

Legally (Relevant



by Gary Hanson, JD
Stumbo Hanson, LLP, Topeka, Kan.

Water supply contracts (Part II)

This is the second installment of a series of articles on water supply contracts. The first installment (see November 2008 issue of *The Kansas Lifeline*) covered the basics: Why are these contracts important, who needs to participate in making them and what is the role of each participant, and what are the essential terms of an agreement. This article is geared towards helping you structure a contract, whether as buyer or seller, that will work for your system. It will also touch on some of the things that can go wrong with a contact over time. The third installment, for the next issue, will concern what happens when things go wrong and you find yourself in a dispute over one of these contracts.

Structuring a contract that fits

It's apparent that no two water systems are alike. Systems vary greatly in size. Some systems are looking for an entirely new water source; some are attempting to obtain a supplemental supply. A system that is a potential seller of wholesale water may be constructing a new water treatment plant that will have excess capacity; others may have an older plant that needs major improvements or even replacement.

Just as no two water systems are alike, there is no reason to think that all water supply contracts should be alike. The days of filling in blanks on a form contract are over, or at least should be. The key to structuring a contract that works requires assembling a team of management and consultants to determine what the client system has and what it needs, based on specific circumstances. Until such an evaluation is conducted, it is not possible to begin structuring a water supply contract.

So once the needs are determined, how does a board or council and staff members start putting the contract together? The first few steps depend initially on the guidance of the technical experts – management and engineering. As a buyer, a system must identify a suitable supplier. A seller must identify a suitable buyer (if the buyer has not already made an inquiry). This depends on obvious factors involving quantities available, pipeline routing and of course, cost of constructing the facilities needed to utilize the supply.

At this point the first of those critical decisions referred to above come into play. Is the buyer looking for a new sole source of supply, or is this to be supplemental to an existing source? If supplemental, can this be an "excess purchases" contract, by which the buyer is simply looking to buy water if and when it is available from the seller, or is it a supply that is going to be relied upon by the buyer to meet some portion of the buyer's needs during all, or at least peak periods of demand? This determination will guide the entire contract formation process, and is the first decision that must be made before the contract can develop. The next decision concerns the amount of supply. If this is to be an excess purchases contract, then this will not be an issue. If the seller has water to sell, the buyer will buy what it needs. There is little reason for a minimum or maximum quantity provision in the contract under such an arrangement.

This is not the typical situation, however. Water suppliers' customers do not just like to buy water – they buy it because they need it. Water suppliers have a responsibility to meet that demand 24/7, and that means that in most instances they must have a contract that commits the seller to supplying water under the terms of the contract at all times.

Assuming this is the case, sellers need to be sure there is a reasonable cap on the water the buyer can demand under the contract. This may be expressed in terms of maximum quantities daily, monthly or annually and/or maximum peak flow rates. Buyers need to ensure that the contract contains caps that are sufficient to meet the buyer's needs at the present and in the future, or contain provisions for how those maximum quantities/flow rates may be adjusted later if circumstances require it. These are management and engineering decisions that lie at the heart of the contract. As we will see later, these decisions also have important financial considerations to the buyer and seller as well.

The next important consideration is for the term (duration) of the contract. Historically, many of these contracts have had forty-year terms because the buyer was a USDA borrower with a new forty-year USDA loan. That is, USDA regulations required that its borrowers have contracts ensuring the supply of water that would not expire before the USDA loan was scheduled for payment in full. This is still a requirement for USDA borrowers, so if you have a USDA loan this must be considered.

For many others, forty years simply seems like too long for a water supply contract. Thinking back forty years from today, to 1969, confirms that a lot of things can happen in forty years. In the water industry many changes have occurred, the most important of which being the enactment of the Safe Drinking Water Act and all the related regulations which have drastically

changed the business of public water supply. Few sellers are willing to bet that such changes will not occur in the next forty years, and as a result are simply unwilling to enter into contracts of such duration. Right or wrong, twenty year contracts seem to be the norm, sometimes with some form of option to renew.

