

Draft Report of the Tennessee Advisory Commission on Intergovernmental Relations

**Ensuring Fair and Equitable Water and Wastewater Rates for Non-resident Customers of City Utilities—A Report on House Bill 600**

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## Ensuring Fair and Equitable Water and Wastewater Rates for Non-resident Customers of City Utilities

Most Tennesseans rely on public utilities to meet their need for a clean and secure water supply. Public utilities in Tennessee include primarily cities and utility districts, but some residents get their water from regional public water authorities or counties, and most residents of Hamilton County are served by an investor-owned utility, Tennessee American Water. Rates charged by these utilities vary based on population density, utility size, the number of customers served, and the complexity of the geography of the region they serve. Rates may also vary among customers of the same utility, particularly when cities extend service beyond their city limits to meet the needs of nonresidents.

Of the 199 cities that provide water service outside their city limits, 24 charge the same rates inside and outside the city. The other 176 charge rate differentials ranging from 4% to 176% more for water service. Thirteen have outside water rates that are exactly double; 29 have water rates that are exactly one and one-half times their inside rates. Rates for sewer service follow a similar pattern. Although utilities commonly use rate studies to determine what to charge their customers, the difficulty of figuring out what it costs to serve customers in different parts of their service area may account for some of these seemingly arbitrary rate differentials.

When rates aren't the result of a rate study, or customers otherwise feel that rates are unjustified, city residents can complain to those they elect, who either set rates themselves or appoint those who do. Likewise, utility district customers can complain to their boards, which are either elected directly by the customers or appointed by the county mayor or executive for whom all county residents vote. Non-resident city customers can complain to the city's utility board; however they do not have recourse to an elected official who can influence the people on the board.

Unlike customers of utility districts, who can appeal rate decisions to the Utility Management Review Board (UMRB) housed in the Comptroller's Office, customers of city water utilities do not have a similar appeal process when they believe their water or sewer rates are too high. Their utilities are regulated by the Wastewater Finance Board (WWFB), also housed in the Comptroller's Office, which does not have the UMRB's authority to handle rate complaints. Investor-owned utilities are regulated by the Tennessee Regulatory Authority and cannot raise rates without their approval.

Residents of Piney Flats in Sullivan County who receive water and sewer service from Johnson City, like all non-resident customers of the city, are charged rates double those charged city residents. They believe their rates are unreasonable and complain that the city utility has not provided any information to justify them. They believe that the rates they are paying are funding large transfers to the city that the city says are appropriate amounts for administrative costs provided to the utility by the city and for reasonable payments in lieu of taxes, all of which are authorized by state law. House Bill 600 by Timothy Hill (Senate Bill 735 by Green) sought to remedy this situation by capping rates for those who live outside Johnson City and in Sullivan County at one and one-half times the rates charged inside the city. All public utilities must be self-sustaining and cannot rely on the tax base for funding and, therefore, must

charge rates sufficient to cover all reasonable costs. While all public utilities may also charge rates sufficient to create reserves in order to, for instance, fund capital improvements, cities cannot charge rates high enough to generate funds for non-utility purposes.

According to the legislature's Fiscal Review Office, Johnson City could lose more than half a million dollars if the bill passed. Unless the city utility could find a way to cut costs, the revenue would have to be made-up by charging other customers more or by reducing the amount paid to the city for administrative costs or in lieu of taxes. Reducing amounts paid to the city would require cuts elsewhere in Johnson City's budget or an increase in revenue from some other source. Regardless of how the loss was covered, city residents would be affected, either through higher costs or reduced services. The utility might be able to use its reserves to mitigate this shift in costs for a year, or even several years, but this would be a temporary solution.

Moreover, based on experience in other states, rate caps may become the standard rate. For example, Florida caps water rates for non-resident city customers at one and one-half times the rate charged residents. Outside rates cannot exceed one and one-quarter times inside rates without a public hearing.<sup>1</sup> It is estimated that about half of Florida's utilities have set their outside rate at exactly that 125% threshold.<sup>2</sup> Wyoming gives utilities that receive state grants or loans the option of setting rates for outside customers at a maximum of 125% of the rate charged customers inside the city or the actual cost of providing water service. Those that don't receive grants or loans can charge up to double the rates paid by city residents. Outside customers can appeal rates to the state's Public Service Commission.<sup>3</sup> Most of Wyoming's utilities charge at or near the 125% cap. Colorado has had a similar experience with its effort to cap the interest rates charged by payday lenders.<sup>4</sup>

Given the tendency of rate caps to have the unintended consequence of becoming the new standard rate, the Commission does not recommend House Bill 600 in its current form. Nevertheless, rates should be both reasonable and justified. Whether a customer lives inside or outside the city is not enough on its own to justify a rate difference. While using cost studies to determine how rates should vary within a utility's service area is unrealistic, it is the consensus of the Commission that some means of ensuring that rate differentials are fairly set is warranted, either through representation on utility boards similar to the representation non-residents of cities have on municipal regional planning commissions or, as in Wyoming, through an appeal process similar to that provided by the UMRB to utility district customers or both. Non-city residents have as many as two members on municipal regional planning commissions;<sup>5</sup> similar representation could be added to city utility boards.

