by Elizabeth M. Dietzmann, JD

# When are 7 U.S.C.A. 1926(b) cases justified?

**Credit-worthy water districts routinely take out Rural Development (RUS) loans for the sole purpose of obtaining territorial protection, so that they can claim the exclusive right to serve these new developments.**

As urban sprawl increases across the United States, public water supply districts inevitably find themselves rubbing shoulders with nearby cities. This friction is leading to an increased number of lawsuits under 7 U.S.C.A. 1926(b), which was enacted to protect federally indebted, nonprofit water associations from "competitive facilities, which might otherwise [be] developed with the expansion of the boundaries of municipal and other public bodies into an area served by the rural system." S. Rep. No. 87-566, at 67, 1961 U.S.C.C.A.N. at 2309. As city boundaries overlap with water district boundaries, more and more water districts are using 7 U.S.C.A. 1926(b) to determine which entity gets to serve new development. Credit-worthy water districts routinely take out Rural Development (RUS) loans for the sole purpose of obtaining territorial protection, so that they can claim the exclusive right to serve these new developments. This is an important distinction to note. Most of the "original" 1926(b) cases dealt with fact situations in which water districts with pre-existing RUS loans had actual district customers and infrastructure seized by competing municipalities. Gradually the fact scenarios have shifted until today most 1926(b) cases involve areas that are targeted for future development. Generally these are areas in which the water district has not made investments in infrastructure. In a previous article, I have reviewed the difficulties and the expenses involved in 1926(b) litigation. This article will focus on whether or not 1926(b) cases make financial sense for water districts fighting over new development and cover some basic financial analysis that should be considered before a case is filed.

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*New development at the edge of Wamego, Kan.*

The first question that needs to be asked is whether or not a credit-worthy water district should even be attempting to seek federal loans with the collateral goal of obtaining 1926(b) protection. This definitely happens on a regular basis. I am familiar with the credit test for RUS, which should preclude water districts that can afford commercial credit from borrowing federal dollars. I also know that tougher standards are being implemented by the RUS state offices, which include a more independent assessment of a water district's financial capacity and some formulas for financial analysis which must be followed. But the fact remains that many otherwise credit-worthy districts have been able to obtain RUS loans for the sole purpose of obtaining 1926(b) protection, when they could have easily sought out commercial credit. I have also worked with districts that have steadfastly refused to re-finance or pay off old RUS loans for the same reason. Those districts seem to be able to avoid graduation of their old loans, even though they have the financial ability to pay them off. I know because I have worked on the projects. I know what techniques are used to get and keep RUS loans.

This is a warped use of federal monies at best. The whole point of these loan programs was to provide grant/loan moneys to areas that could not otherwise afford to build drinking water systems. There are still many areas that cannot afford drinking water systems and the amount of federal funds to build these systems shrinks every year. So is it really appropriate for well-established water districts to gobble up federal dollars in order to serve new construction? Shouldn't the developer and the future homeowners shoulder that burden? Why should ALL the water district customers service that debt, which is incurred for the purpose of fighting over a specific piece of new territory? Shouldn't water districts focus on serving existing district residents who may not have had water service made available? Or maybe improving the quality of service to existing customers or making system improvements? The cost of service is just as important.

Water districts should be working to provide the most cost effective services to as many customers as possible. With commercial interest rates at all time lows during the past few years, the cost of a 30 to 40 year RUS loan may not be all that low. The decision to borrow federal money should be made after comparison of the true loan costs of a longer term RUS loan to conventional financing. The extended period of time it takes to obtain an RUS loan should also be compared to the relatively short period of time it takes to set up commercial financing or in cases, other loan programs. Construction costs are only rising and the savings to be had in doing a project now, instead of three years from now, should also be considered. In addition to longer loan terms, RUS requires more restrictive reserve accounts for debt service and many hidden costs that drive the total loan amount up. Are water district boards making the best financial decisions for *all* of their customers when they choose to use an RUS loan as a weapon in the fight for territorial protection? Notwithstanding the costs of 19269(b) litigation, the decision to obtain an RUS loan may not be in the best interests of the water district financially.

