

# **Water Rates, Fees, and the Legal Environment**

Second Edition

C. (Kees) W. Corssmit, PhD, Editor



**American Water Works  
Association**

**Water Rates, Fees, and the Legal Environment**  
Second Edition

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# **FOREWORD TO THE SECOND EDITION**

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**Bernice Bagnall, Chair, AWWA Rates and Charges Committee**

“Whiskey is for drinking; water is for fighting over.” This quotation, attributed to Mark Twain, seems an apt beginning to the second edition of *Water Rates, Fees, and the Legal Environment*. One doesn’t have to be a part of the water industry to appreciate Twain’s insight. Water is one of the world’s most precious resources, and competition for it can be fierce. If those providing water are perceived to be charging an unfairly high price for it, or showing favoritism to a particular customer or customer class, the result can be sometimes bitter (and frequently expensive) legal proceedings.

## **The Evolving Legal Environment and A New Chapter**

In 2002, the American Water Works Association (AWWA) Rates and Charges Committee presented a workshop at the Annual Conference

and Exposition focused on the legal environment water utilities operate within. Topics included a history of water rate case law, key legal concepts encountered in water rate making, preparation for litigation, case studies, and alternative dispute resolution techniques. Keen interest in the workshop and follow-up inquiries to the Rates and Charges committee suggested that a formal guidance document was needed, and in 2005 the first edition of *Water Rates, Fees, and the Legal Environment* was published. Since then, legal issues and requirements have continued to evolve, particularly in water-deficient regions like the State of California, where utilities are increasingly looking to conservation-oriented rate structures as a way to manage scarce resources. It is reasonable to expect that California-based legal challenges and subsequent refinements to laws governing equitable rate practices will provide a basis for changes in other states facing similar issues.

It is appropriate and timely, therefore, that this handbook has been updated by the primary author, C.W. Corssmit, PhD, and a new chapter has been added specifically addressing “Conservation Rates and Cost Nexus: The California Evolution.” In this chapter, Dr. Corssmit describes how recent legislative changes in California water rate making have addressed the reconciliation of traditional cost-of-service rate-making goals of avoiding subsidizations of customers with local community goals to promote water conservation. Starting in 2009, rates must be based on cost-of-service principles and include a rational nexus between actual costs and each component of the rate structure. All water rate structures, including increasing block rates and water budget rates, can only be based on the actual costs of serving the corresponding consumption. Utilities may only collect user charge revenues sufficient to meet their user charge revenue requirements.

The new chapter 9 contains a review of relevant legal principles for defensible rates, a history of the California legislation since the late 1970s pertaining to water rates, further reviews of relevant recent changes to California law, consistency of the new legislation compared with earlier selected court rulings, and the implications for water utilities in California and possible ramifications for utilities across the United States.

# PREFACE

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C. (Kees) W. Corssmit, PhD

Preparations for this handbook's first edition started during 2001 when the American Water Works Association's (AWWA's) Rates and Charges Committee undertook the task of developing a preconference workshop titled "Water Rates, Fees, and the Legal Environment" for the Annual Conference and Exposition (ACE) in June 2002. Since its publication in 2005, the first edition has been well received and quickly become one of AWWA's best-selling books.

In suggesting the preparation of a second edition, AWWA asked me if new relevant developments had occurred in water rate making since the genesis of the book's first edition in 2001–2002. Indeed, the rapid deployment of conservation rates throughout the United States has caused many water utilities to adopt new rate practices that accentuate conservation of water supplies. Often, such rates have precipitated questions about the

need to maintain cost-of-service principles in rate design that avoid the subsidization of any customer by any other customers.

The purpose of the second edition of this book is to answer these questions. It is important to design rates, including conservation rates, with a strong nexus between cost basis and rate equity with water conservation goals. Water conservation rate structures should not include rates that exceed the actual cost of the water consumed. Nor should they result in interclass or intraclass subsidizations. Rather, interclass and intra-class rate equity considerations can, and should, play a significant role in designing water rates. The recent legal developments in the State of California have provided a useful learning ground to explain the opportunity, and need, to harmonize both of these rate equity criteria with conservation rate structures where increasing block rates, or individual budget rates, are used.