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<sup>1</sup> Florida Annotated Statute, Section 180.191(b).

<sup>2</sup> Telephone interview with Mike Rocca, Director of Florida Operations, Raftelis Financial Consultants, November 25, 2013.

<sup>3</sup> Wyoming Statutes Annotated, Section 15-7-602.

<sup>4</sup> DeYoung 2009.

<sup>5</sup> Tennessee Code Annotated, Section 13-3-102. (Ten is the maximum number of members allowed on municipal planning commissions per Tennessee Code Annotated Section 13-4-101.).

## How Tennesseans Get Their Water

Residents of Tennessee get water service from one of three types of water systems—public water systems, such as utility districts and city water systems; investor-owned water systems such as Tennessee American Water; or non-public utilities, such as community water systems. Both types of public utilities serve residents inside and outside cities. Overall, municipal utilities serve more Tennesseans than utility districts serve. Generally, utility districts serve customers outside city limits, but they may also serve city residents. Utility districts’ boundaries are clearly defined,<sup>6</sup> and if a city expands its limits within those boundaries, the city utility cannot take the district’s customers, but they can provide them sewer if the utility district does not.<sup>7</sup>

A total of 262 cities provide water or sewer service, or both, to customers outside city limits: 199 cities provide water service, 93 provide sewer, and 89 provide both. All together, they provide water to more than 281,000 customers outside city limits and sewer to nearly 60,000. Tennessee’s 170 utility districts provide water to more than 640,000 customers; 15 of them also provide sewer service to more than 92,000 customers. Table 1 shows the number of water and sewer customers by type of public utility. Though utility districts serve primarily rural areas, they also supply several urban population centers. In total, utility districts provide water service to eleven cities with populations of 5,000 or more. See table 2.

**Table 1. Estimated Number of Public Utility Water and Sewer Customers in Tennessee 2012\***

Type of Utility	Total	Inside City Limits**	Outside City Limits**	
			Number	Percent
Municipal Water	1,421,020	1,048,373	281,130	21%
Municipal Sewer	1,235,033	867,789	59,490	6%
UD Water	640,290	Data not available		
UD Sewer	92,280			
Water Authority	51,914			
Wastewater Authority	7,604			

\*Or more current if not included in financial reports.

\*\*Inside and outside do not add to total because some counts did not specify inside/outside.

Source: 2012 annual financial reports and telephone calls to utilities that did not include counts in their reports.

<sup>6</sup> Tennessee Code Annotated, Section 7-82-201.

<sup>7</sup> 7 U.S.C. § 1926(b). The USDA initially provided funding for these districts in the form of grants and loans; any district that holds a federal grant or loan cannot be bought by another water system.

**Table 2. Tennessee Cities with a Population of More Than 5,000 and Served Primarily by a Water Utility District**

City	2012 Population	Water Utility District
Hendersonville	51,500	Hendersonville Utility District
Mount Juliet	24,557	West Wilson Utility District
Farragut	20,688	First Utility District of Knox County
Soddy-Daisy	12,691	Soddy-Daisy-Falling Water Utility District
White House	10,243	White House Utility District
Collegedale	8,367	Eastside Utility District
Hartsville-Trousdale	7,827	Hartsville-Trousdale Utility District
Church Hill	6,710	First Utility District of Hawkins County
Millersville	6,181	White House Utility District
Nolensville	5,812	Nolensville-College Grove Utility District
Mount Carmel	5,409	First Utility District of Hawkins County

***Water and Wastewater Rates Vary Widely Across the State and Within Utilities***

Water rates vary significantly across the state based on population density, utility size, the number of customers served, and the geography of the area served. Rates may also vary among customers of the same utility, particularly when cities extend service beyond their city limits to sparsely populated areas. According to a Texas study of economics of rural water distribution,<sup>8</sup> maintaining water quality within sparsely populated areas can be more challenging than in a system that serves a higher density community.

Lines may only have a few customers, leading to stagnation problems during the summer months. . . . Rural systems typically do not have loops that help reduce stagnation. As a result, rural systems usually flush their lines more frequently than urban systems. If lines are over-sized for their current demands, they require even more water than a system of smaller lines. . . .

