AVAILABILITY FEES:

GROWTH PAYING FOR GROWTH

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A critical issue facing municipal utilities is how to pay for expansions of capacity without unfairly raising the rates of existing customers. A simple example demonstrates the problem. Assume a municipality in a growing area has received an early warning letter from the Indiana Department of Environmental Management ("IDEM") indicating that daily flows in the sewer utility have reached 90% of the design capacity of the existing wastewater treatment plant. At this point, the municipality must commence designing a capacity addition or else run the risk that a sewer connection ban will be imposed in the foreseeable future. The design engineers have recommended the facility to be designed over a 15-20 year planning horizon. If the municipality carries through with this recommendation, it will have sufficient unused capacity to continue adding new customers over the course of at least the next decade. The problem is that it will have to pay for the construction project today, and its current customers will be forced to pay rates to recover debt service on the required bond issue. Rates today will be calculated based upon the current customer base. At no time will the percentage of monthly rates needed to pay debt service on the project be higher then when the project is first constructed. The end result is that today's customers, who did not need the project, will end up paying more towards the cost of the project than any of the customers who are later added and for whose benefit the project was built in the first place.

To address this apparent inequity, many utilities have turned to availability fees. Whether labeled availability fees, system development charges, capacity fees, or contribution fees, the fees serve the twin purposes of providing an additional source of

revenue for capacity additions and of allocating more fairly the cost of capacity between existing customers and new customers. These availability fees should not be confused with tap or similar connection charges. Tap fees are calculated only to recover the cost of making and inspecting individual connections. In other words, if it costs $350 for the labor and materials to make a connection, a tap charge may be imposed to recover this amount. Availability fees recover something more and relate to the capacity of the system to serve new customers.

This paper will address the current trends in establishing such fees. It will also contrast such fees with impact fees. Finally, it will conclude with practice pointers for communities in establishing and defending such fees.

1. Equity Method Versus Incremental Cost Method.

The two commonly recognized methods for establishing availability fees are the Equity Method and the Incremental Cost Method. The American Water Works Association ("AWWA") is a trade association of water utilities and water utility professionals. Periodically, the AWWA publishes a Rates Manual which is entitled "Principles of Water Rates, Fees and Charges." This manual describes in detail and endorses both methodologies.

The Incremental Cost Method assigns to new development the incremental cost of system expansion needed to serve the new development. Future system growth is projected along with the capital improvements which will be needed to meet the growth. The anticipated cost of these capital improvements together with the cost of unused capacity in the existing system is then divided by the number of equivalent dwelling units

the additional capacity will serve. The result is a cost per equivalent dwelling unit for new capacity that is then used to set the availability fee.

Example of Incremental Cost Method

New Plant Cost	$10,000,000
Additional Capacity of New Plant	2,000,000 gpd
Cost/gallon per day	$5.00
Residential equivalency	310 gpd
Cost of new plant per new EDU	$1,550

The Equity Method recognizes that existing customers have paid rates that have helped pay for the existing system. The first step is to determine system equity. This is essentially the balance sheet value of the utility's assets less outstanding debt. That balance is equity which has been generated over time through the rates that have been paid by existing customers. The theory is that new customers should pay an equal amount towards existing equity that has been paid by the existing customer base. The existing equity in the system is divided by the number of equivalent dwelling units served by the existing system. This produces a rate per equivalent dwelling unit which is then used to calculate the availability fee that would be charged all new customers.

Example of Equity Method

Net Utility Plant in Service	$20,000,000
Less: Outstanding Debt	11,000,000
Equity	$9,000,000
Current EDUs	5,100
Equity/EDU	$1,764.71

2. Availability Fees At the IURC.

For nearly 20 years, availability fees were essentially ignored at the Indiana Utility Regulatory Commission ("IURC" or "Commission"). This practice followed the decisions of the Commission and the Indiana Court of Appeals in the *Hidden Valley Lake* cases. *See, e.g., Hidden Valley Lake Property Owners Association v. HVL Utilities, Inc.*, 408 N.E.2d 622 (Ind. Ct. App. 1980), *rehearing denied* ("*HVL I*"), and *Rasp v. Hidden Valley Lake, Inc.*, 519 N.E.2d 153 (Ind. Ct. App. 1988) ("*HVL II*").