For the original book, Rates and Charges committee members David LaFrance, now executive director of AWWA, and I crafted an outline for the 2002 preconference workshop. One of the goals was to produce a workshop that, at least potentially, could lend itself to the institutionalization of the assembled information into a permanent resource for rate practitioners and others interested in this subject. With the approval of the committee, I then wrote a detailed outline for each chapter and approached a number of rate and legal experts to further develop these outlines into a comprehensive presentation. The response by these experts was very positive. Individual presentations were then developed by Integrated Utilities Group Inc. (IUG, now Red Oak Consulting) staff, reviewed and complemented by contributing authors, and, after several iterations, assembled by IUG as chapters in a workbook published for the workshop.

The participating experts subsequently presented each chapter at the ACE workshop. Presentations were by individual authors or consisted of panel discussions with audience participation. Altogether, some 180 overhead slides were used for that presentation. Additional preparatory assistance was also provided by several members of the Rates and Charges Committee and by various staff members of IUG who provided graphics, writing, editing, and coordination among all participants. The detailed overhead slides were produced by IUG and reproduced by AWWA.

The 2002 ACE workshop was well attended and received high ratings from participants. Various individuals and AWWA publications staff expressed interest in having the workshop materials developed into a published handbook. All co-authors, contributors, and presenters at the New Orleans workshop were asked if they were interested in assisting in the development of a handbook from the workshop materials. A significant interest was expressed; albeit the majority of the participants suggested

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that the text for the chapters be written by me, after which they would be happy to review the materials and submit needed editorial changes and suggestions. That process started in the fall of 2002. IUG undertook the drafting of the majority of the chapters and edited the submittals of chapters written by the presenters of the corresponding topics at the workshop. One of the case studies presented in New Orleans was replaced with another similar arbitration case when one of the parties involved in the first case withheld their consent to publish the information.

The production of the handbook was made possible by the enthusiastic and able cooperation of several contributors. A special word of thanks is due to Fred Huff, who was the lead author on chapter 2 and co-author for chapter 3. Huff graciously assisted with the presentation of another section of the New Orleans workshop when the scheduled presenter was unable to do so. He also assisted with the development of the legal strategy presented in chapter 4 and in the editing of several other chapters. This book would not have been possible without the active support of IUG. Several IUG staff members have helped with the production effort. Jason Mumm, a principal in the firm, wrote chapter 7 and was the lead author of chapter 8.

Chapter 9 comprises a discussion of the classical principles of rate equity, the modern-day interpretations of those principles, and the legal rationales behind rate equity that apply to rate making. The new chapter continues with an overview of the history of legislative mandates and challenges regarding the nexus between conservation and equitable cost allocations that have played out in the State of California since 1978. It concludes with a summary that restates the importance of following AWWA-recommended guidelines for developing rates based on reasonable, actual costs, and a rate design that avoids interclass and intraclass rate inequities as discussed in this book.

Carol Malesky, another principal in the firm, provided editorial comments on several chapters in the first edition and on the new chapter 9. A number of other reviewers provided technical and legal review comments. These individuals are listed in the Acknowledgments section. Red Oak Consulting, the management consulting division of Malcolm Pirnie Inc., provided substantial support for the development of the book's second edition. Of special note is the valuable contribution by Rachel Stevens of Red Oak Consulting, who provided the graphics for all chapters.

Any errors or omissions remain the author's responsibility.

Lastly, I would like to acknowledge my wife, Linda, whose interest and support has been invaluable throughout my professional development and career.



## **SECOND EDITION ACKNOWLEDGMENTS**

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The second edition of this book benefited from the collaboration of the author with several colleagues who coauthored a number of presentations with him throughout the three years preceding the preparation of this edition. These include Mark Hildebrand, David Hotchkiss, and Sanjay Gaur. Mr. Hildebrand conducted extensive research of the California laws and legal cases reported in chapter 9. Mark was also the lead author of a 2009 *Journal AWWA* article on the California legal developments affecting water rate making. These presentations and papers are precursors to some of the new materials presented here. Mr. Hotchkiss provided legal review, augmentation to, and interpretations of that research. Mr. Gaur reviewed earlier presentations and technical papers and also assisted with the development of several related presentations given to California water industry members and AWWA audiences. Specific references to the article and presentations are provided within the text.