One of the unique aspects of rural systems is the difficulty in finding and repairing leaks. In more densely populated areas residents frequently see and report leaking water lines. However, in rural areas leaks are seldom observed by residents. In addition, the many miles of unobserved water lines make it relatively easy for unauthorized connections to the system. . . .

Furthermore, reduced demand could lead to additional stagnation problems that are already the result of infrequent use of water lines. Rural systems have more difficulty in identifying and addressing leaks and other losses than urban systems.

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<sup>8</sup> Freese and Nichols 2009.

The study found that overall costs are more strongly correlated with population, number of connections, and water use than with either service area or number of miles of pipeline. Aside from the very largest public water utilities in the state, costs in Tennessee do not appear to vary with the number of customers served.

### **Variations in Water and Wastewater Rates Within Utilities**

The costs of providing water and sewer service can also vary among customers of the same utility. According to the American Water Works Association,

the ideal solution to developing rates for water utility customers is to assign cost responsibility to each individual customer served and to develop rates that reflect that cost. Unfortunately, it is neither economically practical nor often possible to determine the cost responsibility and applicable rates for each individual customer served. However, the cost of providing service can reasonably be determined for groups or classes of customers that have similar water-use or service requirements.<sup>9</sup>

Some outside rates appear to be a simple multiple of the inside rate. Several cities charge outside customers twice as much as the city rate; a few charge them exactly one and one-half times the inside rate. Whole number multipliers such as these appear arbitrary. In many cases, utilities do not use cost-based principles to establish these multipliers, but that alone does not mean that they do not approximate the actual cost difference. Even so, the lack of some kind of cost analysis potentially leaves the utilities open to legal challenge.<sup>10</sup>

Residents of one area outside Johnson City, the Piney Flats community in Sullivan County, expressed concern to their state representative about being charged twice the rates their Johnson City neighbors pay. Their representative, Timothy Hill, and Senator Mark Green of Clarksville introduced legislation to cap rates in the area at one and one-half times the city rate. Rate differentials as large as those in Piney Flats (200%) are not common, but they do occur all across the state, which makes this an issue of interest and concern beyond the Johnson City area. See table 3.

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<sup>9</sup> American Water Works Association 2012.

<sup>10</sup> Ibid.

**Table 3. Cities with Outside Water Rates 200% or More Higher than Inside Rates**

City	Inside Versus Outside Rates		Geographic Region	Grand Division
	Water	Sewer		
Jefferson City	276%	281%	Ridge and Valley and Smokies	East
Kingsport	270%	155%	Ridge and Valley and Smokies	East
Dresden	264%	-	Alluvial and Coastal Plain	West
Portland	230%	130%	Highland Rim	Middle
Monterey	209%	-	Cumberland Plateau	Middle
Scotts Hill	206%	-	Highland Rim	West
Camden	206%	-	Alluvial and Coastal Plain	West
Jasper	200%	200%	Cumberland Plateau	East
Sevierville	200%	200%	Ridge and Valley and Smokies	East
Lafayette	200%	200%	Highland Rim	Middle
Martin	200%	200%	Alluvial and Coastal Plain	West
Englewood	200%	-	Ridge and Valley and Smokies	East
Estill Springs	200%	-	Highland Rim	Middle
Bristol	200%	109%	Ridge and Valley and Smokies	East
Waynesboro	200%	200%	Highland Rim	Middle
Manchester	200%	200%	Highland Rim	Middle
Jellico	200%	200%	Cumberland Plateau	East
Johnson City	200%	200%	Ridge and Valley and Smokies	East
Linden	200%	-	Highland Rim	Middle
Clifton	200%	-	Highland Rim	Middle

Of the 196 municipal systems that provide water service to residents outside their city limits, 173 charge more for outside water service. Thirteen, including Johnson City, set the outside rate at exactly two times the inside rate; seven have outside rates that are more than double the inside rates, for a total of 20, or 10% with rates that are double or higher. Another 29 are set to exactly one and a half times the inside rate. Of the 228 cities with sewer systems, 87 of the 89 that provide both water and sewer service charge a different rate to outside customers for one or both services. However, the most common markups are 40% to 50% more than the inside rate.

Of the 20 municipal water systems that charge outside customers double the inside-city water rate or more, Jefferson City (276%), Kingsport (270%), Dresden (264%), and Portland (230%) have the largest differences. Only Jefferson City has an outside sewer rate more than double the inside rate. Eight of the 20 do not provide sewer service outside the city, three have rates that are less than double, and eight have outside sewer rates that are exactly double.

