

AN INVESTIGATION OF MUNICIPAL UTILITY FUNDING FOR EL CENTRO, CALIFORNIA

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ABSTRACT

To complement an economic and engineering-evaluation of nonelectric utilization of hydrothermal resources in the City of El Centro pursuant to a DOE-funded study, an institutional barriers assessment was undertaken. This assessment explored two major topics, the first of which was the investigation of institutional options available to the City of El Centro in structuring a publicly-controlled geothermal utility for space heating/cooling and hot water heating. After reviewing each option, the municipal utility and nonprofit corporation were chosen as viable alternatives for an El Centro utility system. The second topic explored was the financing for such a utility. It was concluded that financing via traditional sources of municipal funding may be difficult. However, tax-exempt financing through a lease-purchase arrangement with a nonprofit corporation may be feasible.

INTRODUCTION

The City of El Centro, with a population of approximately 25,000, is a general law city organized pursuant to the laws of California. The City currently provides no utility service to residents. The Imperial Irrigation District (IID), a quasi-public corporation, provides electrical service, while Southern California Gas Company, an investor-owned utility, supplies natural gas.

Given these factors early study efforts focused on administrative options suitable for a geothermal utility and the financial resources potentially available for developing a utility.

Discussions with City staff indicated an initial reluctance to organize a utility that was totally municipally owned and operated. There was doubt that the City had adequate resources to secure funding and to provide the man-

power required by utility operation. It was suggested that the City approach the Imperial Irrigation District (IID) to determine what interest the District might have in participating in a utility project.

However, shortly thereafter, the City learned that it owned several parcels of land overlying a potential geothermal resource which might be suitable for development. At this point, interest in a more City-controlled operation emerged. Nevertheless, the City Attorney contacted IID management. Late in the second quarter of the study, an IID spokesman indicated to City staff that any joint participation between the City and the IID was not then feasible.

At this juncture, legal constraints to the formation of each of two selected utility options were identified. These constraints fell into two major categories: (1) the authority of El Centro to organize or to participate in the organization of a geothermal utility; and (2) the financing mechanisms available to the City for implementing a selected option.

A MUNICIPALLY-OWNED UTILITY

The present City Department of Public Works would provide the maximum opportunity for local control of a geothermal operation.

Because El Centro is a general law city, it possesses only those powers expressly given it by the California State Constitution or general laws of the State, or those impliedly granted as necessary and appropriate to the effective exercise of its express powers. Section 9 of Article XI to the California Constitution states that, "A municipal corporation may establish, purchase, and operate public works to furnish its inhabitants with light, water, power, or heat. . ." Further authorization for a utility operation is given by statute

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which states in part: "the legislative body (of a municipality) may acquire, own, construct, maintain and operate... gas and other works for light, power, and heat.. .".

Based on the foregoing, El Centro clearly has the authority to operate a municipal geothermal utility. The financing of such an operation, however, poses a more difficult problem. Four alternative vehicles for raising needed utility capital were evaluated: (1) general obligation bonds; (2) revenue bonds; (3) a loan guaranteed under the Department of Energy Loan Guaranty Program; and (4) a government-funded loan or grant.

General Obligation Bonds

These bonds have typically been the principal means of financing major capital improvements by local government. Such bonds must be approved by the voters. They are ultimately backed by a property tax sufficient to cover the debt service which can be guaranteed by the local government under its taxing power.

In California, the legislative body of a municipality has the authority to issue general obligation bonds for any "municipal improvement" requiring an expenditure greater than the amount allowed for it by the annual tax levy. The definition of municipal improvement includes construction of power works, which appears sufficiently broad to include a district heating and cooling system.

Nevertheless, voter approval of a State constitutional amendment referred to as Proposition 13 has severely restricted future general obligation bond issuances. Proposition 13 generally limits ad valorem taxes on real property to a maximum of one (1) percent of full cash value of real property. Without the authority to tax beyond the one percent ceiling, the City can no longer consider this means of financing for a utility system.