The big issue – water rates and rate adjustments

The elements of a contract described above are all very important. But they are all also fairly objective terms that seem relatively easy to work out between a buyer and seller who are generally interested in water supply contracts. After the contract has been made, these provisions rarely result in conflicts in the future.

Not so for the price and future price adjustment provisions of the contract. This is where most of the time and effort is spent in developing a contract, and where the vast majority of future conflicts arise. Both buyers and sellers need to be extremely thoughtful in developing these terms of a contract. The Kansas Supreme Court has essentially ruled that the parties to a water supply contract are bound by its terms, no matter how ill-advised it may be.

In general, lawyers are not rate-making experts. This is a specialty of its own, usually practiced by financial advisors, accountants and engineers and other technical assistance providers, with the lawyer's job being to reduce the concepts created by the management team to contract terms that are consistent, understandable and enforceable. The lawyer's role is to assist in seeing these negotiations on price and price adjustment through to a final agreement and later, interpreting that agreement for their clients and advocating their client's positions if a dispute occurs. In this role, experience has taught a few lessons:



A contract that contains cost adjustment provisions that wholly exclude the seller's future capital costs from future rate adjustments is bound to result in conflict. This provision is common to USDA form contracts and those modeled after the USDA form.

1. A contract that contains cost adjustment provisions that wholly exclude the seller's future capital costs from future rate adjustments is bound to result in conflict. This provision is common to USDA form contracts and those modeled after the USDA form. It is ill-suited to an era when tightening water quality regulations require improvements to treatment processes that according to such a contract must be performed by the seller in order to deliver a saleable product but for which the buyer has no responsibility to share in any of the costs through the rate or otherwise.
2. Buyers need to be wary of contracts that tie their wholesale rate to that of the seller's retail customers. This is particularly true if the wholesale buyer represents a substantial portion of the seller's total sales.
3. Some contracts allow the seller to establish the rate periodically without any specified criteria governing those adjustments. These are typically found in contracts in which one of the larger cities is the seller. State law contains general restrictions against discrimination among classes of users, and further provides a general reasonableness standard for rates. Challenging the reasonableness of the rate under a contract of this type will be a formidable and expensive task.
4. Many contracts contain a provision that rate adjustments will be based on changes in the costs of performance under the contract. This form appears to be the most objective and reliable method of ensuring a reasonable rate to the buyer, while assuring the seller that it can recover its costs plus a reasonable return on its investment. The fact is that such a provision is

loaded with potential sources of conflict and is the source of more litigation between wholesale water buyers and sellers than all others put together. These provisions typically have numerous undefined terms. For example, are the costs of the entire system to be considered, including maintenance of the distribution system, or just costs of production plus that part of the main transmission system that links the production plant with the wholesale buyer's system? How about administrative expenses? When employees are not devoted to strictly one function within the water system, but instead share duties, are those to be tracked according to time, or are estimates sufficient? Are audited financial statements to be the sources of this information, or internally created cost accounting?

All of these issues have come up in lawsuits, sometimes at a cost of tens of thousands of dollars to have a court sort out the answers. The lesson to be learned with regard to this type of cost-based water rate adjustment provision is that you cannot include too much detail at the outset as to how these costs are to be measured, what costs are included and what are not, and how frequently and when they are to be measured and adjusted. The best such contracts probably contain an attachment that very specifically lists the categories of costs that are to be considered and ties them to a specific accounting product that will be consistently produced and used to compare costs in order to accurately track these changes.

Conclusion

Water systems are different, and water purchase contracts need to reflect those differences. Getting out a form contract and filling in the blanks is the wrong approach. Instead, management needs to consult closely with the system's consultants, particularly financial advisors, accountants and engineers, to accurately assess the needs of that system as either a seller or buyer, and then develop a contract that addresses those needs. Development of a water supply contract is no time to scrimp on these professional costs, as short-cutting the process at the contract development stage almost assures you of spending a lot more in the future when the problems occur.