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Mark D. Rasch

Frank Butterini

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THE WATER FINANCE AUTHORITY

An Evaluation

by Mark D. Rasch and Frank Butterini

Editor's note: The Water Finance Authority proposal was sent to the N.Y. Senate Rules Committee on July 2, 1982. The bill never emerged from committee, nor was it reintroduced in the legislature. While this particular proposal may have been set aside, the issues it concerns have not disappeared. We have elected to include this article for its general examination of the political and economic costs of revenue financing as opposed to general obligation financing.

Due to increased energy and transportation costs and water shortages in the Southwest, industries are re-examining the advantages of remaining or expanding in the northeastern United States. This places the City of Buffalo, with Lake Erie sitting in its lap, in a very advantageous position; yet, the city's water system is antiquated, a victim of age and neglect. An important question facing Western New York is whether Buffalo can utilize its great water asset, particularly in light of estimates which place the price of modernizing the city's water system in the $200 million to $500 million range.

While water resources are plentiful in Western New York, the people and industries which have located in the Sun Belt are being confronted with one immutable fact: that area does not have any water resources. Water is pumped in from a number of sources, primarily ground aquifers such as the Ogallala Aquifer, which stretches from western Texas to northern Nebraska. But each day, twenty-one billion more gallons flow out than seep into these ground sources. Some experts say that the Sun Belt's current reliance upon such sources is one of "buying time"; severe water depletion, if not outright exhaustion in many instances, is predicted within thirty to fifty years.

Mark D. Rasch is a J.D., 1983, State University of New York at Buffalo.
Frank Butterini is a J.D., 1983, State University of New York at Buffalo.

The New York State Water Finance Authority has been proposed, by members of the state legislature, as a mechanism for allowing municipalities to exceed constitutionally imposed debt limits. This would permit localities to utilize the proceeds of revenue bonds to modernize their inadequate water and sewer systems.

While the proposal attempts to deal with pressing local and statewide needs, it is ill-advised. It could easily have the effect of placing localities such as Buffalo in an economic straitjacket which would hinder, rather than promote, economic development. This article examines both the history of water and sewer systems administration and the Water Finance Authority proposal with its implications. It concludes with suggestions for better methods of financing capital projects.

I. THE FISCAL HISTORY OF LOCAL-CONTROLLER WATER SYSTEMS

The City of Buffalo's water distribution system is antiquated, designed in the nineteenth century with more than half of its eight hundred miles of water mains built before 1930. The city loses about 10 percent of the one hundred million or more gallons it pumps daily due to the age and disrepair of the water supply infrastructure. The pumps, transmission lines, and management systems need upgrading. Estimates regarding the cost of modernizing the system range from $200 million to $500 million—figures that dwarf anything that has been done in the city before. (*See*, The Report of Government Finance Associates, Inc., Princeton, New Jersey, April 17, 1980.)

When Buffalo's water system was installed during the early decades of this century, user fees were implemented to recoup the cost of construction and operation. Use taxes or fees are levied on property owners in relation to the actual service or benefit received. As with other cities in the state, once the basic water system was in place, little effort was expended by the municipality to provide funds for capi-

tal rehabilitation. The revenues from the water projects were placed into general coffers. At the outset, most water projects and user fees were overvalued in light of the long, actual useful life of these projects. Because water finance fees represented a steady stream of revenue to the city, there was strong incentive for the municipality to use these funds (to the extent that they were not needed for the day-to-day operation of the water department) to subsidize other municipal projects for public health and for police and fire protection. The arrangement worked while the water projects were running at a profit.

Because of the political difficulty with raising user fees (perceived as taxes by residents), the disparity between costs of providing services and the fees charged narrowed. Profits disappeared as the systems began operating at a loss. The municipality was then faced with the choice of raising fees, subsidizing operations and construction with other municipal revenues, or deferring, delaying, or eliminating entirely capital improvements. Politicians—out of a desire to meet current needs of police and health protection and because of the invisible nature of these capital improvements—preferred the latter course of action. As a result, water systems, which should have been on an eighty-year maintenance cycle, have instead been maintained as if they have a useful life cycle of three hundred to four hundred years. Debilitation has set in, threatening the distribution of the area's water resources. It is to correct such situations statewide that the Water Finance Authority was proposed.

Adding to the neglect of municipal water systems has been the lack of federal financial assistance. While the federal government has paid more than 50 percent of the cost of sewage treatment and disposal, it has contributed only 4 percent to the cost of water supply, with the City of Buffalo itself paying the balance. One major solution, therefore, to the current deterioration of the water system would be for the federal government to make water supply a priority.