The author's understanding of the subject benefited from his collaboration with Mr. Paul Matthews during the course of a water rate study conducted for a very large California water utility during 2005–2007. The technical difficulties facing utilities seeking to comply with then-existing interpretations of Proposition 218 and California Government Code Section 54999 demonstrated the need for clearer guidelines for water pricing. This improved guidance was subsequently provided by Assembly Bill 2882 in 2009. Even though AB 2882 may be characterized as a raising of the bar for meeting legal requirements for rate making, the author's view is that the current requirements, which now add intraclass equity to interclass water rate equity legal criteria, simplify the earlier requirements for rate compliance with California state statutes.

Any remaining errors or omissions are the sole responsibility of the author. Dr. Corssmit would be grateful if such errors were brought to his attention.

### **Peiffer Brandt**

Peiffer Brandt is chief operating officer with Raftelis Financial Consulting (RFC). He joined RFC in 1997 and has managed a variety of projects to assist water and wastewater utilities in addressing economic and financial issues. Mr. Brandt has gained a broad knowledge of water and wastewater rates as the project manager for various rate surveys, including the 1998, 2000, and 2002 editions of the *Raftelis Financial Consulting Water and Wastewater Rate Survey*. He is currently the chair of the North Carolina section of the American Water Works Association and Water Environment Association (AWWA-WEA) Finance and Management Committee. Mr. Brandt holds a BSE in chemical engineering from Princeton University and an MSPH in environmental management and policy from the University of North Carolina at Chapel Hill.

### **Andrew Carlberg**

Andrew Carlberg is the manager of the Breckenridge (Colo.) Sanitation District, servicing, in part, the City of Breckenridge and the Breckenridge Ski Area, one of the most popular ski resorts in the country. He graduated from Fort Lewis College, Colo., in 1982 with a BS in environmental biology and has been a part of the water and wastewater industry for nearly 20 years. Mr. Carlberg has served with several special districts and has a wide range of experience in administrative, financing, and rate-setting issues facing districts in resort communities.

Mr. Carlberg was the manager of Breckenridge Sanitation District during the 1994–2001 period, when the District's impact fee was challenged. As such, he was instrumental in designing the strategy and led the team effort

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to defend the District's fee policy and practices. Eventually, the Colorado Supreme Court unanimously upheld the validity of the fee structure.

### **Thomas Catlin**

Tom Catlin is a vice president with Exeter Associates. He has extensive experience in the review and analysis of the operations of public utilities. The emphasis of this work has been on utility rate regulation and has involved telephone, natural gas, electric, and water companies. He is familiar with all aspects of utility rate making, the use of economic and engineering analytical techniques, rate base and operating income determination, income taxes, and utility accounting. Catlin is currently the vice chair of the AWWA Rates and Charges Committee.

Mr. Catlin has provided expert testimony before 23 public utility commissions as well as before the Federal Energy Regulatory Commission. This testimony has addressed many aspects of utility regulation including revenue requirements, cost of service, and rate design. Catlin has also been responsible for conducting cost of service, rate, and financial studies involving municipal and investor-owned water, wastewater, and storm drainage utilities.

### **C. (Kees) W. Corssmit**

Kees Corssmit authored the additions and changes for this book's second edition. Dr. Corssmit is vice president of Malcolm Pirnie Inc. He specializes in water and wastewater utility financial planning, cost-of-service analysis, and rate design. He was the lead author and technical editor of the first edition of this book. He leads the Quality Control and Best Professional Practices activities within Red Oak Consulting's financial services practice. Dr. Corssmit has extensive experience as an expert witness in water and wastewater fees and rates cases. Several of these cases have established case law on aspects of user charges and impact fees. He was the senior consultant for a comprehensive water rate study for the City of Los Angeles that addressed complex rate-making issues stemming from requirements of California Government Code section 54999 before the recent adoption of AB 2882.

During 2005–2008, Dr. Corssmit was the chair of AWWA's Rates and Charges Committee and initiated the committee's development of the sixth edition of AWWA Manual M1, *Principles of Water Rates, Fees, and Charges*. He has also served as a coauthor and reviewer on the Water Environment Federation's (WEF's) Wastewater Charges and Financing Task Force Manual of Practice 27, *Financing and Charges for Wastewater Systems*. He has written numerous papers on related topics.

Dr. Corssmit holds undergraduate degrees in engineering (Deventer, The Netherlands) and economics (McGill, Canada), a master's degree in natural resources economics (University of Massachusetts), and a PhD in water resources economics from Washington State University.

