

## Outside Customers Must Prove Unfairness of Rate Differential

**F**or years, many municipal-owned water and wastewater systems have maintained rate differentials between customers within their boundaries and customers outside their boundaries. Commonly, the outside rate is one hundred fifty percent of the inside rate.

Generally, inside/outside differentials are supportable if based on differences in costs of service. The issue becomes who has the burden to establish that higher outside rates are justified or not justified by differences in cost of service. Such a burden is met by cost of service studies. A recent decision by the Indiana Supreme Court has addressed this issue. *Farley Neighborhood Association v. Speedway*, 765 N.E.2d 1226 (Ind. 2002).

In the Speedway case, the town adopted an ordinance raising its sewer rates forty percent across the board. Pursuant to a practice in place for fifty years, the new rate for outside customers was set fifty percent higher than the inside rate. Some outside customers challenged the rate differential.

The outside customers presented a CPA witness who testified "that a rate differential must be based on cost differentials; that only a formal cost-of-service study prepared by a team of accountants, lawyers and engineers may adequately justify cost differentials and that Speedway must justify its rates by obtaining such a study" *Id.* at 1228. The witness said that a fifty percent differential appears to be unsubstantiated and ten percent would be more appropriate.

The town presented a CPA witness who stated that cost figures cited by the outside customers' witness were incomplete. He also presented a cost-of-service analysis prepared by following the guidelines in the AWWA Water Rates Manual (presumably M-1). This analysis showed that, based on full cost of service, outside rates actually should be two hundred fifty percent of inside rates.

The trial court made certain findings of fact, including

- The new rates were based on the recommendation of an outside expert consultant.
- All lift stations are outside of town, so all costs related to them are attributable to outside customers.
- Because of location, special sewer lines with increased maintenance costs and risks are needed to serve the outside customers.
- It is reasonable to charge outside customers for outside operations, maintenance, depreciation and return or invested capital.
- Under the AWWA Rates Manual methodology, the differential is reasonable.

The trial court held that the outside ratepayers have the burden to show that the town abused its discretion in maintaining the rate differential. "This burden is not carried merely by claiming that there are different rates within town and out of town. It is not carried merely by challenging the methodology by which the rate is chosen. Instead, it is petitioner's burden to demonstrate that the rate differential is not justified by variations in costs, including capital, of furnishing services to various locations." *Id.* at 1229. Thus, the trial court upheld the rate ordinance.

The Indiana Court of Appeals reversed the trial court, holding that the town had the burden to prove that the rate differential was reasonably related to increased costs of service and that the fifty percent differential was arbitrary, inequitable and discriminatory. *Farley Neighborhood Association v. Speedway*, 747 N.E.2d 1132 (Ind. Ct. App. 2001).

The Indiana Supreme Court reversed the Court of Appeals decision and affirmed the trial court. It held "that the trial court correctly placed the burden on Petitioners to prove that Speedway's proposed rate structure was not reasonably related to either costs or the number of users. Presentation of a *prima facie* case does not suffice." 765 N.E.2d at 1230.

The court said that "the testimony at trial amounted to a battle of experts. Petitioners offered only minimal evidence that Speedway's rate differential was unrelated to costs, and Speedway effectively refuted Petitioners' proffered calculation." *Id.* at 1231.

Thus, the Court agreed "that Petitioners did not carry their burden of proving that Speedway abused its discretion when, with advice from an outside expert with twenty years' experience in utility ratemaking, it continued a fifty percent surcharge adopted when the town first agreed to provide out-of-town service nearly half a century ago." *Id.*

Several observations may be gleaned from review of the Speedway decision.

First, to support any proposed rate increase, a municipal-owned water or wastewater system should have performed a full cost of service study by experienced outside experts.

Second, rates should be established and designed in accordance with applicable rate making principles as set forth in local statutes, case law, bond ordinances and AWWA manuals.

Third, municipal rate ordinances likely will be granted *prima facie* deference by courts. Therefore, outside customers challenging rate differentials probably will have the burden of proving that their rate differentials are unreasonable. 

