CHAPTER 2.  COMMUNITY SYSTEMS

3.  REQUIREMENTS.

   a.  When it is determined that public ownership and operation of central water and sewage systems is not possible, such facilities may be owned by a private corporation (profit or nonprofit). HUD reviews the engineering and planning of community water and sewage systems. All systems must serve sufficient properties to assure a successful operation. An insufficient number of connections usually results in excessive service rates and may cause the corporate organization to abandon the operation.

   b.  There are several acceptable methods of assuring continued service at reasonable rates. Among these are:

       (1)  Control by Public Utility Commission
       (2)  Trust Deed
       (3)  Third Party Beneficiary Contract
       (4)  Property Owners’ Association
       (5)  Franchises from Governmental Authority

4.  CONTROL BY PUBLIC UTILITY COMMISSIONS.

   a.  A community water or sewage system may be operated under control of a state regulatory commission, usually designated as the state public utility commission (PUC), or the state public service commission, where such commission has the statutory authority to control service and rates.

   b.  Although all states have a PUC, it may not be authorized to control water or sewage systems. Some of the state commissions control water systems only while others provide control over both types of utilities. PUC control in some states is provided only when requested by the owner corporation while, in others, such control is mandatory. PUC control is required by HUD in a State where the statutes make such control mandatory.

   c.  The PUC in some states does not have the statutory authority
to provide control of water or sewage systems to the extent that proper control over both service and rates is assured. One of the other acceptable methods described herein would have to be used as a supplement in cases where the PUC does not offer all of the controls considered necessary by HUD. Any questions regarding PUC authority and control for a particular state should be referred to the appropriate Area/Insuring office.

d. Application for control is made to a state PUC office. A Certificate of Convenience and Necessity (or similar permission to operate) is usually issued by that agency as evidence of PUC control. A copy of the certificate is required by HUD. This is usually considered acceptable evidence that control of continued service at reasonable rates has been established.

e. The degree of PUC control over organizational arrangements and continuity of service and equitable rates varies greatly. Some of these commissions do not have the statutory authority to provide the control to the extent required by HUD. Any question as to the adequacy of control must be decided by HUD.

5. PROPERTY OWNERS' ASSOCIATIONS.

a. A property owners' association may be organized for the purpose of assuring continued service of community water and sewage systems at reasonable rates. The association is made up of members who are owners of improved properties served by the system. HUD requires that such membership run with the land so that subsequent owners of a property will acquire the seller's rights in the association. The system is managed by a board of directors elected by the members and the arrangements for the actual operation and maintenance of the system are handled by the directors. Service charges are collected in an amount and at intervals determined by action of the members.

b. A property owners' association for utility ownership is usually formed at the time the land is developed. The association is initially controlled by the developer. The first board of directors is named by the incorporators since, at the outset, there will be usually only a few, if any, individual property owners for membership. As properties are sold by the developer and subsequently connected to the system, a membership in the association is automatically acquired by each purchaser. When a majority of the properties have been sold, the association selects its own representatives as directors, if desired.
c. Legal assistance is required to set up a property owners association since it is necessary to incorporate under the laws of the state as a nonprofit corporation. HUD requires the submission of the Articles of Incorporation and the By-Laws of the association and operating agreements, declaration of covenants, or any other instrument affecting the association or the rights of its members. These instruments are reviewed by HUD to determine if continued service at reasonable rates will be assured.

d. The following is a list of eleven points that must be included in either the Articles of Incorporation or By-Laws, or both:

(1) The association should be nonprofit and incorporated.

(2) Articles of Incorporation shall limit the purpose of the association to necessary functions and services to be provided by the association. Funds collected for domestic water or sanitary sewer assessments, dues, or service charges shall be disbursed only in payment for expenses of these systems.

(3) Articles of Incorporation and By-Laws shall provide for membership in the association for each owner of an improved property in the development. Such membership shall at all times be identified with the owner of the property or properties and shall not be subject to the approval of the Board of Directors or other members.

(4) Articles of Incorporation and By-Laws shall provide for voting rights in the association proportionate to the number of improved properties served by the system and owned by the members.

(5) No expulsion of members or cancellation of voting rights shall be permitted.

(6) Suspension of services provided by, or use of facilities of, the association shall be permitted for the period of time bills due the association are not paid. Liens for nonpayment of bills are permitted. When provision for suspension is included, there must be provision for prompt restoration of service or use of association facilities.

(7) The corporation must own the system. No lease arrangement is acceptable.