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Todd Cristiano is manager of Rates and Rates Administration for Denver Water. Denver Water is known for administering complex cost-of-service-based rate structures, including conservation rates, for numerous municipal and industrial contract customers. Before joining Denver Water, he was a senior consultant with the Red Oak Consulting division of Malcolm Pirnie Inc., providing financial and related management consulting services to water and wastewater utilities. He served as technical and editorial reviewer of the additions to this book. Mr. Cristiano holds a BS in chemical engineering from the University of Tulsa and an MBA from the University of Colorado, Denver.

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Sanjay Gaur is manager with Raftelis Financial Consultants. Mr. Gaur specializes in policy decision making through quantitative analysis for water and wastewater utilities. He has conducted applied research on the relationship between water demand and conservation potential. He serves on the AWWA Rates and Charges committee. Mr. Gaur has collaborated with the author on several papers and presentations pertaining to California water conservation rate making. He has BA and MS degrees in Economics and Environmental Studies and Applied Economics, respectively, from the University of California, Santa Cruz, and an MPA from Harvard University.

### **Richard Giardina**

Rick Giardina has more than 30 years of utility rate and financing experience and is national director of financial services for the Red Oak Consulting division of Malcolm Pirnie Inc. Rick served as a reviewer of the new materials presented in chapter 9 of this book. He is a member of the Rates and Charges Committee of the American Water Works Association. He currently is the chair of the committee's M1 updating working group. He also served as chair of the committee that authored Manual M54, *Developing Rates for Small Systems*; served on the Board of Directors of the National Impact Fee Roundtable in 2005; and was a member of the Financing and Charges Task Force, Water Environment Federation. He received a BA in Business Administration from Western State College of Colorado and is a certified public accountant.

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### **Mark Hildebrand**

Mark Hildebrand is a senior consultant with Malcolm Pirnie Inc.'s Red Oak Consulting division in California. He specializes in utility organizational and strategic planning, rates and fees, and financial planning studies. Mr. Hildebrand served as a technical and editorial reviewer of this edition's new materials pertaining to the California legal developments impacting water rate making. As part of his collaboration with the author, Mr. Hildebrand conducted an extensive review of the legal precedents leading up to the adoption of Assembly Bill 2882. Hildebrand was also the lead author for a publication in *Journal AWWA*, "Water Conservation Made Legal: Water Budgets and California Law," published in April 2009. He has consulted with dozens of California utilities regarding rates and fees and financial planning studies. Mr. Hildebrand holds a BS in Environmental Sciences from the University of California, Berkeley, and a MS in Environmental Studies from the University of California, Santa Barbara.

### **David Hotchkiss**

S. David Hotchkiss is an experienced California lawyer who specializes in complex water law *and* environmental issues. He has been a member of the California bar since 1977. He has worked for the City of Los Angeles since 1979 and is the principal legal advisor to the water and power rates managers of the City of Los Angeles. He provided technical and editorial review comments for chapter 9. Mr. Hotchkiss has worked closely with the author and Mr. Matthews (below) during a major rate study conducted for the City's water utility during 2005–2007 and on other projects with the author. He received his undergraduate degree from the California State University, Long Beach, and his JD degree from Southwestern University School of Law.

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Frederick Huff specializes in publicly owned utility districts and construction law. He was a major contributor to the first edition of this book. He has continued to provide technical and editorial review of the materials covered in chapter 9. He is a 1971 graduate of the Washington University School of Law in St. Louis, Mo., and he currently lives and practices in Denver, Colo. As an attorney in the Office of the General Counsel of the Environmental Protection Agency, he served as counsel in the Western states regarding the administration of grants made under the Clean Water Act for the construction of wastewater treatment infrastructure. Mr. Huff is a member of the bar of the State of Colorado; the District of Columbia; the US District Court for Colorado; the US Court of Appeals for the

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David has more than 21 years’ experience in water rates and financial planning studies. He has experience in both municipal and investor-owned utility rate cases. He has testified as an expert witness for Denver Water and assisted in the preparation of other expert witnesses. He has an MBA degree from the University of Colorado and a bachelor’s degree in economics from Lewis and Clark College, Oregon.

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Carol Malesky is a principal consultant and project manager with the Red Oak Consulting division of Malcolm Pirnie Inc. She has served as a technical reviewer for this edition’s new materials. Carol specializes in cost-of-service and financial plan computer modeling. Carol has more than 14 years of experience in water utility economics. She has managed dozens of water utility financial planning, impact fee, and rate studies including conservation rate designs. Carol holds a MS in resource economics from Colorado State University and a BS from Cornell University in applied economics and business management. She is active in Water For People.

