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Opinion No. 05-165

Requirements for Utility Rates

QUESTIONS

1. Under Tenn. Code Ann. § 7-82-703, the Comptroller must file with the Utility Management Review Board the financial statement of any utility district that fails to comply with the provisions of Tenn. Code Ann. § 7-82-403 for three consecutive years; that is in default on outstanding indebtedness; or that has a deficit total net assets or a negative change in net assets for a period of three years. Under Tenn. Code Ann. § 7-82-403, a utility district must charge fees necessary to ensure that its system will be and remain self-supporting. Fees must produce revenue sufficient to provide for expenses and operation of the system, including reserves, and pay bonds when due, including reserves. Should a utility district be reported if it fails to prescribe and collect reasonable rates, fees, tolls, or charges for the services, facilities, and commodities of its system or systems that provide for all the expenses of operation and maintenance of the system or systems, including the reserves therefor?

2. Is the Comptroller required to submit to the Water and Wastewater Financing Board the financial statements of a municipal water or wastewater system that has failed to prescribe and collect reasonable rates, fees, tolls, or charges for the services, facilities, and commodities of its system or systems which provide for all the expenses of operation and maintenance of the system or systems, including the reserves therefor?

3. Under Tenn. Code Ann. § 7-82-403, utility district fees must produce revenue sufficient to provide for expenses and operation of the system, "including reserves." Does this statute require a utility district to charge fees that will cover depreciation expenses attributable to sewer or water lines that private parties donated to it?

4. Is a municipal water or wastewater facility required to charge utility fees that will cover depreciation expenses attributable to sewer or water lines that private parties donated to it?

OPINIONS

1. Yes, under Tenn. Code Ann. § 7-82-703(a), the Comptroller must file with the Utility Management Review Board the audited financial statements of a utility district that, for three consecutive years, has failed to prescribe and collect reasonable rates, fees, tolls, or charges for the services, facilities, and commodities of its system or systems that provide for all the expenses of

operation and maintenance of the system or systems, including the reserves therefor. This requirement does not apply to a utility district not required to comply with Tenn. Code Ann. § 7-82-403.

2. No, Tenn. Code Ann. § 68-221-1010(a) does not contain this requirement.

3. Assuming that, under generally accepting accounting principles, depreciation expense falls within "all expenses of operation and maintenance of the system or systems, including reserves therefor," of a utility district under Tenn. Code Ann. § 7-82-403, then utility districts must charge fees that include depreciation expenses on their utility systems. The statute contains no exclusion for depreciation attributable to a donated portion of the system. Generally, therefore, rates should be sufficient to cover depreciation expenses attributable to privately donated lines.

4. The answer to this question would depend on the statute under which the particular system operates. Tenn. Code Ann. § 7-35-414, for example, expressly requires a municipal system to which it applies to charge fees to cover system depreciation. The statute makes no exception for depreciation of donated lines. Similarly, under Tenn. Code Ann. § 68-221-1010, the Water and Wastewater Financing Board is authorized to order a municipal system that has been referred to it to adopt and maintain user rate structures necessary to fund, among other items, adequate depreciation. From 1992 until 1998, the statute excluded depreciation attributable to a some systems acquired with grant funds received from a state or federal agency. That statute has been deleted. That statute did not apply to depreciation attributable to lines donated by a private party, nor does any other statute exclude this expense. Generally, therefore, if a system is required to recover depreciation expenses, its rates should be sufficient to recover depreciation expenses attributable to privately donated lines.

ANALYSIS

1. Referring Utility Districts to the Utility Management Review Board

This opinion addresses the Comptroller's responsibility to report certain utility districts and city-owned utility systems to regulatory boards. The first question is whether the Comptroller should refer a utility district to the Utility Management Review Board if the district fails to prescribe and collect reasonable rates, fees, tolls, or charges for the services, facilities, and commodities of its system or systems that provide for all the expenses of operation and maintenance of the system or systems, including the reserves.

The Utility Management Review Board (the "UMRB")was created under Tenn. Code Ann. §§ 7-82-701, *et seq.* The statute provides in relevant part:

> Effective July 1, 1989, notwithstanding the provisions of any law to the contrary, the utility management review board created by this section is vested with authority over all utility districts established pursuant to this chapter or by any public or private act. *For purposes*

> *of this part, "utility district" includes agencies, authorities or instrumentalities of government created by public or private act having the authority to administer a water or wastewater facility, other than those agencies, authorities or instrumentalities of government electing pursuant to § 68-221-1006(a) or § 68-221-1206(a) to come under the jurisdiction of the water and waste water financing board.*

Tenn. Code Ann. § 7-82-701(a) (emphasis added). The italicized sentence was added in 2002. 2002 Tenn. Pub. Acts Ch.603. That act was effective April 11, 2002. It appears, however, that the UMRB was intended to retain jurisdiction over utility districts created under Tenn. Code Ann. §§ 7-82-101, *et seq.* Both provisions allowing systems to elect to come under the jurisdiction of the Water and Waste Water Financing Board expressly exclude utility districts formed under Tenn. Code Ann. §§ 7-82-101, *et seq.* Tenn. Code Ann. § 68-221-1006(a); Tenn. Code Ann. § 68-221-1206(a).