These cases surrounded a sewer utility company which was affiliated with a development company. The development company included in its lot sales agreements a requirement to pay the developer a monthly fee for water and sewer availability even if the property was not connected. An additional availability fee was to be assessed upon connection. Upon connection, the monthly availability fee would cease, and the customer would pay the utility company's approved monthly rates. The developer then used the availability fees collected as a source of funds to infuse capital into the utility, whose rates were set too low to recover operating costs. Despite numerous opportunities to do so, neither the Commission nor the Court of Appeals ever addressed the question whether the availability fee collected by the developer was a rate which required Commission approval. While these decisions in no way held that the Commission affirmatively lacked jurisdiction to approve availability fees, the silence on the question led many water and sewer utilities and practitioners to interpret them in this way. The result was that availability fees were being charged by numerous utilities without Commission oversight. Most utilities simply skipped the intermediary of a developer affiliate and a land sale contract, and included the contractual obligation in main

extension agreements. When someone wanted to extend mains (for new or existing developments), one of the terms in the agreement would be an obligation to pay the availability fee.

That practice came to an abrupt end with the Commission investigation of Boone County Utilities, LLC ("BCU"), which culminated in an Interim Order dated March 12, 2002. This Docket had its genesis in an informal complaint filed by two developers contesting BCU's proposed Main Extension Agreement which would have required the payment of availability fees for all homes in the developments and which reserved the right to BCU to change the amount of the availability fee without obtaining Commission approval. The Commission Consumer Affairs Division issued a decision on the informal complaint on August 22, 2001, which ruled in part that BCU's availability fees were in fact utility rates which were not set forth on BCU's tariff and which must first be approved by the Commission. BCU appealed the decision of the Consumer Affairs Division to the full Commission. In the March 12 Order, the Commission distinguished the various *HVL* decisions because those cases had not decided the precise question presented in *BCU*. Furthermore, applying the plain meaning of "rate" in the Public Service Commission Act, the Commission held that availability fees are rates that require Commission approval.

The Commission directed BCU to file evidence in support of its proposed availability fee and directed that the evidence be such that the Commission could "determine [availability] fees for BCU that are no more than the amount necessary to provide BCU with the funds necessary to pay for the system improvements necessary to serve new customers." *BCU*, p. 19. The Commission cited to a Kentucky Public Service

Commission decision which essentially required the use of the Incremental Cost Method. Finally, the Commission ordered that any availability fees to be collected must be placed in a restricted account only to be used for the purchase of such additional capacity.

BCU was sold in bankruptcy before the Commission could approve final availability fees. In the interim, two other proceedings were filed by the Town of Bargersville and Edwardsville Water Corporation. Edwardsville is a not-for-profit water utility. On June 30, 2004, the Commission issued its Order approving availability fees for Bargersville, and it is believed that this is the first order approving such fees issued by the IURC subsequent to *BCU*. *Town of Bargersville*, Cause No. 42555 (IURC 6/30/04). Three weeks later, the Commission issued the second order. *Edwardsville Water Corp.*, Cause No. 42564 (IURC 7/21/04). The fees in *Bargersville* were calculated pursuant to the Equity Method and in *Edwardsville* were calculated pursuant to the Incremental Cost Method. The Commission approved both fees, and ordered *Edwardsville* to maintain the fees in a restricted account dedicated to the funding of such improvements. The Commission did not order a restricted account for *Bargersville*.

Both BCU and Edwardsville were private corporations and not governmental entities. As a result, it would make no sense to compute an availability fee based upon the Equity Method, because existing customers do not own the equity. Shareholders or members are the equity owners.[1] The Equity Method would only apply to a municipality. While *Bargersville* used the Equity Method, there is no discussion of it in the Commission Order, and so it does not openly endorse or explain how it should be

[1] Edwardsville was a not-for-profit corporation, so its customers are its members. Nevertheless, it is the status as a member rather than a customer which gives them claim to the equity.

applied. It should be expected that the rate must still be no more than needed to fund future improvements. That is because Ind. Code § 8-1.5-3-8 defines the lawful revenue requirements, which include operating expenses, debt service and debt service reserve, working capital, taxes, and extensions and replacements. Rates that recover more are unlawful. Unless the municipality can show it needs the availability fee for extensions and replacements, it would likely be rejected by the IURC even using the Equity Method because it would result in the recovery of more revenues than had been shown to be needed. As such, even where the IURC could be persuaded to implement the Equity Method to design the rates, the evidence of future improvements for the Incremental Cost Method would still likely be needed, thus producing a hybrid of the two methods.

3. <u>Availability Fees For Municipal Sewer Utilities.</u>

Municipal sewer utilities are not regulated by the IURC. Indeed, they are specifically excluded from the definition of "utility" in the Public Service Commission Act. Ind. Code § 8-1-2-1. They are self-regulated either by the municipal council or by a sanitary district board. Ind. Code ch. 36-9-23 and 25.

