BIRCH HORTON BITTNER & CHEROT
A PROFESSIONAL CORPORATION

MEMORANDUM 12-119

TO: **WALT WREDE**
CITY MANAGER
CITY OF HOMER

FROM: **THOMAS F. KLINKNER**

RE: **NATURAL GAS DISTRIBUTION SPECIAL ASSESSMENT DISTRICT**

FILE NO.: **506,742.205**

DATE: **JULY 11, 2012**

This memorandum discusses legal issues related to the use of a special assessment district ("District") to finance natural gas distribution facilities. For the purposes of this memorandum, I assume that the District will encompass the entire City of Homer.

1. How Is the District Initiated?

HCC 17.04.040(a) provides that a special assessment district may be initiated either by (1) a resolution approved by a three-fourths vote of the Council; or (2) petition signatures of the record owners of not less than one half in value of the real property in the proposed district. The three-fourths vote required to initiate the District is determined on the basis of the entire membership of the Council, including members disqualified from voting due to conflict of interest. Thus five affirmative votes on the question are required for the Council to initiate the District. In the event that initiation by resolution fails, there is the option of initiation by a petition signed by the owners of not less than one-half in value of property that is to be included in the District.

2. What Properties Should Be Included in the District?

Under AS 29.46.010(a), a property benefited by the improvement is included in the District. Benefited properties are included in the District even if they are exempt from real property taxation (e.g., properties owned by government agencies, churches, charitable organizations). A property is not benefited by the improvement if it cannot use the improvement, either at present or in the future. A property that is located so that it would be physically impossible to connect the property to the natural gas distribution system should be excluded from the District. Similarly, a property that is subject to permanent, legally enforceable restrictions on use (e.g., a conservation easement) that preclude its development with improvements that could use natural gas service, should be excluded from the District. Properties that are to be excluded from the District should be identified in the City Manager's improvement plan.

3. *May Each Property In the District Be Assessed Equally?*

The assessment of each property in the District is to be proportional to the benefit that the property receives from the improvement.[1] The Council has broad discretion to determine whether a particular assessment method results in such proportionality. "'If the apportionment of special assessments and the question of benefits are matters upon which reasonable men may differ, the determination by the municipal authorities will be sustained by the courts.'"[2] Thus, if the Council determines that equal assessments on each property in the District are proportional to the benefit that each property receives from the improvement, the City may adopt a "postage stamp" method of assessment, under which each benefited property is assessed the same amount for the natural gas distribution system.

The City has received an $8,150,000 appropriation for a "South Peninsula Natural Gas Pipeline."[3] The purpose of this appropriation is to finance the construction of a natural gas pipeline from Anchor Point to Kachemak City. The state-funded natural gas line within the City also will serve as part of the City's natural gas distribution system. Thus, it is appropriate to consider that state funding as part of the funding for the natural gas distribution system as a whole, and that funding may be applied to reduce the cost of the system that must be assessed against benefited properties.

4. *How Should the City Provide for the Cost of Borrowing over Multiple Construction Seasons, and before Assessments May Be Levied?*

Assessments are levied "[a]fter completion of the improvement."[4] While the precise time that will be required to complete the natural gas distribution system in the City has not been determined, Enstar has indicated that completion of the system will require at least two construction seasons. It is expected that Enstar will charge the City for the cost of the construction that has been completed at the end of each construction system. In addition, although some properties will receive access to natural gas service as of the end of the first construction season, they cannot be assessed until the entire project has been completed. This situation raises the following issues:

- Can the City issue obligations backed by special assessments before the assessments have been levied?
- How will the City provide for the interest that accrues on the money it borrows before it levies assessments?

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[1] AS 29.46.060(a); HCC 17.04.070(a).
[2] *Cit of Wasilla v. Wilsonoff,* 698 P.2d 656, 657-658 (Alaska 1985).
[3] §1 Ch. 17 SLA 2012.
[4] HCC 17.04.070(a).