A report issued by the state’s Water and Wastewater Finance Board in 2008 (see appendix A) based on a review of city utilities with outside rates more than double their inside rates made the following general comments about setting reasonable rates for outside customers:

1. Customers outside the municipal boundary of the city should not be charged a higher rate simply because the debt is backed additionally by the “full faith and

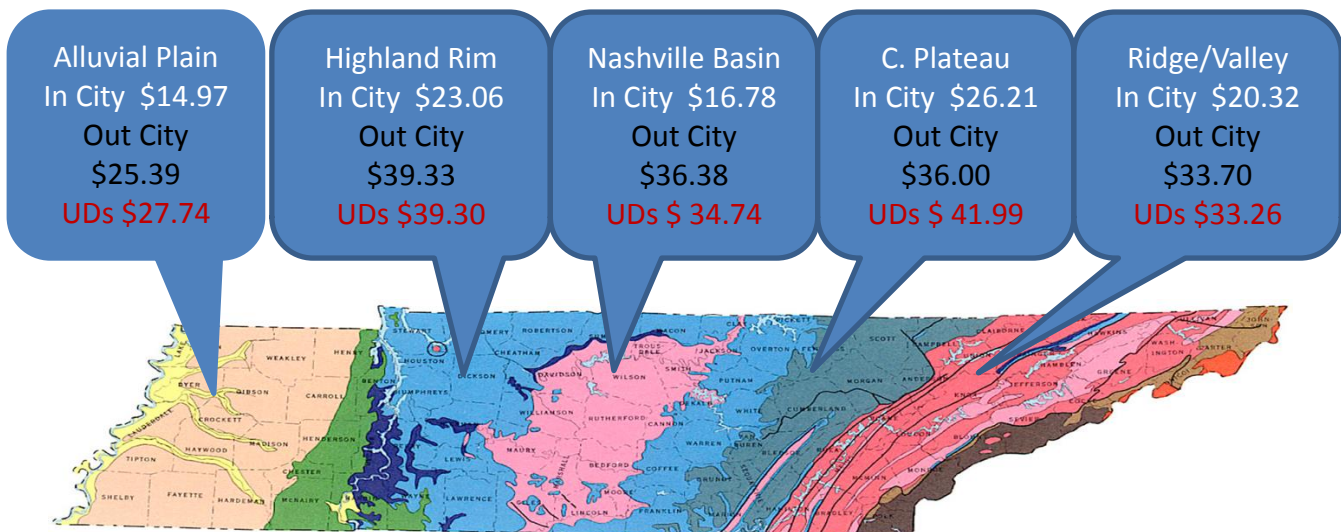


credit” of the taxpayers of the municipality. A utility system should be a self-supporting entity paid for by its users.

2. All fees and charges—whether for inside or outside customers—should be studied to determine that they are defensible, equitable, and reasonable.
3. Tap fees are for a one-time service provided and should be judged differently from the minimum bill or the per thousand gallon rate, which are based on the operational costs of the system.

Comparing the prices cities charge outside customers to the prices they charge their own residents may not be the best way to determine whether they look reasonable. It may be better to compare them to utility districts’ rates. Population density and other characteristics outside cities may be more similar to those of utility districts than to those inside cities and may explain why cities’ outside rates across the state are more similar to utility districts’ rates as shown in figure 1.

**Figure 1. Variation in Water Rates by Geographic Region<sup>11</sup>**



For instance, rates for outside customers in the Highland Rim and the East Tennessee (Ridge and Valley) regions are almost the same as rates for customers of utility districts (within 3 cents in the Highland Rim and within 50 cents in East Tennessee) despite being considerably higher than those paid by city residents. Differences between outside customer rates and utility district rates in the Nashville Basin and West Tennessee regions are less than \$2.50 even though rates for city residents are \$10 or \$20 less. The region with the highest water prices in the state, the Cumberland Plateau, has the largest difference between utility district prices and municipal outside prices. For this region, utility district prices are \$6 higher than outside prices, and inside prices are nearly \$10 less. Kingsport, Jasper, Estill Springs, and Manchester are the only four systems with outside rates 200% or higher, but the cost of 5,000 gallons of water is still lower than regional average utility district and city outside prices. In making these

<sup>11</sup> The cost of 5,000 gallons of water and sewer by county and water system can be found in appendixes B and C

comparisons it's important to realize that utility districts cannot get the favorable interest rates that municipal utilities can because utility districts cannot take advantage of the generally higher bond ratings of the cities and counties they serve. These more favorable bond ratings for cities and counties are available because of their taxing authority. In fact, cities usually issue what they call double-barrel bonds, bonds backed by both pledges of utility revenue and the cities' tax bases, to fund utility improvements.

### ***Establishing Water and Wastewater Rates***

By law, water utilities must be financially self-supporting<sup>12</sup> and, therefore, must charge rates sufficient to cover the full cost of producing and delivering water, including the cost of treatment, storage, distribution, debt service, capital expenditures, regulatory compliance, and other operation and maintenance costs. Water and sewer rates must be structured to ensure that utilities have the financial resources to operate effectively and efficiently now and in the future.