Revenue Bonds

These bonds are usually governmental obligations secured by the revenues generated by the facility financed rather than by the municipality's taxing authority. A California statute limits the power of a municipality to issue revenue bonds to "enterprises" constructed for enumerated purposes. Supplying water and electricity are two statutory purposes arguably applicable to geothermal utilization in El Centro. Under the

first category, bonds can be issued for a system used for "the obtaining, conserving, treating and supplying of water for domestic use..., industrial use..., or any other public or private uses."

For the study, it was assumed that geothermal brine, in passing through a heat exchanger, would heat water which would be "supplied" via a distribution system to various end users. A broad construction of the statute would allow revenue bond financing for the described scenario particularly if municipal development of the resource were excluded. In the latter situation, there would be less concern that the project involved too great a risk for revenue bond financing, and that it might include a non-water resource in possible contravention of the statute.

The second category of an "enterprise" for which revenue bond financing is available is one used for "the generation, production, or transmission of electric energy for lighting, heating and power.. ." The statute makes reference to an electric system; El Centro's proposed system is nonelectric. Nevertheless, the end uses to which both systems are dedicated remain the same—heating/power applications. One can argue that to disallow revenue bond financing for nonelectric, but not electric applications frustrates the purpose of the statute. This reasoning may be persuasive where, as here, the state of the art in energy applications at the time of statutory enactment precluded legislative consideration of alternative energy financing. It should be noted that the statutory language clearly omits funding for the distribution system of any project.

What effect will Proposition 13 have on this method of financing? It has been suggested that local governments may continue to fund projects by revenue bond issuances, unless there is investor concern about the uncertainty of local government revenues because of Proposition 13.

A DOE Loan Guaranty

The loan guaranty program was created to minimize the financial risk in geothermal energy by guarantying loans made by certified lenders to qualified borrowers. El Centro's proposed utilization of geothermal energy for space heating/cooling, and domestic hot water heating qualifies for a guaranty under the project category related to the development, construction, and operation of equipment or facilities for the demonstration or commercial production of energy from geothermal resources.

Amendments and proposed regulations to the statute have attempted to provide incentives for a small municipality to apply. Of interest to El Centro are changes which permit DOE (1) to make interest differential payments for guaranties on taxable borrowing by municipalities and other political subdivisions of states; and (2) to guarantee 75 percent of a project's total estimated costs up to \$50 million for a non-electric project or \$200 million per borrower. The study concluded that El Centro's needs will likely be within the loan guaranty dollar limitation, even if the entire residential and commercial sectors of El Centro were retrofitted.

Another provision permits "sunk costs", or costs already expended on a project, to be applied toward the aggregate project cost. Assuming a City-wide district heating and cooling system were feasible the City of El Centro could locate district facilities on City-owned property. The market value of such property could be applied toward the equity portion of funding; the property itself would serve as project collateral for the loan guaranty. However, City contributions toward the DOE-sponsored Field Experiment would not qualify as sunk costs and would be deducted from the total available for the loan guaranty*

Government Grants or Loans

A final source of funding considered for an El Centro municipal utility was a Federal or State grant/loan. There does not appear to be any major state funding program for a geothermal municipal utility concept. On the Federal level, the Economic Development Administration (EDA)-administered Grants for Public Works and Development Facilities was initially identified. The EDA programs help areas which suffer from high unemployment and low family incomes. Eligible projects may receive funding for 50 percent of total eligible project costs, but must be located in an EDA-designated area. El Centro is within such an area. Eligible projects include utilities, but exclude those utilities involving (1) the generation, transmission, or distribution of electric energy; (2) the production or transmission of gas; or (3) competition with an existing privately-owned public utility. Since Southern California Gas Company falls within this third category, funding for a utility serving the residential and commercial sectors was clearly unavailable.

