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Public Proprietary Businesses: Optimizing Value for the Community

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I. What Is A Public Proprietary Business?

> "Generally, the principal test for determining whether a function is "governmental" or "proprietary" is whether the act performed is for the common good of all, or whether it is for the special benefit or profit of the corporate entity. A municipality acts in a proprietary capacity when it acts as the proprietor of a business enterprise for the private advantage of the municipality, and it may exercise its business powers in much the same way as a private individual or corporation."
>
> *56 Am. Jur. 2d Municipal Corporations, Etc. § 170*

Municipal governments (and State, County and other governmental entities) routinely own and operate business enterprises in their "proprietary capacity" to meet demands for services from the public. When the municipal government collects a payment from the recipient in exchange for receipt of those services (as opposed to providing the service without charge to the recipient and funding the services with general fund taxes or incidental fees) it is operating a proprietary business enterprise.

The United States Supreme Court has often recognized the distinction between when a City acts in its governmental capacity and when it acts in its proprietary capacity. Particularly addressing the subject of municipal government tort liability, the Court in *Owen v. City of Independence, Missouri*, 445 U.S. 662, 100 S. Ct. 1398, 63 L. Ed. 2d 673 (1980), at 646, 1412, noted:

> "To be sure, there were two doctrines that afforded municipal corporations some measure of protection from tort liability. The first sought to distinguish between a municipality's "governmental" and "proprietary" functions; as to the former, the city was held immune, whereas in its exercise of the latter, the city was held to the same standards of liability as any private corporation…The governmental-proprietary distinction owed its existence to the dual nature of the municipal corporation. On the one hand, the municipality was a corporate body, capable of performing the same "proprietary" functions as any private corporation, and liable for its torts in the same manner and to the same extent, as well. On the other hand, the municipality was an arm of the State, and when acting in that "governmental" or "public" capacity, it shared the immunity traditionally accorded the sovereign."

When operating a proprietary business enterprise, municipal governments are constrained only by one of the foundations of their governmental franchise from the people, which is the requirement that the government serve a proper public purpose:

> Since the powers of a municipal corporation are intended to be used for the advantage of the public and the inhabitants, generally, the valid exercise of power must serve a public or municipal purpose. . . . An action or expenditure is for a "public purpose" when it confers a benefit of a reasonably general character on a significant part of the public. The objective of a public purpose is to promote the public health, safety, morals, general welfare, security, prosperity, and contentment of all the inhabitants or residents within the municipality.
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> *56 Am. Jur. 2d Municipal Corporations, Etc. § 177*

Fortunately for municipal governments, this generally accepted definition of public purpose has rather a broad reach, particularly where it speaks of promoting the general welfare, prosperity and contentment of the public. Almost any business enterprise could be supported by this mantra.

Generally, however, municipal governments narrowly focus their public purpose proprietary business aspirations on services that are natural monopolies; that is, businesses that require such a substantial initial capital investment with a limited customers base that it is impractical for two or more service providers to duplicate the capital investment needed to initiate the business and compete for the same limited customers. Most if not all State legislatures expressly authorize municipal governments to provide such natural monopoly services. This tendency to focus on natural monopoly services is further enhanced by municipal governments' general exemption from Federal anti-trust laws. See for instance the Supreme Court decision in *Parker v. Brown*, 317 US 341, 63 S. Ct. 307, 87 L.Ed. 315, at 350, 313 (1943):

> "We find nothing in the language of the Sherman Act or in its history which suggests that its purpose was to restrain a state or its officers or agents from activities directed by its ***351** legislature. In a dual system of government in which, under the Constitution, the states are sovereign, save only as Congress may constitutionally subtract from their authority, an unexpressed purpose to nullify a state's control over its officers and agents is not lightly to be attributed to Congress"

Municipal Governments also tend to fill service niches left unfilled by the private sector due to limited customer market size or other demographics unappetizing to the private sector. Municipal Governments tend to stay away from providing services where a robust competitive market exists with low barriers to entry and reasonable capital requirements. As discussed below, though, the number of businesses that fit within this niche is substantial.