Doing this involves taking a detailed look at current and future costs and expenses, rate structure options, and the amount of water customers use.<sup>13</sup> The EPA, in its rate-setting guide for small water systems, sets out a seven-step process:

Step 1: Determine the full cost of doing business by calculating costs.

Step 2: Determine current revenues.

Step 3: Consider reserve requirements to provide enough funds to cover asset rehabilitation and repair costs as well as unexpected costs during the next 5 years.

Step 4: Calculate the amount of money needed from customer charges to cover costs and fully fund reserves.

Step 5: Evaluate appropriate rate structures and design an appropriate rate.

Step 6: Implement the rates.

Step 7: Review rates and make changes when appropriate.

Following this or a similar process will ensure that utilities can

- maintain their financial stability by ensuring a sufficient revenue stream;
- collect and reserve the funds needed to cover the costs of future asset rehabilitation and repair projects, security upgrades, and compliance with future regulations, among other things;
- plan ahead for reasonable, gradual rate increases when necessary; and

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<sup>12</sup> Tennessee Code Annotated, Section 7-35-414.

<sup>13</sup> United States Environmental Protection Agency 2006.

- deliver fairly priced, high-quality drinking water to customers now and in the future.

Currently there is no requirement that a city utility conduct a cost of service study. The Tennessee Association of Utility Districts recommends that all utilities, except for the very smallest, do a cost of service study every five years. They also recommend that cities, like utility districts, be required to report their rates and calculation methods in their annual financial reports.<sup>14</sup>

### **Extending Service to New Customers**

Extending services to customers outside cities may require investment in new facilities or may cost more because of the need to pump water over longer distances or to higher elevations—all of which can be factors inside the city limits as well.<sup>15</sup> Regardless, existing customers should not be required to subsidize new customers. One way to avoid this is to ensure that tap fees (one-time fees charged for connecting to the water system) are adequate to cover their share of the investment in fixed assets by the existing customers. Another strategy is to use special assessment districts, which enable local governments to collect revenue from the residents who will benefit directly from infrastructure improvements.<sup>16</sup>

When a utility is considering extending service to new customers, they may find it is not cost effective to do a formal cost of service study. Instead, they may rely on the expertise and knowledge of existing staff and contractors to determine whether it is cost effective to add new customers and what rates they should be charged. The University of Tennessee's Municipal Technical Advisory Services (MTAS) has done cost of service studies for municipal utilities, including a few to determine rates for outside customers.

### ***Gaps in Utility Oversight***

Two separate boards housed in the Comptroller's office regulate public utilities: the Utility Management Review Board (UMRB) and the Water and Wastewater Finance Board (WWFB). Both of these boards primarily oversee the utilities' financial health and review financial reports annually for signs of financial distress. Investor-owned utilities, such as Tennessee American Water, the largest in Tennessee, are regulated by the Tennessee Regulatory Authority. If utilities in Tennessee don't charge sufficient rates to cover their costs, including depreciation of their capital assets, the WWFB and the UMRB have authority to intervene and require them to raise their rates. Not only must systems as a whole be self-sufficient, but when they extend services outside their boundaries they must charge rates sufficient to ensure that those outside services are self-supporting.<sup>17</sup>

Although the UMRB and the WWFB play the same role in ensuring the financial health of utilities, only the UMRB has a role in resolving customer rate complaints. Tennessee's

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<sup>14</sup> Testimony by executive director Bob Freudenthal at the October 23, 2013, Commission meeting.

<sup>15</sup> American Water Works Association 2012, p. 167-168.

<sup>16</sup> Tennessee Code Annotated, Section 7-32-101.

<sup>17</sup> Tennessee Code Annotated, Section 7-51-401(b).

448,000-plus water customers—those served by utility districts—have the benefit of an appeals process when they feel that monthly bills are too high or the quality of service is too low. No statute specifically prevents outside rates from being too high, but the law does prohibit utilities from operating for a profit.<sup>18</sup> Although cities can charge their municipal systems for both administrative costs and payments in lieu of taxes,<sup>19</sup> payments in lieu of taxes cannot be more than the property taxes an investor-owned utility would pay. State law exempts utility districts from these taxes.<sup>20</sup>

Unlike customers of utility districts, who can file rate complaints with the UMRB,<sup>21</sup> city residents can complain only to their elected officials about their rates and have no appeal beyond that except to chancery court. A rate review petition to the UMRB must be signed by at least 10% of the system's customers. Three customer petitions for rate reviews were sent to the UMRB in 2012,<sup>22</sup> two of these were rejected because they did not meet the 10% threshold. The third case, which was heard in April 2013, was dismissed by the UMRB because the petitioners failed to meet the burden of proof. The petitioners have appealed the decision to chancery court.<sup>23</sup> Customers of all utilities can take their concerns to chancery court, but the court will presume utility rates are reasonable unless sufficient evidence is presented to demonstrate that they are not.<sup>24</sup> In fact, cases challenging utilities' rates consistently fail because of the state law requiring them to be self-supporting.<sup>25</sup>