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### **Rowe McKinley**

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Mr. McKinley received a BS degree in civil engineering and a BS in business and industrial administration from the University of Kansas. He is a member of AWWA, WEF, and American Society of Civil Engineers.

He is past chair of the AWWA Rates and Charges Committee and served on the editorial committees responsible for writing AWWA Manual M1, *Principles of Water Rates, Fees, and Charges*, and its predecessor manuals. Mr. McKinley recently served as member of the manual review board in conjunction with the update of the WEF's *Financing and Charges for Wastewater Systems* Manual of Practice.

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Jason Mumm is president of Stepwise Utility Advisors, specializing in utility financial planning, cost-of-service analysis, bond feasibility and compliance studies, and rate design. Jason has more than 12 years of experience in the utility economics industry. He has worked extensively with water, wastewater, natural gas, and electric utilities.

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### **James A. (Tony) Parrott**

Tony Parrott is executive director of Metropolitan Sewer District of Greater Cincinnati, Ohio. He was the director of the Butler County (Ohio) Department of Environmental Services (BCDES) from 1995 until 2004. Prior to that, he served as deputy director of the BCDES overseeing the engineering, business administration, and finance divisions.

In 1997, Mr. Parrott was designated the role of primary coordinator of litigation for a Butler County lawsuit against its water provider. He coordinated all of the information gathering, preliminary analysis, prioritization of complaints, selection of advisors, and review of all communications.

Mr. Parrott is a graduate of Georgetown College in Kentucky. He is a member of AWWA, WEF, and the Association of Metropolitan Sewage Agencies/Association of Metropolitan Water Agencies.

### **George Raftelis**

George Raftelis, president of Raftelis Financial Consulting (RFC), is a certified public accountant with more than 30 years of experience in the water and wastewater industry and has served more than 300 local governments across the country. The majority of his projects have dealt with cost of service and rate analysis. He has also served as expert witness on numerous finance-related cases. Mr. Raftelis is currently a member of AWWA's Management Division, and he is a former chair of the Rates and Charges Committee.

Prior to establishing RFC, Raftelis was the partner-in-charge of Ernst & Young's National Environmental Consulting Practice for 10 years.

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Mr. Riordan successfully defended the Breckenridge Sanitation District's rate structure in *Krupp v. Breckenridge Sanitation District*, a case decided by the Colorado Supreme Court in 2001 that became the seminal case for impact fee law in Colorado.

### **Rachel Stevens**

Rachel Stevens is senior graphic designer with Malcolm Pirnie Inc. Ms. Stevens designed the graphic art and illustrations used in both editions of this handbook. Her ability to illustrate complicated utility financial concepts in accessible graphic form has been used in a number of water industry manuals related to utility pricing, fees, and affordability published by AWWA and Water Environment Federation. Stevens was the *Journal AWWA* Gold Award Winner for Best in Advertising ads in 2008.

### **Christopher Woodcock**

Chris Woodcock is president of Woodcock & Associates Inc., a firm that provides water and sewer rate and financial consulting services to municipal and investor-owned utilities. During his career, he has prepared more than 300 water, wastewater, and stormwater rate and financial studies for clients across the United States, as well as overseas.

Mr. Woodcock has testified as an expert witness on rates-related matters before state utility commissions and in court proceedings numerous times. He was chairman of AWWA's Financial Management Committee and was past chairman of AWWA's Rates and Charges Committee. He has been a contributing author to various water and wastewater rate manuals. Woodcock holds degrees in both civil engineering and economics from Tufts University, Massachusetts. He has served as arbitrator in wholesale water disputes.





# INTRODUCTION

**Rowe McKinley, Past Chair, AWWA Rates and Charges Committee**

Water is unquestionably one of the world's most precious resources; for without water, intelligent life on the planet would cease to exist. How is this for an opening to a seemingly straightforward handbook titled *Water Rates, Fees, and the Legal Environment*? The point of this eye-opening statement is to emphasize the nature and importance of this life-giving resource, the protection and sustainability in the United States of which is, in large measure, the responsibility of the nation's water utility industry. Certainly other entities, including various regulatory agencies, environmental groups, agricultural organizations, industrial trade associations, and other water-oriented institutions play a major role in protecting our water resources. However, the majority of the nation's drinking water used for residential, commercial, and industrial purposes is provided by a water utility.