II. What Types of Services Can A Municipal Government Provide To A Community Through a Public Proprietary Business?

The types of business enterprises that municipal governments own and operate are wide and varied, within the public purpose parameters. These include the standard public utility service enterprises like drinking water and wastewater utilities, irrigation and reclaimed water utilities, electric utilities (both fully integrated generation, transmission and distribution utilities, joint-membership generation utilities, and distribution only utilities), and natural and propane gas distribution utilities. They also include quasi-utility services like solid waste collection and disposal services (e.g., landfill, biomass electric generation, incineration, etc), steam distribution, chilled water distribution, storm water collection and disposal services, and biosolids fertilizer/pellets production.

The transportation industry provides another area of business services where municipal governments play a significant role. Transportation related public business enterprises range from owning and operating airports, seaports, rail and bus terminals/stations and the trains, subways, trolleys and buses using those terminals/stations to leasing or issuing licenses for fixed base operators, warehouse and storage space, food & beverage services, merchandise and concessions, and fuel sales. The transportation arena also include automobile based services like owning and operating toll roads, tunnels and bridges, and parking facilities (street meters, surface lots and garages).

The civic and entertainment industry represents the third primary area where municipal governments ply their trade. In this broad market place, municipal governments own and operate such diverse businesses as sports arenas, convention centers, concert halls, marinas, golf and country clubs, racquet clubs, beach clubs, amusement parks, gyms and health clubs. [Note state governments also own and operate such entertainment related businesses like lotteries and liquor stores, but these businesses are generally not within the purview of municipal governments.]

Of note, however, is the one industry that fewer municipal governments play in: the communications arena. This is not surprising given the discussion above regarding the characteristics of businesses favored by municipal governments. Since the deregulation of AT&T, the communications industry has enjoyed a hyper-competitive market fueled by rapidly advancing technologies. Some commentators and communications industry insiders argue that municipal governments should not be permitted to compete in the communications marketplace. For an interesting analysis see, *Does Municipal Supply of Communications Crowd-Out Private Communications Investments? An Empirical Study*, George S. Ford, Applied Economic Studies, February 2005. In Florida, the Florida Supreme Court went further, stating in *Department of Revenue v. City of Gainesville*, 918 So. 2d 250 (Fla. 2005), that "providing telecommunications services does not as a matter of law always serve municipal or public purposes,"

suggesting further that a municipal government providing an activity in a market with significant private sector participants might not serve a public purpose.

III. What Techniques Can Maximize the Benefits A Public Proprietary Business Provides to the Municipal Government?

One of the most important benefits a public proprietary business provides to a municipal government (and indirectly to the public constituents of the municipal government) is the opportunity to earn a profit and to apply that profit to offset the municipal government's general fund expenses. For every dollar of profit applied to the general fund expenses there is one dollar less of taxes needed to pay those expenses.

Of course, the concept of a municipal government earning a profit sounds foreign to many observers, as aren't municipal governments by definition supposed to be non-profit? Municipal governments are non-profit in the corporate sense that no profits are distributed to its owners (or residents). But being non-profit does not mean that components or enterprise funds of the municipal government can not earn a profit or surplus that can be utilized for the benefit of, but not distributed to, the constituents of the municipal government.

Indeed, most State courts throughout the country support the concept of municipal governments earning a profit on their proprietary businesses to one degree or another, with the term "profit" covering a variety of techniques utilized by municipal governments to funnel surplus revenues from their proprietary businesses to their general funds.

In Texas, the court in San Antonio Independent School District v. City of San Antonio, 550 S.W. 2d 262, at 264 (Tex. 1977), stated:

> "A city which owns and operates its own public utility does so in its proprietary capacity. … The general rule is that the city is entitled to make a reasonable profit from its own utility system."