Two points are critical to understanding the limitations of Home Rule as applied to availability fees. First, it has long been the rule that municipalities lack the power "to impose a service charge or user fee greater than that reasonably related to reasonable and just rates and charges for services." Ind. Code § 36-1-3-8(6). Second, municipalities lack the "power to impose a tax, except as expressly granted by statute." Ind. Code § 36-1-3-8(4). These are companion limitations, meaning so long as a charge is an authorized service charge or user fee, then it is not a tax. On the other hand, if it is not reasonably

related to reasonable and just rates and charges for service, then it probably is an unlawful tax.

The argument with respect to availability fees is that if the fee is not a lawful user fee, then it is an unlawful tax. The question therefore is whether they can be justified as lawful user fees. Fees that apply upon connection have long been lawful, as well as fees to recover future infrastructure costs. The more difficult issue has been the combination of these two points: a fee upon connection to recover future costs.

In *Brandel v. City of Lawrenceburg*, 249 Ind. 47, 230 N.E.2d 778 (1967), the Indiana Supreme Court approved as a proper user charge a connection fee based upon the actual costs of facilities that had already been installed to make service available. In 1977, the Indiana Court of Appeals applied *Brandel* and issued an opinion that rendered questionable the ability of a municipal sewer utility to collect the future needs through an availability fee. In *City of Crown Point v. High Meadows, Inc.*, 173 Ind. App. 138, 362 N.E.2d 1166 (1977), Crown Point adopted a connection fee for its sewer utility based upon the Equity Method with the fee being intended to fund future capacity additions that had not yet been designed or estimated. The Court distinguished *Brandel* on the basis that there the cost of the improvements was known (indeed, the cost had been incurred) and held that Crown Point's connection fee constituted an indirect method of raising general revenues and therefore was an unlawful tax. The Court recognized that funding for future capital improvement needs was a legitimate purpose of user charges; "[h]owever, it does not permit such charges to be levied upon the selective basis implicit in establishing the taxable event to be the hookup to the system *when* there is an established group of users of the same system who will, a fortiori, not be subject to the

charge." 173 Ind. App. at 143, 362 N.E.2d at 1169. Further, while the municipality was permitted by Indiana legislation at the time to impose charges based upon the cost of rendering service, which could include future expansions, the costs had to be known. "Here, admittedly, they are not . . .. To hold that such a nexus is unnecessary would permit a city to levy discriminatory excise taxes, not to pay for the services it was providing, but merely as an indirect method of raising general revenues." 173 Ind. App. at 145-146, 362 N.E.2d at 1170.

Since that time, the General Assembly amended the statute setting forth the process for establishing municipal sewer rates to state that "the municipal legislative body may use one (1) or more of the following factors to establish the fees: . . . (10) any other factors the legislative body considers necessary." Ind. Code § 36-9-23-25(d). Similar language is contained is Ind. Code § 36-9-25-12(a) for sanitary districts. This change in language persuaded the Court of Appeals to distinguish *Crown Point* in *Taylor v. Fall Creek Regional Waste District*, 700 N.E.2d 1179 (Ind. Ct. App. 1998). In *Fall Creek*, the District established sewer connection fees based upon the Equity Method, and the appellant argued that *Crown Point* was controlling. The Court of Appeals rejected this argument.

> An important factor distinguishes *High Meadow* from the present case; here, Taylor is not being asked to pay for improvements to the system. Rather, under Ordinance 96-3, the capacity fee reflects the actual "cost of the capacity in [Fall Creek's] plant and transmission line which must be permanently allocated to real estate producing wastewater and connecting to [Fall Creek's] system." Hence, Taylor is not being subjected to charges on a selective basis. As previously mentioned, the initial users were subject to the same charges. The only difference is that the initial customer's charges were provided by state and federal grant monies paid directly on their behalf.

> Additionally, the specific statutory provision at issue in *High Meadows*, . . . lacks the discretion afforded to Fall Creek under IND. CODE § 13-26-11-2. . . .
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> Id. at 141, 362 N.E.2d 1168. The specific statutory provision at issue in *High Meadows* was IND. CODE § 19-2-5-20, which is void of any reference to the type of discretion which is granted to Fall Creek under IND. CODE § 13-26-11-2(7).