II. THE WATER FINANCE AUTHORITY CONCEPT

The primary purpose of the proposal is to permit municipalities of the state, through the Public Authority, to float revenue bonds to pay for the repair, construction, reconstruction, and rehabilitation of water and sewage treatment facilities. Under the plan, the state legislature would create the New York State Water Finance Authority. In the statement of the bill's purpose, the drafters declared that:

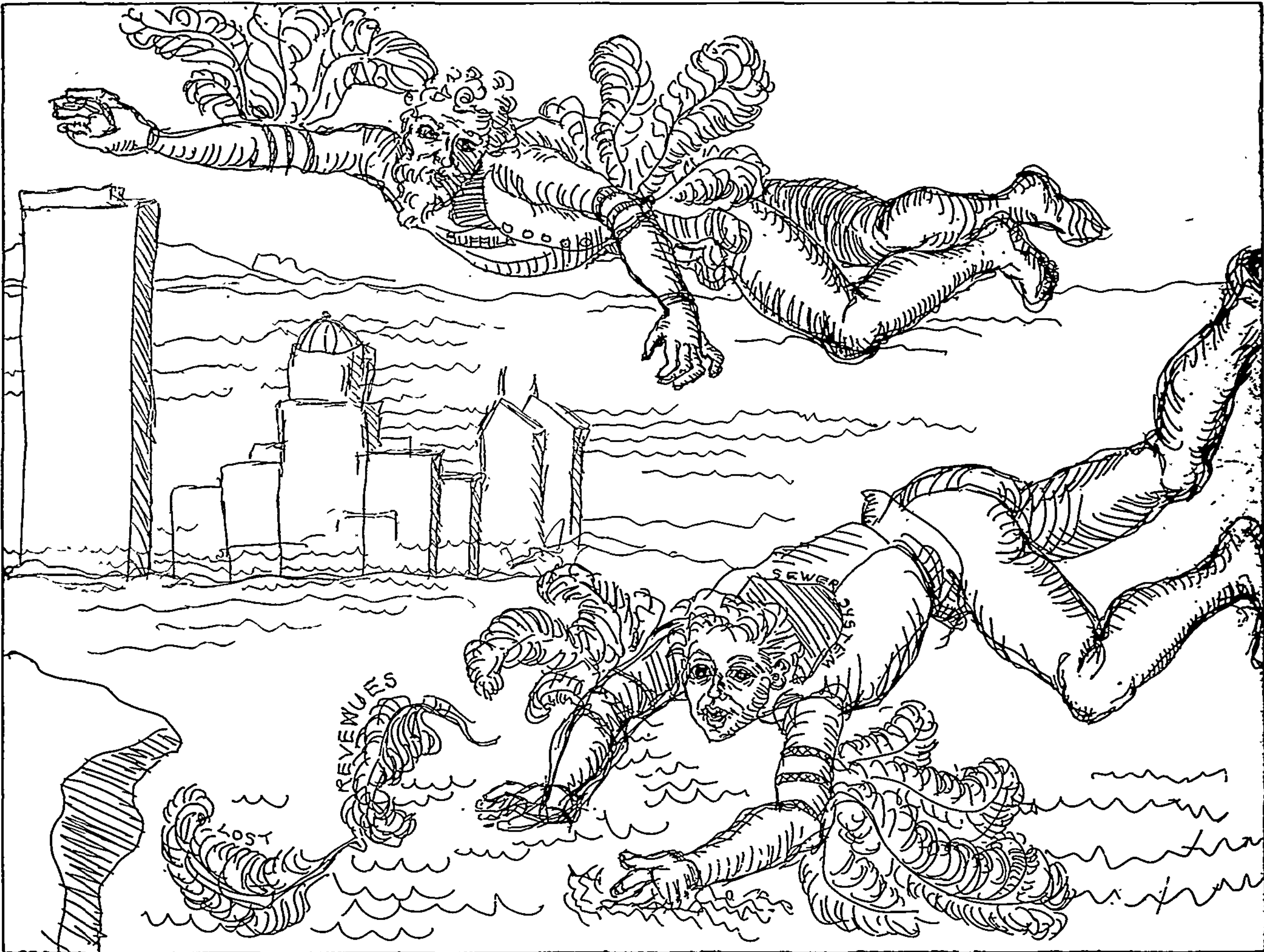
> Unprecedented high interest rates and increased capital costs have caused difficulty for a number of municipalities in selling a sufficient amount of general obligation securities to meet all the capital requirements related to needed construction or reconstruction of and additions to their water and sewerage systems.
> [A. 8035-B, March 31, 1981, Section 1—Findings and Declaration of Purpose]