The Southwest Border Regional Commission (SBRC) has a similar funding

Province program for local governments in designated counties of the southwest, including Imperial County in which El Centro is situated. Like the EDA programs, no assistance is given to projects in categories (1) and (2) above. However, competition with an existing private utility is not prohibited. Nor will El Centro's proposed utility utilize either "electric energy" or "gas".

A final area of grant activity is the Department of Housing and Urban Development (HUD) Block Grant program. HUD provides 100 percent Federal grants (with no matching requirement) to local governments for funding activities in such areas as housing rehabilitation and the acquisition, rehabilitation, or construction of certain public works facilities and improvements.

NON-PROFIT CORPORATION

The formation of a non-profit corporation is governed by state statutory schemes. Under the California statute, corporate power is vested in a Board of Directors. By choosing the City Council as its Board of Directors, the City would maintain strict control over utility operations. However, in this situation, a potential conflict of interest problem could arise. For El Centro, an independent Board to direct utility affairs was considered the better alternative.

The choice of a non-profit corporation for utility formation permits the issuance of bonds without the necessity of voter approval, yet the funding for the project must still be arranged. Typically, an agreement between the City and corporation provides that bonds for construction will be issued by the non-profit corporation on behalf of the municipality and will be served out of periodic payments made to the corporation by the City. Variations of lease revenue bond issuances are usually upheld against attacks that they are violative of debt limitation provisions existing in many (e.g. California) state constitutions.

In order for the corporation's bonds to be given tax-exempt treatment, the corporation must comply with the requirements of Revenue Ruling 63-20. That ruling, in part, requires that the sponsoring city (i.e. one on whose behalf the bonds are issued) acquire title to the utility at the end of financing. This in turn requires that there be a capital asset, i.e. some "facility", to transfer. In the case of geothermal exploration, the only arguable facility is the geothermal supply well. In the

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development phase, the district heating and cooling system would ostensibly qualify. Typically, the non-profit corporation agrees only to supply the "facility" in return for "rental" payments. These payments in effect reflect an amount sufficient to return the principal cost of construction (or drilling) plus interest. The City usually reimburses the corporation for taxes, assessments and insurance, and agrees to maintain the facility.

The foregoing arrangement may become unavailable if regulations proposed by the U.S. Treasury on February 2, 1976, are adopted. Those proposed changes redefine which entities are eligible issuers of tax-exempt bonds under Section 103(a) of the Internal Revenue Code and outline who may be an issuer "on-behalf-of" a state or political subdivision. No final action has been taken on these proposed regulations. Recent I.R.S. rulings based upon the current regulations have held that a state university and community development authority were not a "political subdivision" for purposes of Section 103(a). Later "clarifications" appeared to reverse any negative effects of these rulings, but do illustrate the uncertainties presently surrounding tax-exempt issuances.

Should the City of El Centro apply for a DOE loan guaranty? the interest on the non-profit corporation's securities must be taxable. It has been suggested by other writers that this may raise securities" registration and other regulatory compliance problems.

The Federal securities law exempts from registration those securities guaranteed by the United States. Since the bonds of' the non-profit corporation would be tied to the loan guaranty, the issue would likely be exempt under the statute. "No action" letters issued by the Securities and Exchange Commission (SEC) in situations involving similar guaranties indicate that the exemption from registration applies as long as the full faith and credit of the United States is backing the guaranty. The statute authorizing the Loan Guaranty Program now states that the full faith and credit of the United States supports these guaranties. Language in California securities' qualification laws is patterned after the Federal statute and would therefore, call for a similar result.

The California Public Utilities Commission (CPLJC) also has extensive jurisdiction over public utilities in the areas of securities' issuances and rates. The California Public Utilities

Code grants exemption for CPUC jurisdiction in the area of securities' issuance to those corporations "performing services or delivering commodities to or for...municipal...corporations". The non-profit corporation would be performing such services; therefore, its issuances would probably be exempt.

The Code likewise exempts municipally-operated utilities from the CPUC's rate-making jurisdiction. Since the non-profit corporation would act under City auspices, it is likely that the governing body rather than the CPUC, would set rates for utility service.

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