Tenn. Code Ann. § 7-82-703(a), as amended in 2004, now provides:

> The comptroller of the treasury shall cause to be filed with the board a copy of the audited financial statements prepared pursuant to § 7-82-401 of any utility district which fails to comply with the provisions of § 7-82-403 for three (3) consecutive years, or which is in default on any outstanding indebtedness, or which has a deficit total net assets or a negative change in net assets for a period of three (3) years, hereinafter referred to as a financially distressed utility district.

The statute refers to financial statements filed under Tenn. Code Ann. § 7-82-401. This statute, therefore, appears to apply only to utility districts created under Tenn. Code Ann. §§ 7-82-101, *et seq.* Under Tenn. Code Ann. § 7-82-403, with a few exceptions, utility district boards created under this statutory scheme must charge rates that will enable the utility system or systems the district operates to be self-supporting. The statute provides:

> (a) Except as provided in subsection (b), the board of commissioners of any district shall prescribe and collect reasonable rates, fees, tolls, or charges for the services, facilities and commodities of its system or systems, shall prescribe penalties for the nonpayment thereof, and shall revise such rates, fees, tolls or charges from time to time whenever necessary to ensure that such system or systems shall be and always remain self-supporting. The rates, fees, tolls or charges prescribed shall be such as will always produce revenue at least sufficient to:
>
> (1) Provide for all expenses of operation and maintenance of

> the system or systems, *including reserves therefor*; and
>
> (2) Pay when due all bonds and interest thereon for the payment of which such revenues are or shall have been pledged, charged or otherwise encumbered, including revenues therefor.

(Emphasis added). Under Tenn. Code Ann. § 7-82-703(a), therefore, the Comptroller must file statements with the UMRB of any utility district that falls in any one of three categories: first, it has failed to charge rates sufficient to cover its operating expenses, reserves, and debt for three years; second, it is in default on any outstanding indebtedness; or third, it has a deficit total net assets or a negative change in net assets for a period of three (3) years. The statute does not apply to any utility district exempted from Tenn. Code Ann. § 7-82-403.

2. Referring Municipally-owned Utility Systems to the Water and Wastewater Financing Board

The second question is whether the Comptroller is required to refer to the Water and Wastewater Financing Board a municipally-owned utility system that has failed to charge rates sufficient to provide for all the expenses of operation and maintenance of the system or systems, including the reserves therefor. The Water and Wastewater Financing Board (the "WWFB") was created under Tenn. Code Ann. § 68-221-1008. The WWFB is charged with the responsibility of furthering the legislative objective of self-supporting water systems and wastewater facilities in Tennessee. Tenn. Code Ann. § 68-221-1008(a)(1). The WWFB has jurisdiction over agencies, authorities, or instrumentalities of government, other than utility districts under Tenn. Code Ann. §§ 7-82-101, *et seq.*, authorized to operate a water or wastewater facility that elect pursuant to § 68-221-1006(a) or § 68-221-1206(a) to come under it. *See* Tenn. Code Ann. § 7-82-701(a). Tenn. Code Ann. § 68-221-1010(a) provides:

> (1) Within sixty (60) days from the time that an audit of a water system or wastewater facility is filed with the comptroller of the treasury, the comptroller of the treasury shall file with the board the audit report of any water system or wastewater facility which has a deficit total net assets in any one (1) year or, for a period of three (3) consecutive years, has a negative change in net assets, or is currently in default on any of its debt instruments. However, if a water system or wastewater facility has total net assets at least four (4) times greater than total debt, depreciation expense shall not be considered in determining the above criteria for filing the report with the board.
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> (3) It is the intent of this paragraph to permit and encourage the orderly development of wastewater facilities capable of meeting anticipated growth without overburdening initial users of the facility. In any local government having a wastewater facility, for the first seven (7) years after the beginning of operations there may be a

> phase-in of depreciation costs, as hereinafter provided. In determining whether a facility has a deficit total net assets or a negative change in net assets, during the first seven (7) years of operations, depreciation expense shall not be considered. After seven (7) years of operations all depreciation expense shall be considered.
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> (4) In determining whether a facility has a deficit total net assets or a negative change in net assets, amounts derived from tap fees, connection charges, or other related fees and charges which are considered contributed capital, shall be considered revenue.