Aid to a municipality would be accomplished by the Authority itself assuming direct financial liability for construction costs. Because of this, the Authority is a very attractive concept to financially strained municipalities, since they are limited in their ability to contract indebtedness. For example, the City of Buffalo may only contract debt up to 9 percent of the average full value of its taxable real estate—that is, about $27 million (N.Y.S. Constitution, Article VIII, Section 5). Most cities are near their debt limit. The use of public authorities and revenue bonds has been a method utilized in the past to circumvent constitutionally imposed debt limits.

Another constraint on local governments is the fact that they are constitutionally prohibited from floating revenue bonds. Any municipal debt must be secured by the full faith and credit of the debtor. It is to achieve the flexibility of revenue bonds that the public authority was created in 1923.

A public authority is a public benefit corporation legally separate from a state or municipality. It may have the power to contract indebtedness and charge user fees. It may be created only by a special law of the state legislature; otherwise, localities could simply create a public authority when they need cash, without regard to their own debt capacity (N.Y.S. Constitution, Article VIII, Section 3). Municipalities had the power to create their own public authorities until 1938, when a New York State constitutional convention attempted to curb local abuses of this mechanism. As a consequence of the 1938 constitutional reforms, the public authority system became a mandate of fiscal integrity through the exercise of state control over local expenditures for local services.

The public authority does have some attractive elements. It can uniquely provide a municipal service without burdening the state or municipal body with any *direct* financial obligations. A municipality, with state consent, may delegate a heretofore municipal function (such as public housing or transportation) to a public authority. Municipal governments may also influence the choice of the authori-



ty's officers, delegate direct financial responsibility to the authority, and still receive the benefits of the authority's administered services. A municipality may even go so far as to hold title to the property which is financed by the authority. (*See, Comereski* v. *City of Elmira*, 308 N.Y. 248, 1955.)

III. THE WATER FINANCE AUTHORITY PROPOSAL

Under the Water Authority proposal (A. 8035-A, B, March 1981), the Authority may assist the municipality in one of three ways.

A. The Loan-Agreement Method

The Loan-Agreement Method of the bill (section 1045-e) would permit a municipality to float general obligation bonds—that is, bonds which are secured by the full faith and credit of the municipality. The municipality would sell these bonds directly to the Authority, receiving quick cash in return. The Authority would, in turn, float its own revenue bonds, using both the municipal bonds and state aid intercept as collateral. The state aid intercept acts as a lien that the Authority would have against state aid which is due the municipality.[1] The municipality then would use the monies received from the Authority to construct the water works. Finally, the locality may earmark user fees generated from the project as payment on the loan received from the Authority. This plan is very attractive to those

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financially hard-hit municipalities which may have difficulty selling their bonds on the open market.

B. The Lease-Purchase Agreement

A second method of financing would allow the Authority to enter into a lease-purchase agreement with the municipality (section 1045–f). The Authority would float revenue bonds and construct the water project. The municipality would act as lessee, but the "rent" paid would go toward paying off all principal, interest, and operating costs of the project. In reality, the municipality would be an installment purchaser of the project, with title vesting in the municipality at the end of the lease. In the event that the municipality defaults in payment, the Authority would continue to operate the project and collect user fees from the public.

The advantage to the municipality is that the need to go to the bond market for financing is bypassed. The locality, in effect, is getting and running a water project without impinging on its borrowing limits.

C. Authority Revenue Bonds

The third method of financing grants the Authority the power to issue straight revenue bonds—that is, bonds which are secured to the extent that the project financed actually produces sufficient revenues to meet the payment of principal and interest. Bond proceeds would finance and build the water project itself, which would be administered by a local water board. The board would be established by the state legislature with its members appointed by the municipality. It would set fees and obtain title to the project. The municipality would receive the benefits of the new water project, yet would not have direct control over it.

The legislative proposal provides that no project would be funded by the Water Finance Authority under any of the three options unless it was in compliance with a statewide master plan for water and sewage needs (section 1045–ff).