The WWFB could be given the same authority as the UMRB to hear rate complaints but would need additional staff to handle them. This would provide outside city customers, as well as city customers, a way to appeal rates. The UMRB's experience with similar duties suggests that there would be a significant investment of staff time to process complaints, but giving their customers a right to appeal could increase the incentive for city utilities to deal effectively with complaints locally in order to avoid the time and expense of defending them at the state level. For example, the Public Service Commission in Wyoming, which handles these kinds of complaints against water utilities there, hasn't received a single complaint in at least ten years.<sup>26</sup>

Individual customers may also request a UMRB review of other decisions or policies of their local utility district boards, including the availability and quality of service, adjustment of bills, and local utility rules and regulations.<sup>27</sup> UMRB reviews occur only after rate decisions are made by local boards or after other complaints have been handled at the local level. UMRB

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<sup>18</sup> Tennessee Code Annotated, Section 7-34-115(a).

<sup>19</sup> Tennessee Code Annotated, Section 7-34-115(a)(9).

<sup>20</sup> Tennessee Code Annotated, Section 7-82-105.

<sup>21</sup> Rules of the Comptroller, Chapter 1715-01.

<sup>22</sup> Annual Report of the Utility Management Review Board 2012.

<sup>23</sup> WJLE 2013.

<sup>24</sup> American Water Works Association 2012.

<sup>25</sup> *Killion v. City of Paris*, 241 S.W.2d 524 (Tenn. 1951); *Parsons v. Perryville Utility District*, 594 S.W.2d 401 (Tenn. App. 1979); *Morrison v. City of Bolivar*, 2012 Tenn. App. LEXIS 382.

<sup>26</sup> Telephone interview with Art Schmidt, Wyoming Public Service Commission, December 12, 2013. In the ten years he has been at PSC no complaints were filed and had never heard of one ever being filed. The PSC stays out of city utilities.

<sup>27</sup> Tennessee Code Annotated, Section 7-82-402(b).

staff received 139 complaints in 2012, 47 of which were referred to them by the TRA. Most complaints were resolved through staff contacts with the utilities. Only four cases were actually heard by the board, and all were decided in favor of the utility districts.<sup>28</sup>

### **Water and Wastewater Finance Board 2008 Review of Rate Differentials**

Although the WWFB does not have the authority to routinely review rates, Public Chapter 779, Acts of 2008, directed the board to compile the water rates of every municipal water utility, require a one-time justification for outside rates that were more than double the inside rate, and determine whether those rates were reasonable and justified. The original version of the bill that became Public Chapter 779<sup>29</sup> would have required the WWFB to approve any outside rate that was 20% greater than the inside rate if the outside subscriber base was equal to or greater than 20% of the inside subscriber base. Any subscriber would also have been able to complain to the WWFB about rates. The law would have applied to about 71 utilities. Public Chapter 779 did not include any of the limits on outside rates that were contained in the original bill.

The board sent letters to the 27 municipal water utilities with outside rates more than double the inside rate asking them to justify them. The primary reason given for greater outside rates was lower population density in areas outside the city, requiring longer water lines, more pumps and water tanks, higher energy costs, greater distances between meters, and costs spread over fewer customers. Other reasons included differences in elevation and rockier terrain. In cases where the utilities had taken over an insolvent utility district, they also encountered unique financial circumstances, such as the need for infrastructure improvements and repayment of debt.

According to board staff, these letters also included some less convincing explanations for higher outside rates, including rate comparisons to other utilities, inside customers having to back utility bonds, encouraging voluntary annexation, and inside-city customers having to pay higher taxes. Between 2008 and 2013, 8 of the 27 cities decreased their inside-outside rate differential; two cities increased it.

### ***Consequences of Capping Water and Wastewater Rates***

Thirteen city water utilities currently have outside rates that are exactly double their inside rates and would not have had to explain their rate differentials to the WWFB in 2008. Of the 27 utilities that had outside rates that were more than double the inside rates in 2008, three reduced their outside rates to less than double the inside rate and one reduced theirs to exactly double. Outside rates that are exact multiples of inside rates appear arbitrary. Customers of one city whose outside rates are exactly double the inside rates complained to the city and when they found the city unresponsive complained to their legislator because they had nowhere else to go. In response to their concerns, Representative Timothy Hill introduced

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<sup>28</sup> 2012 Annual Report of the Utility Management Review Board.

