

Legally (Relevant



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Rates and Ratemaking – the Legal Guardrails

The manager of a rural water district is in her office, studying the district's financials. The annual audit was recently completed and the auditor expressed concern that the income statement shows that the district lost money the previous year, continuing a trend over the past several years. The district has plans to borrow money to do a much-needed pipeline improvement project, and the audit confirmed that the district would not be able to meet the required debt service ratio. The district has not increased rates in a number of years, and the board has made it clear that it has no desire to increase rates anytime soon. The district purchases water from a nearby city under a wholesale water supply contract. The city has been increasing its wholesale rate by five percent per year for the past few years, with more such increases expected in the future. What is she to do?

This article is not about how to set rates – articles frequently appear in *The Kansas Lifeline* that provide guidance by qualified experts on that subject. Rather, this article will explain some of the legal parameters – the “guardrails” – on rate making, both as to a system's retail in-city/in-district and out-of-city/district customers, as well as wholesale contract customers. It will provide some suggestions on how to arrive at a rate structure that stays within the law, but also highlight how difficult it can be to apply those rules of law to a given case.

Rates matter!

Why do rates matter? A dumb question perhaps, but an important starting point. The object of rates should not be just to make the customers happy today by keeping them as low as possible. This is true for every water and wastewater system, but

especially true for rural water and sewer districts because such rates produce the only revenue these systems have to perform the very service they were created to provide. For cities, the situation can be somewhat more flexible due to their ability to fill gaps, at least in the short term, through fund transfers. But in every case, having a sound rate structure is vital to each system's long-term viability.

The General Rule: Reasonableness

Kansas courts recognize that the setting of utility rates is a "legislative function" performed by the governing body of the city or district. Legislative functions are generally presumed to be valid, not subject to being struck down or modified by court action. (Remember that city and wastewater utility functions performed by a city or water district are not subject to Kansas Corporation Commission regulation).

But the courts have made clear that there are limitations to this general rule of presumed validity of water and wastewater rate-making. Those limitations are spelled out in a number of court decisions, such as the Kansas Supreme Court's opinion in *Shawnee Hills Mobile Homes v. RWD No. 6*. This case from 1975 involves a claim by a mobile home park that the rate it was being charged was excessive. The court, while noting the legislative nature of the district's rate setting, held that such deference to the legislative function also imposes a requirement that such rates be reasonable, not arbitrary, but actually based on investigation into the costs and needs of the system, using judgment to determine what is fair and reasonable. Reasonable rates are often described by their opposite – rates that are not only arbitrary but excessive and confiscatory – meaning simply taking customers' money just because they can. Rates



that are not based on investigation and reason, and therefore not fair and reasonable, are subject to being struck down by a court.

The rules that apply to customers outside a city are similar, but with the important addition that the courts have approved rates for out-of-city customers that are higher than in-city so long as there is a reasonable basis for the difference. In cases such as *Usher v. City of Pittsburg* and *Mitchell v. City of Wichita*, the court approved of these rate differentials between in-city and out-of-city customers (55 percent in the Wichita case) so long as the

reasonableness standard is met. In these cases, studies performed by the cities took into account investment in plant and facilities inside and outside the city, and allocation of operating, maintenance and depreciation charges. In other words, the cities went through a thorough investigation and exercised judgment to arrive at a fair and reasonable rate.