- Should the City allocate the cost of interest on the amount that is borrowed to finance the first season's construction to properties that gain access to natural gas service by the end of that season, and if so, how can the City accomplish this allocation?

The City is authorized by state law to borrow in anticipation of the levying of special assessments, to finance the cost of a local improvement project.[5] However, the City Code does not permit the City to issue special assessment bonds "prior to the expiration of the time period allowed for the payment of assessments without penalty or interest."[6] Since it will be impractical for the City to undertake the natural gas distribution system project without the ability to borrow in anticipation of special assessments, I recommend amending the Code to conform to state law, by authorizing the City to issue bonds in anticipation of the levying of special assessments.

To provide for interest that accrues before assessments are levied on the money it borrows to finance the construction, the City's borrowing should be sized to provide funds to pay that interest. This is a common practice in financing revenue-producing assets. An alternative would be to defer the payment of interest on the borrowing until assessments have been levied, but lenders/investors are likely to find this alternative unattractive.

If the City determines that properties that gain access to natural gas service by the end of the first construction season receive a benefit that is not shared with other properties in the assessment district, it could elect to allocate the first year's interest expense to only the former category of properties. This would cause the assessments on those properties to be slightly larger than the assessments on the remaining properties. However, it also could be argued that all properties in the district benefit equally from the initial season's construction, so that the borrowing cost that is associated with that season should be shared equally.

5. *What Security May the City Provide for Its Financing of Natural Gas Facilities?*

The City may not pledge tax revenues to secure financing for the natural gas distribution system, because it will be owned by Enstar, a private company. Article IX, §9 of the Alaska Constitution authorizes a municipality to secure a borrowing with a pledge of its taxing power in the following terms:

> No debt shall be contracted by any political subdivision of the state, ***unless authorized for capital improvements*** by its governing body and ratified by a majority vote of those qualified to vote and voting on the question. (Emphasis added)

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[5] AS 29.46.130(a).

[6] HCC 17.08.010(a).

Under this constitutional provision, a city may issue general obligation bonds only for capital improvements. A bond-financed asset is not a capital improvement if it is given away to another entity.[7] Because Enstar, and not the City, will own the natural gas distribution system, that system will not be a "capital improvement" that the City may pledge its taxing power to finance. This restriction would apply to bonds secured by a pledge of sales tax revenue as well as bonds secured by a pledge of the City's property tax, because the former still would be secured by a pledge of the City's taxing power. Although there is no Alaska decision on this issue, other jurisdictions have specifically rejected such a pledge of a bond issuer's sales tax revenue under similar constitutional debt limitations.[8]

Apart from a provision for interim borrowing that must be repaid by the end of the next fiscal year, the only exceptions to the capital improvement requirement in Article IX, §9 appear in Article IX, §11:

> The restrictions on contracting debt do not apply to debt incurred through the issuance of revenue bonds by a public enterprise or public corporation of the State or a political subdivision, when the only security is the revenues of the enterprise or corporation. The restrictions do not apply to indebtedness to be paid from special assessments on the benefited property, nor do they apply to refunding indebtedness of the State or its political subdivisions.

Thus, under Article IX, §11 the City may finance the natural gas distribution system with bonds secured by special assessments on the benefited property.[9]

However, the fact that the City may not ***pledge*** tax revenue to secure bonds issued to finance the natural gas distribution system does not preclude the City from using tax revenue to pay debt service on the bonds. The City could elect to use tax revenue to pay all or part of the debt service on the bonds, crediting those payments against assessment installments payable by owners of benefited properties. The levying of assessments in this case would provide a "back-up" source of revenue to pay the bonds in the event that tax revenues were insufficient.