Now, lets consider the cost effectiveness of 1926(b) litigation. I mean the real cost effectiveness. Unfortunately, I do not believe that most water boards really analyze the cost of pursuing 1926(b) litigation in the same objective way that they would otherwise analyze the cost of providing water service to an area. Maybe that is because water district boards are the unsung heroes of the utility world. These are often lay volunteers for the most part, struggling to provide clean drinking water to rural areas. These board members have tremendous loyalty to the district and they tend to become very zealous about protecting the district against perceived threats. Egos become involved and strong personalities often emerge. The district's territory becomes sacrosanct. After years of being treated like second class amateurs by the "professional" city utility employees, many board members and managers react emotionally to territorial conflict, rather than rationally. O.K., I am trying to be

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# Park City, Sedgwick RWD 2 compromise "working out"

*By Elmer Ronnebaum*

A dispute over service territory between Sedgwick RWD 2 and the city of Park City led to a compromise that averted a lawsuit nearly 8 years ago. According to Paul Carey, RWD 2 Chairman, that agreement is working out just fine.

The compromise in 1997 came nearly a year after Park City filed suit against the RWD over land the city annexed within the District's boundaries. Under state law, Park City had the option to provide water service to the area after paying the District the value of facilities assumed. However, because Sedgwick RWD 2 had an outstanding federal debt, the RWD contended that it had protection under 1926b and that the federal law superseded the state law. Park City maintained that the RWD was not protected by federal law because it did not have an adequate water supply to service the annexed area.

Under the agreement between Park City and the RWD, Park City pays RWD 2 a $250 connection fee for each new customer that connects to the city system in the area that was annexed. The city also pays a 17 percent franchise fee on the gross water sales for each single-family residence and an 8.5 percent fee for commercial, industrial and multi-family dwellings.

Park City's rates at the time of the agreement in 1997 were $225 and a monthly water bill of about $22. The franchise fee added about $3.50 per month. Had the RWD attempted to serve the area, it would have needed to improve its capacity and new connections would have cost applicants $2,250 with an average water bill of $47.

Carey says that the agreement is working out well after eight years. "Our RWD would have been limited to 5-acre tracts under county zoning regulations," Carey reports. Park City on the other hand, has extended utilities into the area and is not bound by the acreage limitation, allowing much more dense construction.

In another area of the Sedgwick RWD 2, the city of Valley Center annexed territory and agreed to a payment for RWD facilities that were assumed. "The final settlement between RWD 2 and Valley Center amounted to 23% of the District's outstanding indebtedness – but that was a cash settlement and there's no further agreements involved," Carey says.

Carey suggests that RWDs need to be sure to be adequately compensated for any facilities assumed by a city in an annexation.

The payment from Park City to Sedgwick RWD 2 averages about $2000 per quarter for new connections made by the city and the franchise fee on water sold by the city.

"People need to be reasonable about service territories," Carey said. Carey suggests that people need to be realistic from a fudiciary perspective when public water suppliers are in disagreement over territory issues or such things as water purchase contracts.

diplomatic here. The fact is, often the biggest obstacle I have faced in negotiating a realistic resolution of a territorial conflict is my own board. Personality conflicts and old personal grudges are the order of the day. On more than one occasion I have had board members refuse to consider beneficial settlements because they say "The city isn't going to serve any customers in our district as long as I am on this board!"

The problem is, to my knowledge, no one has really studied the **cost effectiveness** of 1926(b) litigation. It would be really intriguing to have NRWA economically analyze the cost of 1926(b) cases to see if historically the districts have benefited or not. In its simplest form the question should be: when a district has won a 1926(b) case, are the total costs of that case ever recovered out of the revenues generated by the disputed territory? That is the real question. If the cost of 1926(b) litigation was simply the cost to the district to provide water service to a new area, if all the emotional and personal issues were removed, then it would be a purely economic decision. And just possibly, as an economic decision, it might not make sense to spend that kind of money to serve relatively few customers. I have routinely seen water boards tell customers that it simply is not cost effective to run a new line out to them because the cost would not be justified by the number of users. Why should the decision to file a 1926(b) case be any different?