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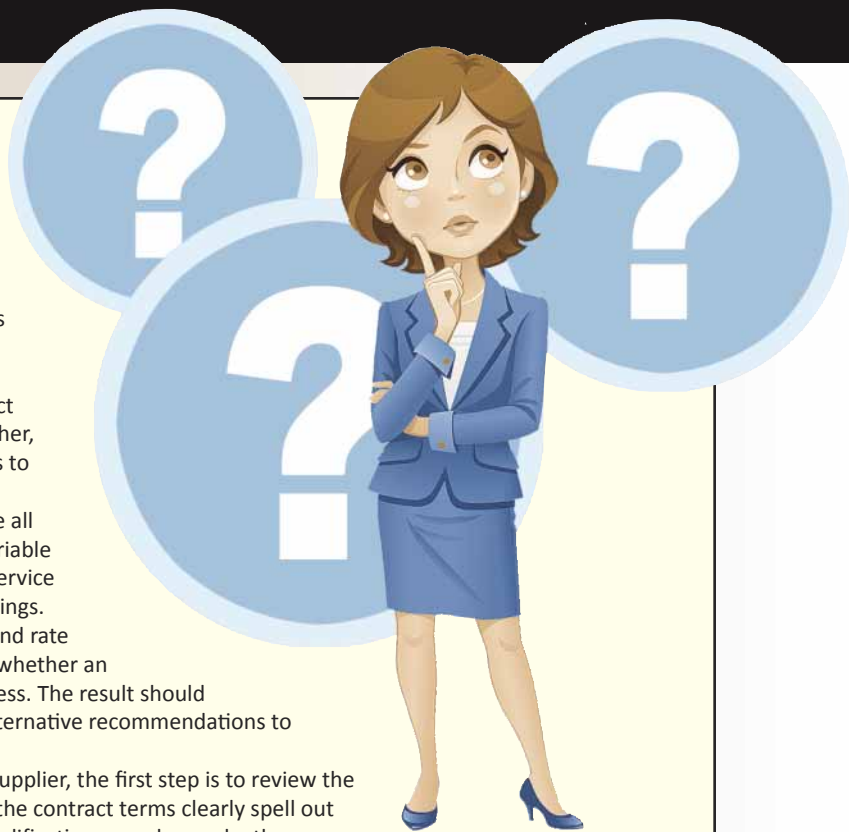
In addition to courts' inherent authority to review rates, specific state statutes may apply to some cities. For example, cities that operate a combined water and wastewater system through one department are

So, what is the manager to do?

The mission of every public water supply system is to provide adequate supplies of safe drinking water to its customers. All else is secondary. Low rates are obviously desirable, but artificially, unsustainably low rates that impact the system's ability to perform its mission are unacceptable. With audits confirming that the district has been losing money for some time, making a needed project unaffordable, and the prospect for district costs rising further, a rate increase is needed, and responsibility is to bring this to the board's attention.

Assuming the board agrees, the next step is to assemble all of the pertinent information relative to costs, including variable and fixed costs, past trends and future projections. Debt service for the new project should be considered, among other things. Unless the manager is very skilled in evaluating this data and rate modeling, the next step should be to engage expert help, whether an accountant or other rate professional to assist in this process. The result should be a reasoned, fact-based recommendation or series of alternative recommendations to present to the board for consideration.

As for the anticipated rate increase from its wholesale supplier, the first step is to review the contract, involving the system's attorney in that review. If the contract terms clearly spell out the basis for rate modification and the time when such modifications may be made, then review the proposed change with the rate analyst or accountant and attorney for contract compliance. If those provisions are not clear, a conversation with the seller needs to begin to review the basis for the increase. Qualified professionals, including legal, a rate analyst or engineer may need to be involved in this discussion and review.



subject to KSA 12-856 et seq., which provides that rates “be sufficient to pay the cost of operation, repairs, maintenance, extension and enlargement of the water and sewage system” and improvements and bonds and interest. Because such are not generally applicable but are specific to certain systems, they will not all be covered here. If in doubt if any such statutes apply, the city attorney should be consulted.

One factor that may be of interest, but has no bearing on actual “reasonableness” of a given rate is a comparison to neighboring or similarly sized systems. The circumstances surrounding each system's operation are bound to be so dissimilar as to make such comparisons of little value.