(8) The Articles of Incorporation and/or By-Laws shall provide
for proxy voting, but proxies shall not be valid beyond eleven months nor shall they be binding upon the purchaser of the property from the grantor of the proxy.

(9) Voting rights must be restricted to property with improvements only.

(10) No provisions restricting the ownership of improved properties may be contained in Articles of Incorporation and/or By-Laws.

(11) For newly formed property owners' associations, it shall be specified that the above ten points cannot be changed during the first year of operation except by a two-thirds majority of eligible voters and with the approval of HUD. For property owners' associations in existence over one year, the above ten points may be changed only by a two-thirds majority of all eligible voters.

6. TRUST DEED.

a. The operation of a private water or sewage system under a Trust Deed is another acceptable method of assuring continued service at reasonable rates. The Trust Deed is an instrument by which the owner legally (but not practically) conveys the system to a third party, (the trustee), who, on behalf of the consumers, has the authority to take possession in the event the corporation fails to operate the system in accordance with the provisions of the Trust Deed regarding reasonable rates and continued satisfactory service.

b. The trustee should preferably be a governmental authority. An established community utility, approved mortgagee, or a title company would also be acceptable. If a trustee other than a unit of local government or an approved mortgagee is proposed it will be necessary to determine that there is no identity-of-interest between the owners of the system and the Trustee.

c. The Trust Deed also contains a provision for arbitration in the event differences of opinion arise over a need for changes in service charges. This provision also includes an equitable method for determining the amount of a rate increase or decrease where such change is found to be justified.

d. Sample Trust Deeds are designated as Appendices 1 and 3 to this Handbook. Alternative paragraphs numbered 1 are designated as Appendices 2 and 4 to this Handbook. It is permissible to
use this alternative in substitution for paragraph numbered 1 whenever the "Grantor" of the trust property (Party of the First Part to the Instrument) prefers to use it. HUD will require the use of the alternative paragraph if it determines that the proceeds from a subsequent sale of the trust property should be distributed among the property owners.

e. The field offices can process a Trust Deed without further legal review if it complies with the sample Trust Deed, if service charges are reasonable, if the Trustee is acceptable, and if the properties to be served are properly described as an exhibit made a part of the Trust Deed. Legal review will be necessary where the instrument submitted is a modification of the Sample Trust Deed.

7. THIRD PARTY BENEFICIARY CONTRACT.

a. The operation of a privately owned water or sewage system under a Third Party Beneficiary Contract is another acceptable way to assure continued service at reasonable rates. This instrument incorporates many of the features of a Trust Deed. The basic difference between the Trust Deed and Third Party Beneficiary Contract is that the former conveys legal title of the system to the trustee, whereas the latter creates a covenant running with the land giving each homeowner and the Representative the right to commence suit for defaults in operation or unreasonably increased rates. The owner corporation agrees to perform Satisfactory service at reasonable rates. The instrument provides that any person whom the agreement benefits may petition a court of competent jurisdiction to appoint a receiver for the purpose of operating the system in event the owner does not provide service. The instrument also includes an arbitration clause similar to that in the Trust Deed for the adjustment of service rates.

b. The requirements or qualifications for the Representative are the same as those for the Trustee described above under the Trust Deed.

c. A Sample Third Party Beneficiary Contract is included in Appendix 5.

d. The field offices can process a Third Party Beneficiary Contract without further legal review if it complies with the Sample Contract, the service charges proposed are reasonable, the Representative is acceptable, and the properties to be served are properly described as an exhibit made a part of the form.
Legal review will be necessary where the instrument submitted is a modification of the sample contract.

8. FRANCHISES FROM GOVERNMENTAL AUTHORITIES.

a. Privately owned water and sewage systems can be operated under a franchise from a unit of government having franchising powers granted by state statutes. Evidence of this authority to franchise shall be required where such proposals are submitted for HUD's consideration.

b. A standard form would not be applicable for this method of assuring continued service. It is necessary that any franchise be submitted to the Field office for its review. Further review will be made by the Office of Underwriting Standards, Central office, when requested by the Regional Administrator.

c. The provisions of any franchise will have to assure control by the franchising authority of the quality of service as long as the use of the utility is necessary. If the initial term of the franchise is considered too short, it will have to be coupled with options to extend the term. Approval of a franchise arrangement will depend upon the circumstances surrounding each proposal.

d. It is also necessary to include in the franchise a provision for controlling the service charges and a provision for continued operation if the event service is unsatisfactory.