Now getting hard data is tricky. Not only would it be time-consuming, but few districts really track this information. Even if they did, I doubt that they would be very interested in undergoing this kind of analysis. I am not an economist or an engineer, but the basic formula would have to follow these lines. In a scenario

where a district is fighting for the right to serve a previously undeveloped area, the district would need to know their actual cost of providing water and after comparing that to the rates charged, calculate the actual profit to be made on the disputed area. Then divide the total cost of the 1926(b) litigation (attorney fees, discovery costs, expert's fees, overtime hours, etc) by the number of connections to be gained. Some adjustment would have to be made for the fact that all the new construction wouldn't take place at once, so you wouldn't recoup all the money at one time. But you would have a rough estimate of the additional debt per connection, on top of any infrastructure cost that the district would have to retire before it could make a profit on those new connections. With 1926(b) litigation costs regularly running close to $250,000 (I have seen double that on more than one occasion) and with the typical case involving a few hundred customers, I wonder if many cases make financial sense. It is really a simple allocation of resources argument. Does it make sense to spend X in order to serve Y customers? Let's be realistic. The entire revenue base of the district is going to have to be used to service the debt on any federal loans so it is simply not credible to argue that the water districts must pursue 1926(b) litigation or they will be unable to pay their federal loans. In fact I have seen just the opposite occur. I know of one water district that was behind in its federal loans before it ever filed a 1926(b) case and I know of several others that were so broke after winning their 1926(b) cases that they also fell behind in payments and were forced to raise rates.

The only example of a recent 1926(b) case which makes financial sense to me is *Village of Grafton; King, Ltd. V. Rural Lorain County Water Authority, Slip Opinion Number 04-3643, 6th Circuit.* I was skeptical at first as to why it made sense for the water district to fight over thirty new connections. But after a long conversation with Dennis O'Toole, the attorney for the water district, I was surprised to discover that this case did make economic sense because of the unique fact situation. First, Rural Lorain County Water Authority actually provides all the water needed by the village of Grafton, Ohio and had taken out federal guaranteed loans in order to in part meet the additional water needs of Grafton. Second, RLCWA had the authority to provide water service in all the unincorporated areas of Lorain County, so it was a large, well-funded utility. Third, RLCWA provided water to many towns in the county and previously negotiated profit sharing agreements with other towns for the service of new developments. RLCWA had separate rates for wholesale water to towns and retail water to direct customers, and it would allow the towns to serve new areas directly as long as the town paid RLCWA its net profit. Fourth, and most importantly, Dennis O'Toole was kind enough to share the fact that the total litigation costs were around $30,000, the district stood to earn $363 per year per connection with little cost outlay,

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and that the number of connections would be about double what the court referenced in its opinion. This is an unusual set of facts that clearly indicated that it made economic sense for RLCWA to bring suit under 1926(b). The problem is that most 1926(b) cases do not met these criteria and the water district may spend hundreds of thousands of dollars to secure the right to serve a comparatively small number of customers. On top of that is the fact that victory in one 1926(b) case will not guarantee a water district blanket protection. The tests for ability to serve have become so narrow that water districts now face the reality of having to file suit under 1926(b) for each new area that is disputed.

So if it is too expensive for water districts to fight over new territory, what can they do? If 1926(b) litigation is too costly for districts to use to protect infrastructure investments in new areas, can they risk making those investments? Many water districts feel that they must pursue litigation in order to serve new areas, because they are afraid that if they do not, then cities will attempt to seize areas where the district has already made a significant investment (like the "original" 1926(b) cases.) Instead of drawing that line in the sand, maybe water districts can use some other approaches. Many rural sewer districts and towns have faced this problem because of the high cost of sewer infrastructure. One of the requirements of SRF funding is that a sewer use ordinance must be enacted that specifically states that once a customer connects to the sewer system, they must remain a sewer customer. In addition, water districts in states where these same systems also provide sewer service, require that all sewer customers become and remain water customers, so that billing and shut-offs can be handled consistently. In both of these situations, the customer does not get to disconnect from sewer and go back to a septic system. What if water districts started looking at some incentives and restrictions on water service agreements? If there is a landowner who wants water service, why not ask them to sign a binding agreement that states that in exchange for water service they agree to remain customers of the district? If agreements were filed of record like easements, then any future landowner would be bound by them. Districts could explore incentives such as reduced tap fees or advance development agreements in exchange for such commitments. There are definitely some creative ideas to be explored. It would be ideal if this issue could be addressed on a national level and a stake holder's group could be formed through NRWA to really analyze the effectiveness of 1926(b) litigation and to explore realistic, cost effective ways to resolve territorial conflicts. I would be excited to work on such a project and I bet I could get Dennis O'Toole and others to do the same. I also know that Kansas Rural Water and other state Associations are anxious for productive discussions along these lines.