

## **XENIA RURAL WATER NORTHERN GROWTH NEGOTIATIONS**

8/13/2013

### **CITY COUNCIL DIRECTION:**

On June 25, the City Council discussed options for providing water service to land within the City's northern growth area. This discussion was driven by annexation requests made for the Athen and Quarry Estates developments; and was affected by changes in how the Xenia Rural Water District is now handling service territory transfers to the City. Xenia currently provides water service within this area.

At this meeting, Council directed staff "to keep working on the monthly buy-out option with Xenia to get more reasonable numbers than what have been proposed and to arrive at an amount that is more equitable based on the acreage in comparison to what the Xenia District has as a whole and to include the historic equivalent buy-out options for a one-time developer fee."

In addition, Council also directed staff "to provide a map to Council of the rural water contracts and non-contracted areas in the fringe."

At earlier meetings, Council had also directed staff to seek outside legal counsel assistance in answering several legal questions that could impact the City's decision.

### **IOWA RURAL WATER DISTRICT LAW:**

Iowa law requires a rural water district to notify a city when it intends to provide water service to a new area within two miles of that city's corporate limits. This notification must include a water plan indicating the area to be served. The city then has 90 days to respond, but may ask for an additional 90 days (180 total) to review the request. Three potential outcomes exist in this process:

1. If the city **does not respond** within the time limit, the rural water district may serve the designated area.
2. The city may **waive** its right to the area, allowing the rural water district to serve the designated area.
3. The city may **reserve** the right to serve the designated area, in which case the city must provide water service within four years of receipt of the plan.

## **TERRITORY MAPPING:**

In order to provide territory maps, City staff looked at numerous City records including, but not limited to, Council meeting minutes, staff reports, Story County records, written requests from the rural water provider. As a result of this search, City staff has found records that reference Xenia Rural Water District territory adjacent to the City of Ames approximately 14 times. Of these, the City explicitly denied Xenia the right to serve at least three times. Interestingly, it is clear that maps Xenia has published showing their service territory within the City's fringe area are in conflict with the record search performed by staff.

**Since many of the available records are incomplete, do not contain legal descriptions, or use unclear maps, it is presently difficult to confirm whether the appropriate procedures outlined in the *Iowa Code* were followed, and therefore whether there have been valid requests made. Accordingly, the staff has requested our outside legal counsel to review the above documents and confirm the extent to which Xenia does or does not have service rights in these areas. Therefore, additional review time is needed before staff is confident that a completely accurate territory map requested by the City Council can be provided.**

## **REPORT ON LEGAL ISSUES RAISED BY COUNCIL:**

Per the direction given by Council to seek outside legal counsel for assistance in answering the complex issues which may impact the ultimate decisions council must make, the Legal Department and Manager's Office conducted a search of firms and attorneys with expertise and experience in this field, and ultimately retained the firm of Dorsey and Whitney to assist with the Xenia issues. Their attorneys are familiar with and have assisted other Iowa cities with municipal water issues as well as having considerable experiences with issues of municipal finance that are also intertwined here, having served as the City's bond counsel many times in the past.

There were several questions raised by Council, staff, and other interested citizens. Since some of the questions assume a buy-out is preferred, they relate to the possible means of paying for that buy-out. Other questions relate to whether to take the buy-out approach or look for some other option for water service.

### **Debt Question**

Addressing the first category of questions, which assume a buy-out and are related to financing options for it, an initial inquiry was whether the assumption by the City of the debt of an association or corporation was constitutionally permissible. Article VII, section I of the Iowa Constitution provides:

“...the state shall never assume, or become responsible for, the debts or liabilities of any individual, association, or corporation, unless incurred in time of war for the benefit of the state.”

In context of this situation, the concern is the debt Xenia is obligated for may be factoring into its estimation of market value and hence into its asking price. Preliminarily, it should be noted that the City is a political subdivision of the State, and Iowa Supreme Court decisions have applied this provision to political subdivisions. **The answer to this question is that as long as the City does not become liable as a surety for the debt, it may pay Xenia for the right to provide water service.**

The Iowa Supreme Court has consistently held that “Article VII, section I only prohibits the state and localities from incurring secondary indebtedness as sureties.” On thirteen occasions, the Iowa Supreme Court has considered the constitutionality of state and local action under Article VII, section 1. Each time, the Court narrowly interpreted the constitutional provision to uphold state or local action when their actions incur primary indebtedness. As long as the creditors of the other entity have no recourse against the City, the City’s payments are a permissible primary obligation and do not create a surety relationship.