While there are various goals, objectives, missions, visions, and obligations for each water utility, whether it is small or large, rural or urban, municipally owned or investor-owned, one of the overriding objectives of a utility is financial self-sustainability. This may be termed, in the municipally owned instance, an enterprise fund type of operation—one that meets its financial obligations solely from its own revenues, fees, and income sources. Certainly this is a requirement of most every investor-owned utility operation. The American Water Works Association (AWWA) includes this objective as a cornerstone of its policy related to utility financing, accounting, and rates.

In developing its financial plan, a utility must include projected revenue requirements for operation and maintenance expenses, capital improvement program financing, renewal and replacement expenditures, and other requirements of its system revenues. In establishing this plan, a utility must be cognizant of its responsibility to protect its precious water resource, to use this resource wisely, and to meet all regulatory requirements related to the provision of an adequate and safe water supply to its customers. As a self-sustaining enterprise fund operation, in meeting these financial obligations, the utility must implement rates, fees, and charges for the provision of service to its customers, which recover the revenue requirements reflected in its financial plan.

## Avoiding or Meeting Legal Challenges

Recognition of cost-of-service principles, contractual obligations with certain customers, policy issues, practicality, and compliance with legal requirements all have a role in the determination of the rates, fees, and charges ultimately adopted by the utility with the approval of the applicable governing or regulatory body. It is here that the subject matter of this handbook comes into play. The rates and fees charged by a utility must not be developed in a vacuum relative to the potential for a legal challenge. Certainly there are various legal precedents, case histories, and guidance documents with regard to utility rates and fees with which the utility or its rate adviser should be aware.

Unfortunately, compliance with these various legal resources, no matter how rigorously followed, does not always preclude the initiation of a legal proceeding against a utility and the rates and fees that it has adopted for implementation. It is this disruption in the financial operations and the challenge to the utility's financial integrity that puts the utility at potential risk in being able to adequately carry out its mission

of providing quality service to its customers and in protecting its water resources.

As in the case of the manuals of practice that have been prepared by the AWWA Rates and Charges Committee, this handbook will not prescribe a solution. Rather, it is intended to provide guidance and advice. The examples presented, while taken from actual cases and events, are merely presented as examples to facilitate the understanding of the issues presented in this document. The purpose of this handbook is to describe and present issues and concepts associated with avoiding, to the extent possible, legal challenges, and in preparing to respond to such legal challenges should they occur.

## **Background for the Handbook**

The materials presented in this handbook have their genesis in a preconference workshop sponsored by the AWWA Rates and Charges Committee at the AWWA Annual Conference and Exposition (ACE) held in New Orleans, La., in June 2002. The idea for the workshop was originally developed by Rates and Charges Committee member Kees Corssmit, and the then chair and vice chair of the Rates and Charges Committee, David LaFrance and Rowe McKinley. The subject matter of the workshop included a comprehensive overview of the history of pertinent water rate case law; the organization of the judicial system; key legal concepts encountered in water rate making; suggested team member selection and preparation for litigation; and alternative dispute resolution techniques. A number of case studies were also included in the workshop. Because of the interest in the workshop, as evidenced by its large and attentive audience of participants, and because of the importance of avoiding litigation, or being prepared to address litigious issues when they arise, the preparation of this handbook as a resource to the water utility industry and others was endorsed by AWWA.

The AWWA Rates and Charges Committee has several responsibilities with regard to utility rates, fees, and related financial issues. Among these responsibilities are developing and updating manuals of practice and other reference works related to water rates and charges; developing approaches, technical guidance, and other documents that are responsive to emerging rate- or financial-related issues, challenges, and regulations confronting the water utility industry; providing liaison and direct interaction with the AWWA Finance, Accounting, and Management Controls Committee, and other AWWA committees, on rate-related issues; and providing educational materials and conducting relevant rates and charges seminars and forums at the ACE and other AWWA-sponsored

conferences and meetings. It is in view of these responsibilities of the Rates and Charges Committee that the subject of “rates, fees, and the legal environment” was conceived.

One of the principles advocated by AWWA and the Rates and Charges Committee is that rates should reflect consideration of cost of service and not be arbitrary or capricious in their establishment. In the application of such considerations, it is believed that a utility is well positioned to avoid legal action against its rates and fees or is in a better position to defend itself in the event that the utility does ultimately face litigation. Other than this general connection to legal issues, none of the Rates and Charges Committee work products have specifically focused on the legal environment in which rates and fees are established. This handbook should help to fill this void.