In Missouri, a federal court in United states v. City of Columbia, Missouri, 914 F.2d 151, at 155 (8th Cir. 1990), also endorsed the profit motive, holding:

> "We believe, as the City has persuasively argued, that the PILOT [payment in lieu of taxes] is simply the profit component of the City's utility rate, a component which is measured by lost tax revenue. An important, threshold principle in this regard-and one that does not appear to be disputed at this point-is that municipalities may permissibly seek some reasonable profit in setting their utility rates. This is not a case in which a party has challenged a municipality's basic power to obtain some measure

> of profit from its utility enterprise. That a municipality may do so appears accepted."

This Missouri decision by the court goes even further in describing one of the significant benefits of a municipal government owning a proprietary business - that while the federal government does not pay taxes to a municipal government, it does have to pay utility rates that generate a profit for the municipal government, indirectly off-setting municipal taxes:

> "Nor does the United States apparently contend that it is immune from the City's profit-producing utility rates. That is, it is agreed that the City can seek a profit from its utility customers, including the federal government. . . . When the United States purchases water, electricity, and related services, and then pays the utility bill, it does so as a vendee pursuant to its voluntary, contractual relationship with the City. The City imposes the charge not in its capacity as a sovereign, but as a vendor of goods and services."

Id., at 155, 156.

Likewise in Pennsylvania, the court in Appelmans v. City of Philadelphia, 826 F. 2d 214 at 216, 217 (3rd Cir. 1987), endorsed the ability of a municipal utility to earn a profit. It also outlined a number of the arguments made against allowing a municipal government to earn a profit, and rejected them:

> "We interpret appellants' argument to be that Pennsylvania law requires that the earnings of a municipal utility be retained and applied to fund the internal operations of the utility. If the funds had been retained, rates either would have been reduced or at least would not have been raised. Therefore the direct taking of the funds for the city's general fund amounted to an indirect tax on gas consumers in the form of higher rates. The result is that the property of the gas consumers is being taken in the form of higher rates and that gas consumers are forced to assume an unequal burden of taxation amounting to a taking without just compensation and violation of equal protection of the laws. … These contentions are without merit."

Perhaps the strongest statement endorsing municipal government profit on its proprietary business is in the Florida decision in City of Pompano Beach v. Oltman, 389 So. 2d 283, at 286 (Fla 4th DCA 1980):

> "While its utility rates must be reasonable and non-discriminatory a municipality is entitled to make a reasonable profit from its utility operations and to use the proceeds thus derived for other valid municipal purposes…One may logically ask how can the public be better served than by the provision of municipal services

> made possible through reasonable earnings of the municipality from reasonably and competitive rates charged to users of its publicly owned and operated utility."

Florida courts have been perhaps the most generous in the nation on the amount of profit that can be earned by the municipal government. In Rosalind Holding Co. v. Orlando Utilities Commission, 402 So. 2d 1209, at 1213 (Fla 5th DCA 1981), the court dropped a footnote about the magnitude of profit that could be earned which stated:

> "fn 19. The City of Jacksonville receives [a profit of] 30% of its utility gross revenues. In an extreme case, there may arise the specter of a tax-free town made wealthy by its utilities operations both inside and outside its political limits."

On the other side of the spectrum from Florida courts on the issue of profit are the California courts. As an consequence of Proposition 13, certain limitations have been imposed on municipal governments with respect to revenue generation techniques. California courts disagree with their non-California brethren on the broad scope of ability to earn a profit, as noted in Hansen v. City of Buenaventura (1985), 213 Cal. Rptr. 859, at 882, where referring to payments in lieu of taxes as a means of generating a profit on customers outside of a municipal government's boundaries, the court stated:

