaper of general circulation in the member communities and filed with the County Clerk and the Michigan Secretary of State. The authority is conclusively presumed to have been validly incorporated unless questioned in court within 60 days after the filing of the certified copies with the Secretary of State and the County Clerk.

Board. Act 233 requires no set method of selecting the authority's governing body, instead leaving the board structure to be determined by the member municipalities and provided

in the articles of incorporation. The Act therefore permits the local units creating the authority to structure the board in a manner which meets the objectives of the member municipalities.

Authority Lacks Taxing Power; System Financing. An Act 233 authority is expressly precluded from having taxing power.⁴⁴ An Act 233 authority therefore is limited to supporting its operations through rates and charges received pursuant to contracts with constituent municipalities. The authority can issue bonds to finance acquisition and construction of a system, to which the authority's revenues may be pledged, although it is common that each contracting municipality pledges its limited tax full faith and credit as secondary security for the bonds.

Contracts with Municipalities; Rates Imposed. The authority contracts with its member municipalities for the provision of service. The authority may contract with non-member municipalities for service as well. The charges and rates of the authority are to be set forth in the contracts with municipalities, although they may be subject to change by the authority if necessary to meet its obligations.⁴⁵

3. Rate Settlement Agreements

The City has entered into two separate rate settlement agreements pertaining to the water system; neither agreement limits the proposed transaction in any material respect. One agreement was entered into in 1998 between the City and the City of Portage (the "Portage Agreement"). The Portage Agreement allows the City to calculate rates using the utility basis of ratemaking, requires the City to conduct a rate study every two years, and allows the City of Portage ("Portage") access to all of its records. In addition, the parties agree that the City shall

⁴⁴ MCL 124.293.

⁴⁵ MCL 124.287, .290.

recognize a \$1 million system-wide contribution in aid of construction made by Portage as of January 1, 1999, to be amortized over a 20-year period (through 2018), when calculating rates. Arguably the present value of this contribution may have to be taken into account when determining the value of the system for potential transfer or sale and some type of prorated credit may be due to Portage. The Portage Agreement otherwise places no limitation on the City as to retaining the system or prohibiting its sale or transfer.

The other rate settlement agreement was entered into in 1988 with the Townships of Oshtemo, Comstock and Texas, and the Gull Lake Authority (the "Township Agreement"). The Township Agreement resolves allegations related to unfair rates, charges, and administration of the water system. This Agreement places no limitation on the City as to retaining the system or prohibiting its sale or transfer. In fact, the Agreement foresees creation of an authority to manage the system in the future.

III. RECOMMENDATIONS

Based upon the foregoing analysis, we are making the following recommendations in respect of the Growth Plan proposal:

1. Establish a sale price for the systems based upon objective, demonstrable measures of asset value, using a valuation methodology which is reasonable, consistently applied, and explainable to a court.
2. Establish a rate-setting methodology that spreads the systems' acquisition cost over all users on a standard cost-allocation basis attributing the cost of providing service to classes of customers in relation to use characteristics.
3. Pursue an amendment to 1909 PA 279, Sec. 4e(3), regarding permissible use of proceeds from the sale of a municipally owned utility.
4. Pursue an amendment to 1909 PA 279, Sec. 4i(g), clarifying appropriate subjects of referenda.
5. Structure the transaction to provide for repayment or defeasance of the existing systems' debt coincident with sale of the systems to the authority.
6. Seek EPA approval of the wastewater system sale under CFR 31.31 or EO 12803. In the alternative, seek Congressional assistance in respect of the regulation.
7. Use 1955 PA 233 as the appropriate means of incorporating a regional authority.