<sup>29</sup> House Bill 3104 of 2008 by Curtiss, Senate Bill 3631 by Ketron, Marrero, and Beavers.

House Bill 600<sup>30</sup> (Senate Bill 735 by Green), which was sent to the Commission by the House Local Government Committee. The bill, if passed as amended, would cap the rates of Johnson City water and sewer customers residing outside the city in Sullivan County at 150% of the rates charged to customers inside the city. The bill would not affect Johnson City's customers who live outside the city limits in Washington, Unicoi, and Carter counties. The original bill would have applied only to water rates.

Residents of Piney Flats brought a number of concerns to Representative Hill: first, that rates exactly double those paid by city residents do not represent the actual cost of serving them; second, that outside rates subsidize transfers to the city; and third, that Johnson City has been unresponsive to these concerns and unable to explain the basis for their rates. Johnson City's response is that residents of Piney Flats are charged the same rate as all other outside customers, that most of the customers outside the city have been taken in from financially distressed utilities, and that it does not have enough information to determine exact costs for each of these areas. They also said that transfers of utility funds to the city's general fund are for administrative services to the utility and payments of in lieu of ad valorem taxes allowed by state law.<sup>31</sup>

Johnson City's main concern about the bill is that a cap on rates for outside customers would shift costs to other customers and potentially to the city's taxpayers. According to the legislature's Fiscal Review Office, Johnson City could lose \$560,300 if the bill passes.<sup>32</sup> Johnson City raised the possibility of increasing property taxes in order to cover this loss; however, because utilities must be self-sustaining, this is unlikely unless payments to the city for administrative costs and in lieu of taxes are not considered part of what is required to be self-sustaining. More likely, a cap on water and sewer rates for outside customers could cause a restructuring of rates for other customers that would shift the burden to them, decreasing reserves, or reducing costs. Regardless of how the loss was covered, other customers or city residents would have to pay it.

The only way to avoid shifting costs among customers would be to reduce the amount paid to the city for administrative costs or in lieu of taxes. Reducing amounts paid to the city would require cuts elsewhere in Johnson City's budget, an increase in revenue from some other source, or both. In that case, city residents would be affected, either through higher costs or reduced services. The utility might be able to use its reserves to mitigate this shift in costs for a year or even several years, but this would be a temporary solution.

Another concern raised about the bill as written is whether it would be unconstitutional because it applies only to certain water and sewer customers. Article XI, Section 8, of the Tennessee Constitution prohibits laws that grant "any individual or individuals, rights, privileges, immunities, [immunities] or exemptions [not] extended to any member of the

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<sup>30</sup> See appendix D.

<sup>31</sup> Tennessee Code Annotated, Section 7-34-115.

<sup>32</sup> Fiscal Memorandum 2013 (see appendix E).

community who may be able to bring himself within the provisions of such law.”<sup>33</sup> This constitutionality question arises most often when a bill makes an exception to general law. To pass constitutional muster, the classification, in this case the limitation to Johnson City water customers living outside the city in Sullivan County, must bear a reasonable relationship to a legitimate state interest.<sup>34</sup> A classification may be upheld “if any state of facts can reasonably be conceived to justify the classification or if the reasonableness of the class is fairly debatable.”<sup>35</sup> The answer to the constitutionality question is unclear as it relates to this bill.

If a cap similar to the one imposed by House Bill 600 were applied statewide, the municipal utilities whose outside rates are currently above the cap would be affected in the same way. The unintended consequence of capping rates in state law might be to establish an acceptable standard rate differential. The result could be many cities raising outside rates to the cap rather than basing their rates on actual costs. Outside-city customers whose current rates were above the cap would benefit, but those with rates below the cap would end up paying more if their utilities raised rates to the cap as has happened in other states.

Only two states cap outside rate differences statewide. Outside rates in Florida cannot exceed one and one-quarter times inside rates without a public hearing; with a public hearing, they can be raised as high as one and one-half times the inside rates.<sup>36</sup> It is estimated that about half of Florida’s utilities have set their outside rate at exactly that 125% threshold.<sup>37</sup>

Wyoming gives utilities that receive state grants or loans the option of setting rates for outside customers at a maximum of 125% of the rate charged customers inside the city or the actual cost of providing water service. Those that don’t receive grants or loans can charge up to double the rates paid by city residents. According to utility officials in Wyoming, the 125% cap has become the standard rate. Outside customers can appeal rates to the state’s Public Service Commission. Customers can also submit complaints about rates, maintenance, or service to the state’s Public Service Commission. The PSC may review the matter, hold hearings, take testimony, and make recommendations; however, no complaints have been filed in more than ten years.<sup>38</sup> Those recommendations may be appealed to the district court.<sup>39</sup>

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<sup>33</sup> Article XI, Section 8 says, “The Legislature shall have no power to suspend any general law for the benefit of any particular individual, nor to pass any law for the benefit of individuals inconsistent with the general laws of the land; nor to pass any law granting to any individual or individuals, rights, privileges, immunities, [immunities] or exemptions other than such as may be, by the same law extended to any member of the community, who may be able to bring himself within the provisions of such law.”