As for wholesale contracts, the same reasonableness standard applies, but again subject to a very important qualification. Most water supply contracts contain not only a rate that applies at the

outset, but also terms for how the rate may be changed in the future. The original Farmers Home Administration (FmHA) form water supply contract contained the term that rates could be modified based on a “demonstrable increase or decrease in costs of performance” of the contract. Despite the vagueness of this term, which has launched more litigation between buyers and sellers than anyone can count, it persists in many current contracts. Other contracts may tie the rate to future modifications to the seller's retail customers' rates (for example, the wholesale rate shall increase or decrease by the same percentage as the retail rate), may contain a fixed periodic rate change or be tied to an index, such as consumer price index, or contain a formula based on changes in the seller's specific cost categories. Whatever the contract provisions, the courts will not interfere with the terms unless entered into without legal authority or otherwise illegal.



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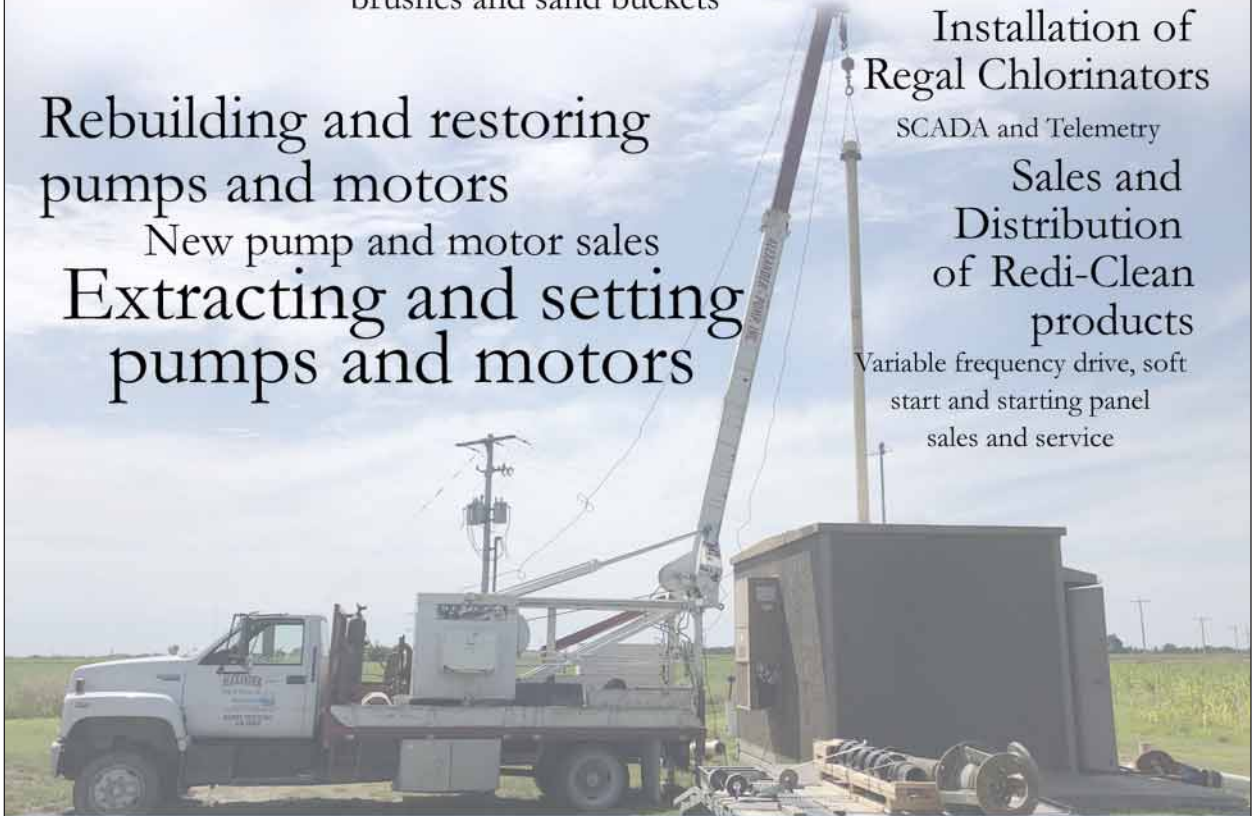
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