The first point of distinction was not really pressed in the *Crown Point* case; had it been, this would have been a distinction without a difference. In *Fall Creek*, the Court found that equivalent connection charges had already been paid on behalf of existing users through federal grants that had been received. In *Crown Point*, which used the Equity Method as well, the connection charges were also based on actual historical costs and the equivalent of the connection charges had also been paid by existing users through their rates and charges over time which had supplied the equity just as the federal government had in *Fall Creek*. *Fall Creek's* reasoning likely opens the door to revisit *Crown Point* on this basis.

The second distinction renders the first one moot with respect to municipal sewer utilities. Municipalities now possess the same discretion as the regional district in *Fall Creek* to set fees. *Fall Creek* should be controlling that municipal sewer utilities have the discretion to establish an availability fee based using either the Incremental Cost Method or the Equity Method.

4. <u>Municipal Water Utilities Removed From IURC Jurisdiction.</u>

Municipal water utilities are presumptively regulated by the IURC, but the process exists by which they can be withdrawn from such jurisdiction. Those that have

not withdrawn should be able to obtain approval of availability fees using the *BCU/Edwardsville/Bargersville* approach.

There continues to be an issue for municipal water utilities that have withdrawn from Commission jurisdiction. The discretionary language found in the municipal sewer and regional district ratemaking statutes is not contained in the municipal water utility ratemaking statute. *See* Ind. Code § 8-1-3-8. As such, it is difficult to rely upon *Fall Creek* for the proposition that *Crown Point* is not applicable due to the statutory discretion in setting rates. As a result, an unregulated municipal water utility must still deal directly with *Crown Point* in setting availability fees.

The first approach is to use the Incremental Cost Method and to establish the rates based upon solid engineering estimates of the costs for future improvements. Recall that *Crown Point* did not reject out of hand the notion of collecting a connection charge to fund the cost of future improvements so long as those costs are reasonably known. "The City's formulation clearly represents an effort to arrive at a 'fair' figure to constitute the charge to be levied. Just as clearly neither the figure nor the approach provides an amount, individually or collectively, which bears any demonstrable relationship to the actual costs of the contemplated new services and facilities." 173 Ind. App. at 145, 362 N.E.2d at 1170. This implicitly endorses the Incremental Cost Method as one that would have been acceptable.

The second approach is to use the Equity Method but be certain the rate is still no higher then needed to fund the cost of the future improvements. In other words, use the hybrid of the two methods that one would expect to use at the IURC. This would fit

nicely within *Fall Creek's* first distinction of *Crown Point*, that the rates merely compensate for amounts that have already been paid by existing customers, and it addresses *Crown Point's* concern that there must be a connection between rates and future infrastructure needs.

With either approach, remember that municipal water rates must be "non-discriminatory, reasonable and just." Ind. Code § 8-1.5-3-8(b). Two additional factors will help make this showing. First, the IURC approves the use of an availability fee. Second, the American Water Works Association endorses the use of an availability fee.

5. <u>Availability Fees Contrasted With Impact Fees.</u>

Impact fees are established pursuant to Ind. Code § 36-7-4-1300, are imposed upon new developments, and are to be used to pay for infrastructure needed to serve such development. Impact fees can be used to defray or mitigate the cost of water and sewer infrastructure necessitated by the development as well as roads, drainage and other infrastructure. Ind. Code §§ 36-7-4-1305 and 1308.

Ind. Code § 36-7-4-1311(d) provides that the Impact Fee Series is "the exclusive means for a unit to impose an impact fee." This provision led to the argument that municipal sewer and water availability fees are illegal unless established pursuant to the procedural requirements for impact fees. In *Burke v. Town of Schererville*, 793 N.E.2d 1086 (Ind. Ct. App. 2000), the Town of Schererville established sewer and water connection fees pursuant to the Incremental Cost Method. Long after the time for appealing water and sewer rates, the plaintiffs filed a declaratory judgment action seeking to invalidate the fees on the basis that they were illegal impact fees. The Court held that

the water and sewer ratemaking statutes provide an independent mechanism to recover these costs and that these connection or availability fees were not impact fees. A critical distinction between the two types of fees is that impact fees are imposed on new construction and availability fees are payable for all new connections regardless of whether connection was to new construction. In other words, existing structures would be subject to the fee upon connection in the same fashion as new construction. The lesson from *Schererville* is that availability fees can be established without compliance with the procedures for establishing impact fees.

6. Practice Pointers.

a. Be Fair and Predictable.

The objective of availability fees is to establish rates that are fair and equitable as among existing and new customers. Care must be exercised not to set rates or engage in practices that will chill growth. This requires that the rates be fair as well as commensurate with what is charged in neighboring communities. The first step is to hire a qualified rate consultant to calculate and recommend an appropriate availability fee.