## **History of Water Rates and Legal Challenges**

This chapter contains a review of the key legal cases that form the foundation for water rate making, along with a discussion of current trends in user fees and impact fees litigation.

The legal authority for establishing rates and charges varies with utility ownership. Investor-owned utilities are generally regulated by state public utility commissions (PUCs) or state public service commissions (PSCs). Municipally owned utilities most often are governed by a municipal board or city council, or by an authority or a district board. In some states, municipally owned utilities may be fully or partially regulated by the state PUC or PSC.

Key case law with regard to rates and fees for utility service include the *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia* (the *Bluefield* case) involving the right of a utility to earn a fair rate of return; the *Hope* case that delineated what was appropriately included in “capital costs” for a utility; the *Durant v. City of Beverly Hills* case that addressed presumptions of reasonableness, fairness, and legality; the *Village of Niles v. City of Chicago* case involving burden-of-proof issues; and various other case law.

## **The Legal Environment**

This chapter presents various issues and aspects of the legal environment in which water utilities operate. Discussions in this chapter include an overview of the court system in the United States; a discussion of alternative dispute resolution techniques, including arbitration and mediation, and the applicability of each; a review of the various steps involved in a

legal proceeding and the purpose of each; and a discussion of various case studies that address the various aspects of the legal environment.

## **How to Avoid Lawsuits**

In this chapter, guidance is provided to assist the utility in following a course of action in establishing its rates and fees that will help to avoid litigation. Such steps include laying a foundation of defensible rates and fees. Included in these steps are recognizing cost of service in the design of rates and fees. A brief discussion of the cost-of-service process is provided, including the determination of revenue requirements, identification of appropriate classes of customers and related annual use, peak use, customer-related units of service, and the distribution of the utility's costs to customer classes in proportion to each class's demands on the system.

A discussion of system development charges is included, plus the need to establish a "rational nexus" between the charge and the benefits received by the customer. The appropriate use of funds from such charges is also covered in the chapter. The importance of compliance with contracts for water service to wholesale or other large users to avoid litigation is another matter addressed in this chapter.

## **How to React to Lawsuits**

This chapter is devoted to the situation where a utility has become involved in a legal challenge. The first part of the chapter discusses a case study in which a water utility was faced with a legal problem involving the rates it was charging for water service according to a wholesale water supply contract. A discussion of the steps taken to initially identify that there was a legal problem with the charge for service, the process by which information was exchanged by the parties to identify the issues and to resolve them without litigation, the decision process as to whether or not to pursue a legal solution to the issue, and the public information aspect of the situation are included.

The second part of the chapter focuses on how to select the appropriate team to pursue a legal challenge once it is apparent that it will result in formal litigation. The team should consist of both legal advisors and technical experts. A discussion of how to identify these experts and their requisite expertise includes researching both within the organization and externally for the legal and the technical expertise. The selection of the appropriate team members is critical if the utility is to effectively and successfully address the issues of the case in a manner that is understandable to the judge or jury.

The third section of the chapter discusses the development of a successful litigation strategy. Steps described in this process include determining the relevant legal principles, researching applicable state law, discussing the nature of the legal issues involved, drafting briefs and filing complaints, coordinating the legal work and the expert witness testimony, and preserving the necessary records.

The final section of this chapter relates to the role of the consumer advocate in a regulatory proceeding. This section explains what a regulatory proceeding consists of, who retains the consumer experts in such a proceeding, what role the expert witness provides during the proceeding, and how the consumer expert is funded.

## **Case Studies**

Several case studies are presented in this section of the handbook. The subject matters addressed in these case studies include the following examples, which are commonplace in the water utility industry: inside- vs. outside-city user rate disputes, impact fee litigation, revenue bond compliance issues, and wholesale water rate disputes. Various points and counterpoints, methodological rate issues, resolution of the issues, and lessons learned are included in these interesting case studies.

Studies and depositions of experts were taken between 1977 and 1979. The trial was heard in 1979, and the ruling was issued in 1980. During the actual trial, a court-suggested settlement negotiation was attempted. This negotiation failed. The two parties could not see eye to eye on a solution that would present an equitable, cost-based water rate. The final ruling overturned the outcome of the first two trials and ruled that the rate differentials set by the Village were fair, equitable, and defensible. A separate proceeding on the award of attorney and expert fees was conducted during the pursuing year. All with all, the case took about four years from beginning to end. The final results were not appealed.

