

Legally (Relevant



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Water supply contracts (Part I)

This is the first installment of a series of articles that concern water supply contracts. This first installment will cover the basics, with later installments to cover ideas on how to structure a contract that will work for you and what happens when a dispute occurs between the buyer and seller to a water supply contract.

Why are water supply contracts important?

Many water systems do not produce their own water. In some instances there is no water supply available to them, or the cost of developing an independent water supply is prohibitive. This has never been more true, with regulations requiring a higher quality product, and ever higher water treatment plant construction and operating costs. The economies of scale can make a larger facility,

-serving a broader geographic area, more economical and dependable than a series of smaller, less efficient plants spread around the country. In addition to availability and cost, operation of a production system adds a new level of demands on the technical and managerial capabilities of the city or rural water district. Again, it is often preferable to concentrate these resources in one, larger supplier rather than trying to develop and maintain these capabilities through a number of smaller plants.

For these and other reasons, a large number of public water supplies in Kansas are dependent upon purchase of water at wholesale from a supplier, and as a result, a large number of water supply contracts are in use in Kansas. That means there are constantly new contractual arrangements being made, or old ones amended or renewed. So how do you get started?

The players

Development of a new water supply contract, or amendment of an old one, should be a team effort. The manager or superintendent should lead that team, assigning the roles each of the team members should play, supervising their involvement and seeing development of the contract until it is ready to present to the governing body for approval. That does not mean that the governing body should see or hear the proposed contract for the first time at the meeting where it is asked to approve it, but it is impractical to expect the actual negotiation and development of an agreement by a committee of five, seven or nine members.

The development of a good water supply contract is necessarily a technical exercise. Every water supply contract has two important aspects: a capacity/demand function and a financial function. No system should be agreeing to sell water under a water supply contract if it lacks the supply, ability to treat and deliver the quantity of water it is contracting to sell. Conversely, no system should be contracting to buy a supply that will be inadequate or that it can not use due to difficulties with delivery pressures or other circumstances. If the expertise to evaluate these considerations is not available in house, then the system's engineers

must be involved in the contract development process.

The financial aspect of the contract is also vitally important. It goes without saying that a seller should not be agreeing to sell a product for less than it costs to provide it. This is not a simple calculation to make, and it is very important that the seller utilize resources, whether those available in house, through its engineers or accountants or technical assistance providers, to evaluate its costs in supplying water to the prospective purchaser and pricing the product accordingly. The buyer needs to understand how the seller is pricing the product, how that will impact its rates and how those costs will really compare with other alternatives available to them. In most cases this will also require outside assistance from capable professionals.

Lastly, the parties each need an attorney who can assist them in assimilating the terms that they are developing for the contract and reducing them to an understandable contract. Most contract terms contain advantages and disadvantages, and in many instances unintended consequences, that

the parties need to have explained to them, and a competent attorney can help do that.

Getting started

Once the desirability of a water supply contract has been determined and the prospective buyer and seller have each assembled their teams, it's time to start working on the terms of a contract. In general, the elements of a water supply contract consists of the following:

1. Specifications (quantity - minimum and maximum; quality, pressure and rate of delivery);
2. Connection fee, if any;
3. Initial water rate, and basis for future rate adjustments; and
4. Duration.

These are the basic terms, but there are others that should be included as well, such as the place of delivery and any extension or improvements needed to make water available for delivery and purchase, meter ownership, access, maintenance and accuracy; provisions for what to do in the event of shortage or outage, and similar terms. The contract may also be a

place to deal with future adjustments to boundaries that may occur through annexation or otherwise. The team needs to understand the capabilities and needs of each system and work towards agreement on these terms.

Setting and adjusting rates

Setting the initial rate is critical to a successful contract, but if that rate is unacceptable to one party or the other, the negotiations will come to an end and there will be no contract. The seller's and buyer's teams need to work to make sure that the rate is adequate for the seller and fair and affordable to the buyer.

As complicated as the process may be to establish

PHOTO BY DENNIS SCHWARTZ



Many water utilities are required to make improvements to water treatment processes to comply with Safe Drinking Water Act regulations. A frequent source of disagreement when negotiating water purchase contracts is whether those improvements should be factored into the costs of production and subsequent water rate adjustments.

this initial rate, that is not where the potential for future conflict exists. That distinction lies with the terms for future rate changes.

Perhaps no term in a water supply contract is the source of more friction between buyers and sellers, and thus more important than the provision that concerns how water rates will be modified in the future. There are three general types in use in Kansas:

1. The seller simply sets the rate;
2. The seller can set the rate, but any increase must not be less than an increase to the seller's other customers or other customers of a similar type or class; and
3. The rate is to be modified based on increases in the seller's costs. Sometimes these types are seen in combination, sometimes called the "belt and suspenders" type such as where the rate can change based on changes in the seller's costs, but by not more than the seller increases its charges to its other customers.

The first type, in which the seller is allowed to modify costs periodically is most often found in contracts with larger cities that have large scale operations and frequently have multiple wholesale customers. The seller's rate-making ability is not as broad as it might first appear because, as will be discussed in a later installment, the law places some limitations on the seller under such contracts that restrict the seller from simply charging whatever it wishes. However, such contracts would not be appropriate in all circumstances, for example for those sellers whose operations are relatively small in scale.

The second method of controlling rate increases is premised on the idea that the seller will not be inclined to raise rates excessively to the wholesale purchaser if it could do so only by raising rates excessively to all of its customers. There is some logic to this idea, and the law does again provide some restrictions on how much the seller can charge for its product. This method of limiting increases in rates has the advantage of being simple to apply, and it appears in a surprisingly large number of water supply contracts in use in Kansas. It does have its

disadvantages. Because most wholesale sellers have retail customers as well as the wholesale customer being served under the water supply contract, the costs of serving the retail customers may be significantly different than the costs of serving wholesale customers. Even the costs of serving certain wholesale customers may be significantly different than the costs of serving others. A contract that requires that all of these rates move in lock-step during the duration of the contract can result in some customers paying much more than their fair share while others pay less.

There is nothing in a water supply contract any more likely to create disagreement than a provision that bases water rate increases on the seller's increase in costs. This subject will be discussed in much greater detail in a later installment. At this point, suffice it to say although this type of rate adjustment provision appears to be the one most closely tied to the requirements of Kansas law, and also the most fair to both seller and buyer, it is full of potential disagreements, and as a result the source of more fights between sellers and buyers than any other.

Conclusion

For many water suppliers, water supply contracts are an essential part of their business either as seller or buyer. These contracts serve an exceedingly important role in many systems' ability to deliver a safe, reliable and affordable product to their customers. Great care needs to be used in the developing a new contract or amending or replacing an old one. A team of professionals needs to work with the system's management to effectively meet its goals. There are some essential elements to every water supply contract, and great care needs to be given to making sure that those elements are satisfied by negotiating terms that are workable for both buyer and seller. Some important choices will need to be made in the course of developing the contract, and the alternatives and consequences of those choices need to be understood as they will impact both seller and buyer for years to come.

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