Thus, under this statute, the Comptroller is required to refer to the WWFB the audit report of a water system or wastewater facility that falls within any of the following categories: it has a deficit total net assets in any one year; it has a negative change in net assets for three consecutive years; or it is currently in default on any of its debt instruments. The statute does not require the Comptroller to refer a system to the WWFB that has failed to prescribe and collect reasonable rates, fees, tolls, or charges for the services, facilities, and commodities of its system or systems which provide for all the expenses of operation and maintenance of the system or systems, including the reserves therefor.

3. Rates Charged by a Utility District

The next question is whether a utility district is required to charge fees that will cover depreciation expense attributable to sewer or water lines that private parties donated to it. As quoted above, Tenn. Code Ann. § 7-82-403 provides:

> (a) Except as provided in subsection (b), the board of commissioners of any district shall prescribe and collect reasonable rates, fees, tolls, or charges for the services, facilities and commodities of its system or systems, shall prescribe penalties for the nonpayment thereof, and shall revise such rates, fees, tolls or charges from time to time whenever necessary to ensure that such system or systems shall be and always remain self-supporting. The rates, fees, tolls or charges prescribed shall be such as will always produce revenue at least sufficient to:
>
> (1) Provide for *all expenses of operation and maintenance of the system or systems, including reserves therefor;* and
>
> (2) Pay when due all bonds and interest thereon for the payment of which such revenues are or shall have been pledged, charged or otherwise encumbered, including revenues therefor.

(Emphasis added). Under the statute, therefore, utility district rates are to be sufficient to cover all expenses of operation and maintenance of the system, including reserves. The statute does not

define the terms "expenses of operation and maintenance" or "reserves." But rules governing the UMRB provide that it will use generally accepted accounting principles and the interpretations of the Tennessee Comptroller of the Treasury. Tenn. Rules & Regs, Ch. 1200-22-7-.04(4). Further, the rules provide that in dealing with a financially distressed utility district, the UMRB may order district management to adopt and maintain user rate structures necessary to, among other goals, "[f]und depreciation in 1-3 years." Tenn. Rules & Regs, Ch. 1200-22-7-.05(c)(3). Assuming that, under generally accepted accounting principles, depreciation expense falls within "all expenses of operation and maintenance of the system or systems, including reserves therefor," of a utility district, then utility districts must charge fees that include depreciation expense on their utility systems. The statute contains no exclusion for depreciation attributable to a privately-donated portion of the system. Generally, therefore, rates should be sufficient to cover depreciation expenses attributable to privately-donated lines.

4. Depreciation for Water and Wastewater Systems

The last question is whether a municipal water or wastewater facility is required to charge utility fees that will cover depreciation expense attributable to sewer or water lines that private parties donated to it. The answer to this question depends, first, on the statute under which the facility is operated. Under Tenn. Code Ann. § 7-34-114, for example, a local government operating a utility system under that statutory scheme must charge fees that will produce revenue at least sufficient to, among other matters, "[p]rovide for all expenses of operation and maintenance of such public works, *including reserves therefor*." Tenn. Code Ann. § 7-34-114(a)(2) (emphasis added). Under Tenn. Code Ann. § 7-35-414(a), a city operating a utility system under that statutory scheme must charge rates and fees to provide funds sufficient to, among other matters, "maintain an adequate depreciation account." Neither of these statutory schemes exempts a system from charging fees adequate to cover depreciation attributable to a system financed with grant funds.

The statute under which a local government operates a system must be read in conjunction with the powers of the WWFB. Under Tenn. Code Ann. § 68-221-1010, as discussed above, the Comptroller is required to refer to the WWFB any water or wastewater system that falls within any of the following categories: it has a deficit total net assets in any one year; it has a negative change in net assets for three consecutive years; or it is currently in default on any of its debt instruments. The WWFB is authorized to order the facility to adopt and maintain user rate structures, necessary to, among other matter, "[f]und operation, maintenance, principal and interest obligations and adequate depreciation to recover the cost of the water system or wastewater facility over its useful life." Tenn. Code Ann. § 68-221-1010(b)(2)(A). The statute now contains no provision exempting a water or wastewater system from charging rates sufficient to cover depreciation attributable to a donated system. Between 1992 and 1998 a statute did require the Comptroller, in determining whether a system should be referred to the WWFB, to exclude depreciation expenses attributable to certain systems acquired by grant funds provided by a state or federal agency. Tenn. Code Ann. § 68-221-1010(a)(2) (now deleted.) But that statute did not apply to depreciation attributable to lines donated by a private party, nor does any other statute exclude this expense. Generally, therefore, if a system is required to recover depreciation expense, its rates should be sufficient to recover depreciation expenses attributable to privately donated lines.

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