6. Is Tax Exempt Financing Available for Natural Gas Facilities?

Tax exempt financing is not available to finance natural gas facilities that are to be owned by Enstar. Interest on bonds issued by state and local governments

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[7] *City of Juneau v. Hixson,* 373 P.2d 743, 748 (Alaska 1962); *Wright v. City of Palmer*, 468 P.2d 326, 329-330 (Alaska 1970).

[8] *State v. Martin*, 384 P.2d 833, 843 (Wash. 1963); *Eakin v. State*, 474 N.E.2d 62, 66-67 (Ind. 1985); *Terry v. Mazur*, 362 S.E. 2d 904, 911 (Va. 1987).

[9] *See, Weber v. Kenai Peninsula Borough,* 990 P.2d 611 (Alaska 1999) (special assessment district to finance natural gas facilities to be owned by Enstar serves a public purpose).

generally is excluded from gross income for federal income tax purposes.[10] However, this exemption does not apply to a bond that is a "private activity bond" other than specific types of "qualified bond."[11] A bond is a private activity bond if two features are present. The first is "private business use," and the second is "private payment or security."[12] Bonds issued to finance natural gas facilities would meet the "private business use" test because the bond-financed facilities will be used in the trade or business carried on by Enstar, a private company. The bonds also would meet the private payment or security test because the debt service payments on the bonds will be derived from special assessments levied on the basis of benefit received from the same privately used bond-financed facilities.

Among the "qualified bond" exceptions to the disqualification of private activity bonds from tax exemption are bonds issued to finance facilities for the local furnishing of electric energy or gas.[13] However the "local furnishing" of electric energy or gas is limited to furnishing solely within an area consisting of one city and one contiguous county, or two contiguous counties.[14] The area being served is the furnishing utility's entire service area. The Enstar service area includes the Kenai Peninsula Borough, the Municipality of Anchorage and the Matanuska-Susitna Borough—an area encompassing more than two contiguous counties. Thus, bonds issued to finance Enstar facilities cannot be tax exempt as bonds issued to finance facilities for the local furnishing of gas.

7. In Addition to Costs of Construction and Interest During Construction, Must the City Finance any Other Amounts?

In addition to financing costs of constructing the natural gas distribution system, and interest that accrues before assessments are levied, lenders/investors likely will require that the City finance a reserve fund to secure the repayment of the bonds. The amount of such a reserve fund typically is equal to one year's debt service on the bonds, although it may vary depending on the requirements of lenders/investors. The reserve fund will remain in place while the bonds are outstanding, and often is applied to pay the last installments of debt service on the bonds. The reserve fund also may provide a mechanism for the earlier prepayment of bonds as described below.

8. Are There Other Sources of Funds that Will Reduce the Amount of Special Assessments for the Natural Gas Distribution System?

The Enstar tariff provides for the refunding of certain amounts that a customer must advance to pay the cost of a main extension, such as the natural gas distribution system in the City. The refunded amounts consist of (i) a portion of the construction cost that is reallocated upon connection of a customer located outside the special

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[10] I.R.C. §103(a).
[11] I.R.C. §103(b).
[12] I.R.C. §141(a).
[13] I.R.C. §§141(e)(1)(A), 142(a)(8).
[14] I.R.C. §142(f)(1).

assessment district within two years of completion of the improvement; and (ii) a "free main allowance" based on the estimated gas consumption of any customer that connects to the natural gas distribution system. Other municipalities that have levied special assessments to finance natural gas improvements for Enstar have deposited these refunds in a special account for the benefit of the assessed properties. When the amount of refunds that have been received, plus the amount in the reserve fund, is sufficient to (i) equalize the amount of each assessment that has been prepaid, by refunding a portion of each prepaid assessment that equals the unpaid principal of assessments paid in installments; and (ii) pay off the remaining bond principal plus accrued interest; the municipality has made those payments, and canceled the payment of unpaid, non-delinquent assessment installments. The availability of these refunds may reduce substantially the amount of the assessment that a property in the District is required to pay.

Please let me know if I may be of further assistance in this matter.

TFK/