### **Monthly Surcharge Question**

A second inquiry concerning financing was about the methods to fund a buyout. Research done to date has not revealed a completely clear answer about whether the City may impose a “surcharge” on only future customers of this service territory. **Even assuming a surcharge may be imposed legally, the ability of the current Council to mandate or obligate future councils to continue that surcharge is questionable, since generally one council may not require a later council to impose or continue a charge related to a governmental function such as a water utility.** That said, however, it is clear that the City is authorized to create a “connection district” and collect an amount from each new customer in that district as that property connects to the water system. This procedure is specifically authorized under Iowa Code § 384.38(3).

### **Installing Water Infrastructure In Absence Of Buy-Out Question**

Another inquiry was posed by the Council that asked what could happen if the City simply proceeded with the annexation of this land without a buy-out and then proceeded to provide water service in the Northern Growth Area. For purposes of this question, our outside counsel assumed the validity of the 1996 agreement and that the area in question is clearly part of the area covered by the agreement. **With those assumptions, both the agreement and applicable Federal law give Xenia rights that are protected from infringement by annexation and provision of water service by the City. Taking that action, the City could subject itself to legal action by Xenia. The possible outcomes could include not only damages awarded to Xenia, but claims for payment of attorney fees. Case precedents have shown this to be the result in situations involving other cities in Iowa and elsewhere.**

### **Additional Legal Questions**

As staff has delved deeper into this water service issue, additional legal questions have been raised that are being reviewed by our outside legal counsel.

## **DISCUSSIONS WITH XENIA CREDITORS:**

Since June 25, staff has met with Xenia's two major creditors regarding how the current negotiations might be affected by their debt restructuring agreements with Xenia.

On August 5 staff met with Bill Menner, State Director of the **USDA's Rural Development** program. The following information was gained at this meeting:

- USDA has approval authority (or "veto power") over Xenia contracts to either sell off service territory or to provide urban water service.
- USDA's only criterion is to protect the US taxpayer relative to repayment of Xenia's federal loans.
- USDA does not approve or deny any of Xenia's operating decisions.
- USDA's granting of prior loans did not presume any particular development around Ames such as is now being considered.
- Similarly, USDA does not care whether Xenia or the City is serving the area into the future, as long as the interests of the taxpayer are protected.
- USDA would not micromanage negotiation of an agreement, but would be concerned with how the agreement affected Xenia's cash flow, debt repayment, and operations.
- USDA would almost certainly approve whatever had been agreed to by Xenia's general manager and Board of Directors.

On August 6 staff spoke with Terry Workman and Barbara Boullé of **Assured Guaranty Municipal Corporation's** New York office. Assured is a large public finance firm that holds and guarantees a substantial portion of Xenia's debt, and which recently reached a "forbearance agreement" that allowed Xenia to restructure its debt and avoid going into receivership. The following information was gained at this meeting:

- Assured is in a "review and approve" mode for the type of agreements being considered by Xenia and the City.
- Assured asserts that its consent would be needed for **either** a buy-out agreement or an "urban services" agreement where Xenia serves the area within Ames. [Note: Xenia's legal counsel may believe that Assured only has this "consent right" in the case of a buy-out agreement.]
- Assured's financial interests very closely parallel those of Xenia.
- Assured is not in a position to force Xenia to accept any agreement that would be of particular benefit to Assured.

- In determining whether to give its consent, Assured has no specific parameters; but would review an agreement on its face value.
- Assured would generally accept Xenia's judgment on acceptability of the agreement, but would still perform a due diligence review to make certain it is not detrimental to repayment of Xenia's debt.

Staff queried both entities regarding the timing of their review and approval of an agreement. **Surprisingly, both USDA and Assured indicated that, after an agreement had been negotiated and signed by Xenia's Board, their review and approval could be accomplished within 30-45 days.** Both groups indicated that, while they would want to understand all relevant facts, they would rely heavily on Xenia's recommendation. It was also determined that review of a signed agreement by both creditors could occur simultaneously, rather than sequentially.

### **XENIA RURAL WATER FINANCIAL CONDITION:**

On June 25, 2013 the Auditor of State released the audit report for the Xenia Rural Water District's year that ended on December 31, 2012. The auditor issued a "qualified opinion." A qualified opinion is issued when portions of the report do not adhere to generally accepted accounting principles. In the case of the Xenia 2012 report, the auditor provided the following as the basis of the qualified opinion:

"Adverse economic conditions have limited the ability of the District to obtain customers in amounts sufficient to service its long-term debt. As a result, the District restructured debt obligations to extend the terms and to reclassify short term debt to long term debt. **However, significant uncertainties remain regarding the District's ability to continue its operations and to satisfy its obligations to its creditors on a timely basis.** Consequently, adjustments may be required to the recorded asset amounts and the classification of liabilities" (emphasis added).