IV. PROBLEMS IN THE WATER AUTHORITY PROPOSAL

The Fallacy of the Municipality Escaping Potential Liability

The state legislature long ago recognized that water supply was too important a municipal responsibility to be subject to constitutionally imposed bonding limits. Such projects have thus been excluded from the calculation of a municipality's debt load (N.Y.S. Constitution, Article III, Section 5). This affords the municipality the freedom to build and operate its own water project which may generate revenues beyond the system's actual cost. These excess revenues greatly contribute to the municipality's flexibility in structuring its finances. Unfortunately, the municipality remains directly responsible for the debt obligations of the water system.

The first two financial schemes mentioned above are intended to allow municipalities to escape direct financial liability; yet this liability would still exist. In the bill's loan-agreement provision, the municipality enters into a contractual agreement with the Water Finance Authority bond holders by using its general obligation bonds as collateral. Under the lease-agreement provision, the municipality has a direct and binding contractual obligation to the Authority to rent, and ultimately to purchase, the water system.

Under these two plans, then, the city incurs an obligation to repay the cost of financing the water project. The Authority simply acts as a conduit for the funds; its financial liability is *directly* and *immediately* transferrable to the municipality. It would be folly to assume that the overall debt position of the municipality would not be evaluated in light of this liability. (*See, Ayer* v. *Commissioner of Administration*, 340 Mass. 586, 165 N.E.2d 885, 1961; *In re. Advisory Opinion*, 400 Mich. 270, 254 N.W.2d 528, 1976.)

In connection with the bill's third financing provision, which permits the Authority to actually assume the cost and responsibility of administering the project, it cannot be forgotten that a municipality has an obligation to provide for the health and sanitary needs of its constituents (N.Y. Public Health Law, Article 11; N.Y. Environmental Conservation Law, Article 15). Should a water authority default, the municipality would likely be forced to pick up the cost of completion and operation. Thus, the Water Finance

Authority proposal does not absolve a municipality of financial liability.

Increased User Fees

A pivotal issue in the water finance authority concept is the use of revenue bonds. One advantage of these bonds is that they require the financed project to be self-supporting; that is, the user fees must be sufficient to pay off the project's bond obligations. By that very fact then, revenue bonds avoid default by the public authority.[2] Their use requires that revenue from the project be sufficient to cover the costs of construction, operation, and principal and interest payments. Because water projects are currently undervalued, this type of financing would cause a dramatic and sudden increase in water fees. The ramifications of this increase could be severe and costly.

Since water user fees are considered a form of regressive taxation, and because of the relatively inelastic demand for water, poorer families would ultimately pay a greater percentage of income in fees compared with higher-income households. Additionally, these increased fees could have a potentially tremendous adverse impact on the numerous industries of the state, particularly in the chemical, paper and lumbering, beverage processing, and steel production industries, which use large quantities of water. The historic undervaluation of water projects has acted as an indirect subsidy to industries in the state which are the largest water users. The increase in water fees will no doubt inhibit the inclination of new or existent industries to locate within the state.

The Increased Cost of Revenue Bond Financing

Revenue bonds do not have the broad financial backing of general obligation bonds (full faith and credit of issuing municipality) but are repaid only by the revenue produced by the particular projects that they finance. Because of this, they represent a higher risk investment by bond holders. As a result, revenue bonds generally carry an interest rate which is one-half to one percentage point higher than that of general obligation bonds. Thus, a program financed by revenue bonds would result in even higher user fees to cover the cost of higher interest rates. The impact upon the poor and existent industries, noted above, would be exacerbated by this method of financing.

At the same time, a bond issue which is floated by the Authority, by its very nature, decreases the amount of money in the credit market available to the municipality. This in turn increases the interest rate which the municipality owes on its bond to investors. As a result of this fiscal interplay, the municipality has a decreased ability to provide for other needed services.

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The Lack of Local Control

The current economic stagnation requires fiscal flexibility on the part of municipalities. The indirect subsidization of industries, which has resulted from the undervaluation of water fees, would be removed by the use of revenue bonds. This traditional subsidy would disappear at a time when the state and local governments are desperately trying to lure new industry. In effect, a municipality which chooses or is forced to use the Water Finance Authority as a mechanism for modernizing its water facilities would lose the power to decide whether to continue the subsidy. Instead of this decision being reached at the political level, it is automatically invoked as part of the project's financing scheme.