> "Under article X111 B, with the exception of state subventions, the items that make up the scope of 'proceeds of taxes' concern charges levied to raise *general revenues* for the local entity." "Proceeds of taxes" in addition to "all tax revenues" includes "proceeds ... from ... regulatory licenses, user charges, and user fees *[only] to the extent that such proceeds exceed the costs reasonably* ****882*** *borne by such entity in providing the regulation, product, or service....*" (§ 8, subd. (c), italics added.) Such "excess regulatory or user fees are but *taxes* for the raising of general revenue for the entity City of Madera v. Black (1919) 181 Cal. 306, 313–314 [184 P. 397]...." … Thus, unlike the many states which have sanctioned the practice of allowing a municipality to make a profit on service to customers outside city limits previously served by a private water company, California law would prohibit such a practice. Furthermore, as a general proposition, a rate which produces an excessive return is a tax, and there is no California statute allowing a municipality to tax nonresidents by way of an in lieu tax, or otherwise."

Given that courts endorse a municipal government earning a profit to one degree or another, what are some of the current techniques that municipal governments been utilizing to fairly address and generate surplus funds from their proprietary businesses?

There are two principal accounting methods municipal governments use to address profit are to explicitly include a line item for profit "above the line" or to include a profit line item "below the line". In this context, "above the line" means adding it as a budget expense item or including it as an expense item in the calculation of the rates or charges for the service so that it is sure to be earned. On the other hand, "below the line" means that profit is not budgeted or included in the calculation of rates or charges, but is contingent upon there being a surplus after all other enterprise expenses are paid.

Some municipal governments favor the "below the line" method as it presents better optics to the public and provides an incentive for the municipal government to maximize efficiency of operation to assure generation of a profit. A municipal government using the "below the line" method can take steps "above the line" to provide assurance that profit will emerge "below the line". These include budgeting a healthy contingency reserve and conservative budgeting of operational expenses. Understanding the uncertainty of reliance on "below the line" profit, some municipal governments set a fixed "below the line" profit goal and accrue profit to be paid in future years if current surplus is not sufficient to fully fund.

Another tool used to assure "below the line" profit takes advantage of a standard requirement of municipal revenue bond debt issued to support the proprietary business. Most revenue bond debt covenants require the issuer to set rates and charges sufficient to pay all of the enterprise's operating expenses, debt service and an additional safety margin called "coverage". This coverage generally ranges from 10% up to 50% depending on the credit worthiness of the enterprise issuer. Like with the profit calculation above, "coverage" can be applied "above the line" or "below the line". Applying "coverage" above the line as an expense assures that the "coverage" falls to the bottom line as profit. A municipal government that wants to better secure their bottom line profit could choose to negotiate a higher "coverage" requirement on its bond debt (which would could have the added benefit of boosting the issuer's bond rating and potentially lowering its interest costs).

With many municipal proprietary businesses, however, the ability to increase rates or charges to generate profit is limited by constituent pressures or external competitive market forces. Where the proprietary business has reached a stage of maturity and revenue stabilization, the business often has embedded equity that could potentially be tapped for the benefit of the municipal government's general fund needs. One technique that has been used successfully has been to re-capitalize the business by transferring the assets to a newly created quasi-government entity controlled by the municipal government, releasing the embedded equity for use by municipal government. A number of variations on this technique have been used, including transfer of the business to a friendly independent quasi-government entity or another local municipal government. Public Private Partnership concessions are a further variation that has been used to release embedded equity.

This strategy of accessing embedded equity in a proprietary business can be structured to maximize the benefit to the municipal government owner. If the municipal government has more infrastructure capital needs, the transfer can be structured as a one-time capital recovery payment to the general fund. If the municipal government has more operating expense needs, the transfer can be structured payment can be structured like an annuity providing an annual revenue stream to the municipal government. And if the municipal government has both capital and operating needs, the transaction can be structured with a down payment and lower annuity.

As identified in the opening section above, a municipal government's public proprietary business is and can be operated like a private corporation, with the beneficiaries being the constituents of the municipal government as the beneficial owners of the proprietary business.