The audit report also noted multiple instances of noncompliance with debt provisions. The management of Xenia expressed similar concerns in the "Management's Discussion and Analysis, Economic Outlook" section of the report, stating:

"The District believes there is substantial doubt about its ability to continue as a going concern. The District has not produced sufficient net revenues (gross revenues less on-going costs of operation and maintenance) to stay current on debt payments and to replenish its debt reserves. In this regard, the District did not achieve sufficient net revenues from the water system during 2012 or 2011 to meet sinking fund requirements and debt service reserve fund requirements."

**In March of this year, Xenia entered into debt forbearance and restructuring agreements to lower interest rates and extend the terms of outstanding debt. This provided some relief on principal and interest payments over the term of the outstanding debt. The 2012 financial statements reflect the adjusted debt, but indicate that Xenia may still have difficulty meeting their debt service payment**

**obligations and the other debt agreement provisions such as funding improvement accounts and sinking funds.**

## **PROGRESS OF NEGOTIATIONS WITH XENIA – BUY-OUT OPTION:**

### **Xenia's Position**

Following the City Council's June 25 direction to pursue a buy-out option and ascertain Xenia's best offer. To determine their position, Xenia staff indicated that their Board's Finance Committee had directed them to prepare an evaluation of the income potential to Xenia under a series of different scenarios based on various assumptions. Xenia officials indicated that none of the scenarios contained repayment of any of Xenia's current debt. **Based on this analysis, Xenia's position is for the City to pay a monthly fee of \$17.92 per customer (inflated by 2% annually) over the next 28 years.** This fee was based on the following assumptions:

- 15 year build out
- 2% inflation rate
- 4% investment rate
- Monthly fee - (\$17.92 per month per customer inflating to \$31.30 by the end of the agreement)
- Anticipated Gross Income over 28 years - \$6,305,660
- Net Present Value - \$3,163,774

### **City's Offers**

Proposal 1. The City staff suggested a \$3.98 per month per customer fee with no annual inflation adjustment over 28 years. This option reflected anticipated gross revenues to Xenia of \$999,617, with a net present value of \$519,944.

Proposal 2. The City staff suggested a connection fee of \$486 per new customer with no annual inflation adjustment over 28 years. This option reflected gross revenues to Xenia of \$486,000, with a net present value of \$359,332.

Proposal 3. City staff subsequently presented Xenia staff with the following scenarios, based on the Council's June 25 motions:

- (1) A payment reflecting a proration of the Ames land area (less than one square mile) compared to Xenia's total land area stretching over 13 counties.
- (2) A proration of the projected number of Ames customers (1000) compared to Xenia's total customers (currently 9400).
- (3) A "per acre" payment amount equivalent to what Barilla paid the Central Iowa Water Association (CIWA) in 1997. In that case, Barilla's Parcel C was 96.61 acres and CIWA accepted a payment of \$7,268, for a per acre amount of \$75.23. An equivalent payment to Xenia for the proposed annexation areas (including Rose Prairie) would be 459.22 acres times \$75.23 = \$34,550. Inflation could also be added to this amount.

- (4) An equivalent to the amount per acre paid by the Northridge Heights developers in 2000 when they negotiated a buy-out of that territory from Xenia. In that case, the developers only paid to relocate a portion of Xenia's water main. With an estimated cash outlay of \$154,000 divided by 220 acres, this equated to a cost of \$700 per acre. An equivalent payment to Xenia for the proposed annexation areas (including Rose Prairie) would be 459.22 acres times \$700/acre = \$321,500. Inflation since the year 2000 is 36%, which could bring this amount up to \$437,000. This scenario is obviously the most comparable option, since Xenia itself accepted this arrangement 13 years ago.

Unfortunately, Xenia staff did not believe any of these proposals would be acceptable to their Finance Committee, which had already determined that the \$3,163,774 net present value was their desired payment.

Proposal 4. In light of the recent legal question regarding whether or not the current City Council can commit future Councils to maintain a monthly customer fee, a fourth buy-out proposal was identified. This would be a one-time \$3,762 fee charged when the customer is connected to City water service. This option reflected anticipated gross revenues to Xenia of \$3,762,000, with a net present value of \$2,587,833. **Xenia staff indicated that they could also recommend this option to their board.**

There would be two benefits to this last option. First, the developers would not need to make up-front payments. Second, the cost to the property owner would be less than \$20.00 per month if folded into their home mortgage, which in addition would be tax deductible.

#### **PROGRESS OF NEGOTIATIONS WITH XENIA – OPTION OF XENIA SERVING AREA:**

Given the significant monthly and/or up-front costs to our future citizens under the various buy-out options described above, Council may again want to consider whether it would be acceptable to allow Xenia to retain the annexed service territory. According to Xenia officials, they would still impose an up-front charge estimated at \$1000 per customer that each home owner would pay to help cover the cost of Xenia's new infrastructure in the area. In addition, there would be ongoing monthly charges to cover Xenia's system availability charge (currently \$17.92), plus the actual cost of water purchased by each customer from Ames.