The biggest deterrent to growth is probably not a high availability fee but rather a utility which is unpredictable or unfair. Developers want to know three things about utility service: (1) how much will it cost to make it available, (2) when will it be available and (3) will any competitors incur the same costs. With answers to these questions, a developer can decide whether to pursue a project. Do not surprise developers with hidden costs or unexpected delays. If the developer is forced to install infrastructure to extend service to the development, provide a fair mechanism of recoupment so that other

developers who will also use that infrastructure will share equitably in the costs. These are far more important keys to encouraging development than deciding whether the availability fee should be $1,500 or $2,000.

b. Take care in drafting the ordinance.

When drafting an ordinance many practitioners quickly move past perhaps the most important section: the introduction. The standard of review in an appeal from a municipal ordinance is abuse of discretion. Just as it is difficult to overturn the findings of a trial court on appeal, it is difficult to overturn the municipal council's findings in adopting an ordinance. The key is for the council to make findings, and that is done in the WHEREAS section of the ordinance. Do not simply use a form or an ordinance prepared for another community as a template. Prepare the ordinance from scratch as if you expect an appeal.

c. Insist on strict compliance with the statute.

The appeal process for municipal sewer rates is as follows:

> **36-9-23-26.1. Objection to rates - Petition - Bond - Notice and hearing - Order. -** (a) Owners of property connected or to be connected to and served by the sewage works authorized under this chapter may file a written petition objecting to the rates and charges of the sewage works so long as;
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> (1) The petition contains the names and addresses of the petitioners;
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> (2) The petitioners attended the public hearing provided under section 26 [IC 36-9-23-26] of this chapter;
>
> (3) The written petition is filed with the municipal legislative body within five (5) days after the ordinance establishing the rates and charges is adopted under section 26 of this chapter; and

(4) The written petition states specifically the ground or grounds of objection.

(b) Unless the objecting petition is abandoned, the municipal clerk shall file in the office of the clerk of the circuit or superior court of the county a copy of the rate ordinance or ordinances together with the petition. The court shall then set the matter for hearing at the earliest date possible, which must be within twenty (20) days after the filing of the petition with the court. The court shall send notice of the hearing by certified mail to the municipality and to the first signer of the petition at the address shown on the petition. All interested parties shall appear in the court without further notice, and the municipality may not conduct any further proceedings concerning the rates and charges until the matters presented by the petition have been heard and determined by the court.

(c) At the discretion and upon direction of the court, the petitioners shall file with the petition a bond in the sum and with the security fixed by the court. The bond must be conditioned on the petitioners' payment of all or part of the costs of the hearing and any damages awarded to the municipality if the petition is denied, as ordered by the court.

(d) Upon the date fixed in the notice, the court shall, without a jury, hear the evidence produced. The court may confirm the decision of the municipal legislative body or sustain the objecting petition. The order of the court is final and conclusive upon all parties to the proceeding and parties who might have appeared at the hearing, subject only to the right of direct appeal. All questions that were presented or might have been presented are considered to have been adjudicated by the order of the court, and no collateral attack upon the decision of the municipal legislative body or order of the court is permitted.

The process for unregulated water utilities is nearly verbatim. Ind. Code § 8-1.5-3-8.2.

First, there are no collateral attacks on rates. Any challenge filed to a rate ordinance outside this process should be the subject of an immediate motion to dismiss.

Second, to sign a petition, one must attend the public hearing. Take attendance and place the attendance sheet in the minutes.

Third, to sign a petition, one must own property connected or to be connected to the works. Non-owner developers do not have standing.

Fourth, the court must set the matter for hearing within twenty (20) days after it is filed. After twenty (20) days, the court loses jurisdiction. *Smith v. King*, 716 N.E.2d 963 (Ind. Ct. App. 1999). Admittedly, this can be overcome due to backlogs on the court's docket, but the municipality should preserve its objection on the record to holding the hearing beyond twenty (20) days. The quicker the hearing the better, and nothing assures a quick hearing more than the threat of reversal from extensive delays.

Fifth, do not agree to interim terms that would limit the petitioners' potential liability. Under the statute, no further proceedings may be conducted concerning the rates until the matter is decided. This means the rates cannot go into effect. Additionally, the petitioners are potentially liable for all damages that are sustained if the petition is denied. A bond may be required. The petitioners are potentially liable to pay all of the rates that would have been collected from all customers (not simply those who have petitioned) but were not because of the pendency of the challenge. Do not agree that rates may be implemented on an interim subject to refund basis. The statute does not permit it but instead requires the petitioners to assume ownership of the full risk from filing the petition.