<sup>34</sup> *Doe v. Norris*, 751 S. W. 2d 834, 52-54 (Tenn. 1988).

<sup>35</sup> *Harrison v. Schrader*, 569 S.W.2d 822 (Tenn. 1978).

<sup>36</sup> Florida Annotated Statute, Section 180.191(b).

<sup>37</sup> Telephone interview with Mike Rocca, director of Florida operations for Raftelis Financial Consultants, November 25, 2013.

<sup>38</sup> Telephone interview with Art Schmidt, Wyoming Public Service Commission, December 12, 2013. In the ten years he has been at PSC no complaints were filed and had never heard of one ever being filed. The PSC stays out of city utilities.

<sup>39</sup> Wyoming Statutes Annotated, Section 15-7-602.

North Carolina has capped rates in only one city, Asheville. This cap has been set at 100% since 1933. The City of Asheville has challenged the cap in court several times, as recently as 2008, but has lost every time.<sup>40</sup>

Colorado had an experience similar to Florida and Wyoming's with caps on interest rates charged by payday lenders. When the cap was first imposed, in 2000, 69% of lenders were already at it. By 2006, the percentage had increased to 97%. According to a study by the Federal Reserve Bank of Kansas City, the cap became a focal point that allowed payday lenders to abandon price competition.<sup>41</sup>

### ***Representation for Nonresident City Customers***

Non-resident city customers are the only utility customers who have no influence over the people who set their rates. City residents can complain to those they elect, who either set rates themselves or appoint those who do. Likewise, utility districts' customers can complain to their boards, which are either elected directly by the customers or appointed by the county mayor or executive for whom all county residents vote. While customers of city utilities who live outside the city can complain to the city's utility board, the fact that they don't elect the board or those who appoint its members greatly limits their ability to influence it. Representation on city water boards for non-resident customers could be provided by adding members to existing boards. Legislative bodies that serve as utility boards could be required to include representatives of non-resident customers when acting in that capacity.

Municipal water and wastewater boards are either the city legislative bodies themselves or are appointed by them.<sup>42</sup> Adding board members that represent customers outside the city could give those customers some influence over rates. In at least one other instance in which non-city-residents' rights or privileges are controlled by city boards, non-residents have been given representation on those boards. Municipal regional planning commissions, which have authority to plan and regulate land use beyond their corporate boundaries within the urban growth boundaries established under Tennessee's Growth Policy Act, are required to include two representatives from the area outside the city on the planning commission if the area outside the city limits is at least half of the entire planning region; otherwise, only one need be appointed. Appointments are made by the city.<sup>43</sup>

Legislation to give outside customers representation on city utility boards was introduced in 2008 but did not pass. House Bill 3103 by Curtiss, Senate Bill 3657 by Ketron, would have created a new five-member governing board for municipalities whose outside customers numbered 50% or more of inside customers. It would have divided the utility service area into five districts. City residents would have been guaranteed at least one district. The districts for outside customers would have been drawn, to the extent possible, to prevent city residents from dominating them. The bill was never debated.

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<sup>40</sup> *City of Asheville v. State*, 192 N.C. App., 1665 S.E.2d 103, 2008 N.C. App. LEXIS 1556, (North Carolina 2008).

<sup>41</sup> DeYoung 2009.

<sup>42</sup> Tennessee Code Annotated, Section 7-35-406.

<sup>43</sup> Tennessee Code Annotated, Section 13-3-102.



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## **Persons Interviewed**

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Tennessee Association of Utility Districts

Timothy Hill, State Representative  
State of Tennessee

Jerry Kettles, Chief of Economic Analysis and Policy Division  
Tennessee Regulatory Authority

Bart Kreps, Manager  
Raftelis

Wade Morrell, Executive Vice President – Chief Financial Officer  
Tennessee Municipal Bond Fund

Denise Paige, Government Relations  
Tennessee Municipal League

M. Denis Peterson, City Manager  
City of Johnson City, Tennessee

Sharon Rollins, Technical Consultants Program Manager  
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Art Schmidt, Section Supervisor  
Wyoming Public Service Commission

Joyce Wellborn, Legislative Auditor  
Tennessee Comptroller of the Treasury

Lex Warmath, Vice President  
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Tom Witherspoon, Director of Water and Sewer Services  
City of Johnson City, Tennessee