Should this option be pursued, staff has indicated that the following terms would need to be confirmed in an agreement approved by both governing bodies:

- Xenia would provide an “**urban level**” of **water service**. This includes building and maintaining its infrastructure to City standards, and making its hydrants and water available to the City for firefighting.
- Xenia would **serve the area with Ames water**. While this may not be practically feasible due to mixing of water in the mains, the overall volume of water purchased from Ames would roughly be equivalent to the volume used by all Ames customers within Xenia's territory.

- The **City would inspect Xenia's water main construction and maintain Xenia's distribution system within the City** (including making emergency main break repairs). Expenses for these services would be reimbursed by Xenia.
- The **City would handle billing and collections for Xenia's water service.** Combining Xenia's water billing with the City's sanitary sewer billing provides the legal means whereby water service can be cut off when a customer fails to pay their City sewer bill.
- A **rate formula** would be specified that confirms the basis for rates charged to Xenia customers living in Ames. This formula would confirm that Ames customers will not be charged for repayment of Xenia's existing debt, and would seek to protect those residents from major Xenia rate increases such as those that have been imposed on existing Xenia customers over the past few years.
- Should Xenia fail to perform any of its responsibilities under the agreement, the **annexed territory and infrastructure would revert to City control.** Xenia would be compensated for the depreciated value of infrastructure that it had paid to install to serve the area.

Xenia staff has indicated the general acceptability of these terms, but a great deal of time and effort would undoubtedly be needed to work out details that are mutually acceptable.

### **SUMMARY OF KEY POINTS:**

The following points summarize key findings of the above report. Council may identify other key points that should also be taken into consideration in making this decision.

- Additional time is needed for outside legal counsel to confirm the extent to which Xenia does or does not have service rights in areas surrounding the City.
- Legal counsel is unsure at this time whether the current Council can bind future Council's to maintain a monthly buy-out fee.
- Xenia staff is willing to recommend to their board that Xenia sell Ames the designated northern growth territory that includes the Athen property and the Grant Avenue properties for a non-inflating connection fee of \$3,762, which has a net present value of \$2,587,833.
- Should Council decide that it desires to move forward to finalize an agreement prior to receiving answers to the outstanding legal questions, and if the general terms of an agreement can be firmed up next week, the Xenia Board could approve a conceptual agreement at their August 22 meeting. A legal agreement would then be negotiated and presented for approval by both governing bodies. Ideally this could be accomplished within 45-60 days.



- Once approved by the Xenia Board, creditor review of any agreement would then take 30-45 days. USDA and Assured Guaranty report that they both will largely rely on the Xenia Board's recommendation in giving their consent to an agreement. This would be the same timeframe whether the City decides to buy out the area or to allow Xenia to serve the area.
- Xenia is also willing to serve this territory themselves. In order for this to be acceptable to the City, staff would need to negotiate a detailed agreement confirming Xenia's willingness to provide an urban level of water service. This includes buying Ames water to serve areas within the City, allowing the City inspect and maintain their distribution system within the City, allowing the City handle billing and collections, including rate formula protections for Ames residents, and including a reversion clause in case Xenia fails to perform its responsibilities under the agreement.

### **STAFF COMMENTS:**

City staff understands the urgent need for additional residential lots for our growing community. However, before finalizing an offer that would be very costly to the residents of our northern growth area for the next 28 years, it seems prudent to allow time for outside legal counsel to confirm the extent to which Xenia does or does not have service rights in areas surrounding the City.

If the Council ultimately decides to proceed, staff believes the preferred course of action would be to pursue a buy-out scenario with a one-time, non-inflating connection fee with no monthly customer charge. From the residents' standpoint, this approach puts the cost of the buy out where it properly belongs, in the cost of developing the property, and not in the cost of providing drinking water. It also allows the home owners to claim income tax deductions on the interest. From City staff's perspective, it also keeps water rates uniform across our entire system, greatly simplifying billing and public relations messaging. In addition, it will be easier and faster to negotiate an agreement under this approach, and will be far easier to administer this type of agreement with Xenia.

The downside to this approach is that the \$3,762 fee imposes a significant additional cost to the price of housing in Ames. It would also set an unwelcome precedent for other cities that are experiencing this same type of interaction with rural water, and that may not be able to absorb this type of added cost in their home prices. In addition, whatever agreement is negotiated with Xenia will undoubtedly impact expectations and negotiating positions as the City deals with Central Iowa Water Association in the months ahead regarding our eastern industrial expansion.

Finally, if the City Council feels that the buy-out option described above is still too costly, staff could be directed to communicate that message to Xenia and to present additional buy-out offers.