### **Butler County, Ohio**

In 1997, Butler County Department of Environmental Services conducted preliminary investigations into the nature and level of the water rate charged by its wholesale provider, the City of Hamilton, Ohio. The County concluded it was being overcharged for its wholesale water bought from the city. Butler County is a dynamic and growing area north of Cincinnati. Hamilton was an old industrial city with surplus water supply that was economically lagging at the time. A contract between the parties contained information on the respective service contract responsibilities and certain rate provisions. The two parties disputed several rate provisions, which were unclear and internally inconsistent.

Complaints, motions for summary judgments, briefs, and various related filings were submitted in 1997. Studies by experts were conducted in 1997 and 1998. The court-appointed mediator, a retired judge, conducted mediation sessions in 1997 and 1998. Depositions of fact and expert witnesses were taken in 1998 and 1999. A summary judgment in favor of the defense was issued later in 1999. An appeal of the summary judgment was filed in 1999, and the appellate court of the State of Ohio ruled in 2001 partially in favor of plaintiff, Butler County, and instructed the lower court to proceed with a trial. Further negotiations between the two parties were conducted in 2001, and a settlement was reached in 2002. About five years transpired from the initial investigations by the Butler County staff to the settlement of the dispute.

### **Durango West Metropolitan District No.1, Colorado**

This Colorado case initially started in 1995 before the Colorado PUC in Docket No. 95F-446W. It is known as *Durango West Metropolitan District Number 1 v. Lake Durango Water Company* (LDWC). It concerned the proposed quadrupling of water rates in 1995 by LDWC to its wholesale (bulk) and retail customers. District Number 1 (DW1), representing about 300 moderate-income single-family residences, decided to dispute this

significant rate increase. It filed motions with the Colorado PUC to make LDWC subject to regulatory oversight. The claim was accepted by the PUC and hearings were held. The PUC ruled that LDWC was a privately owned water utility subject to PUC regulation. LDWC then had to file tariff (rate) applications to justify its proposed rates. After two one-week hearings conducted in 1996 and 1997, the PUC found LDWC's proposed tariffs unreasonable for a number of reasons. Specifically, it found that the company's cost data were not supportable. The PUC ruled, in Docket No. 97-S-182, that the rate to all customer classes, in conformance with rates proposed by intervenor DW1's expert, should be lowered instead of increased.

In 1998, LDWC then filed for a Certificate of Public Convenience and Necessity (CPCN). A CPCN entitles a utility to be the sole provider of the service within the defined service area. However, LDWC tried to exclude the bulk customers from service. Again, DW1, not having alternative water supply options, felt obligated to intervene. The CPCN was denied. In 1998, DW1 was awarded compensation for its legal and expert costs. This award was then disputed in La Plata County District Court in 2000, and the decision upholding the award was issued in 2001. This decision was eventually appealed to the state's supreme court and again upheld in 2003. The case took eight years from initial complaint to the final ruling.

## **Summary**

The US court system and its judiciary protocols are complex. Court systems will differ from state to state, and procedures, laws, and case law findings will also be somewhat different from state to state. Therefore, a water rate dispute in one state might not necessarily be ruled on in the same manner in a different venue, meaning in other courts in the same or in another state. Water rates and fee disputes tend to be highly technical in nature. Resolving these disputes through a formal court procedure is typically cumbersome, time-consuming, and expensive. The following two chapters will, on one hand, deal with recommended procedures to avoid lawsuits and, on the other hand, prepare for a lawsuit if such preparation is needed. The case studies presented in subsequent chapters will illustrate how typical rate and fee disputes were resolved. They will include individual studies of wholesale water contract rates and impact fee disputes; a (anonymous) case study regarding a default of bond coverage requirements; and a final case study with outside-user rate disputes, the technical work performed in that case, and caveats on the arbitration process used in that case.

## References

### Legal Cases

- Burba v. City of Vancouver*, 113Wn2d 800, 783 P.2d 1056, WA (1988)  
*Butler County, Ohio v. City of Hamilton, Ohio*, Court of Common Pleas,  
Butler County, Case No. 97-A-273-W (1998)  
*Retirement Builders Inc. v. Village of Palm Springs*, 15th Judicial Court  
Palm Beach County, FL (1980)