This result illuminates the reality that public authorities represent an assault on the traditional democratic notions of public accountability and responsibility. While executive departments are directly responsible to the governor and indirectly to the legislature in terms of funding, public authorities tend to be insulated and inflexible. They are able to incur debt and thereby indirectly force the state to incur this debt, free of the requirement that it submit the proposal to a public referendum. Not only does this result in substantial financial imperatives placed upon the municipality, but it does so independent of local power to control these consequences. Eventually, the Authority's independence may encroach upon the locality's constitutional protection from state interference (N.Y.S. Constitution, Article IV, Section 2[b][2]).

Additionally, financing by the State Water Authority would only be permitted if the locality agreed to have its water project run in accordance with a state master plan. Yet, the needs of localities with respect to water projects

vary widely in different areas of the state. The primary problem in New York City is one of water supply; on Long Island, it is one of water quality; in Buffalo, one of water distribution. Local governments, aware of their own needs and priorities and responsibility to the electorate, should be given primary control over these projects.

It is axiomatic to recognize that proximity increases accountability by increasing access. In the case of a public authority in which access is limited, accountability is also limited; but authorities tend to be cumbersome and unresponsive for other reasons. The legislature is not permitted to direct the accounts of a public authority, a task left solely to the state comptroller (*Patterson* v. *Carey*, 395 N.Y.S. 2d 411). Consequently, a public authority, which is the creature of the state legislature, can tie the legislature's hands. Through the use of bond covenants (contractual obligations between the public authority and its creditors), the authority can oblige itself to perform some function (for example, charging a particular fee), which the legislature is constitutionally unable to rescind. As a result, the public authority can, in some cases, exert more control over the public than even the elected representatives. Added to this is the fact that the proposed water authority is specifically exempted from the requirements of competitive bidding (Section 1045–f[3]).

Inefficiency Created by a State Water Authority

Public Authorities can also tend to create fragmented delivery of services. Many authorities are given responsibility for various aspects of the same operation (financing, construction, management). This control may also be exerted by an executive or local department. The result is often waste and overlap. The proposed Water Finance Authority would not dismantle any existing agencies or departments of water or sewer facilities.

New York State is currently composed of a crazy quilt of local water and sewer departments. In Erie County, for instance, the City of Buffalo has its own water and sewer system, yet the Erie County Water Authority, a public-benefit corporation, has its own facilities and sells its water to numerous localities in the county. Some of these municipalities buy water from the Authority but administer their own systems; in some instances, the County Authority sells directly to residents. Other municipalities, like the City of Buffalo, have both constructed and operated their own systems. So, rather than simplifying the system, the Water Authority concept would add yet another layer to an already complicated bureaucracy.

SOME PROPOSALS

There are ways in which municipalities can take advantage of revenue bonding without sacrificing either local control or paying a premium interest rate.

Local governments are not prohibited from floating what can be termed *revenue-backed general obligation bonds.* In this way, the municipality could float a general obligation bond, backed by the full faith and credit of the municipality, and pledge that the bond will be used to construct a particular project, the revenues from which will be sufficient to pay back the principal and interest of the bonds. Should municipal default occur, the holders of these bonds would carry a lower interest rate. To the extent that they are self-amortizing, they would have little, if any, effect on the municipality's credit rating.

If the state wishes to establish a unified plan for water projects, the legislature can mandate state approval of all water projects as they arise individually. Such a proposal would be more direct, more effective, and less costly than the proposal requiring adherence to a statewide master plan under the aegis of the Water Finance Authority.

If the state wants to increase the acceptance of municipal bonds on the market, it can require that all municipalities adopt the state comptroller's accounting system. This would bring an end to the fraud and chicanery which has characterized the municipal budgeting process in New York State for many years.

Another mechanism exists which allows financially insecure local governments to enter the credit municipal bond market. Both the Municipal Bond Insurance Association and the American Bond Assurance Company currently insure municipal bonds. This type of insurance has been successfully used for Nassau County Sewer Bonds and by the State of Washington to lower overall interest rates.

Finally, the real solution to the state's capital improvement needs is for the federal government to finance a greater share of the burden than it presently does. Without the infusion of new funds, there can be no guarantee that the capital requirements of the older northeastern cities will be met. This is, after all, a problem of national dimension.

FOOTNOTES

1. However, in *Wein* v. *City of New York*, 370 N.Y.S.2d 550, the Court of Appeals held that the state-aid concept was not a true lien, because it required the nondiscretionary assistance of the state comptroller to enforce it.

2. An examination of the recent Washington State Power System default indicates that this may no longer be true.