

Current Township Water & Sewer Issues

Townships frequently contract with cities and villages for water and sewer service. In some cases, cities and villages demand township residents pay substantially more for the same sewer and water service than city and village residents pay. Sometimes, cities and villages charge township residents twice as much as city or village residents. Discriminatory and excessive water and sewer rates violate Michigan law, and in some cases may violate federal law. These occurrences result in rate disputes. This E-Letter discusses available options for townships to obtain water and sewer service, some of the pressures that public water and sewer utilities are currently facing, and Michigan legal requirements for water and sewer rates that are reasonably based on the actual costs of service.

TOWNSHIP CONTRACTS FOR WATER/SEWER SERVICE

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FEDERAL FUNDING AND GROWTH ESTABLISH NEW WATER AND SEWER SERVICE CONTRACTS

Regulation of Public Water/Sewer Utilities

Michigan is known for abundant fresh water. The wide availability of water minimizes disputes common in the western states, where water is often scarce. Even with ample availability of water, fresh water from the Great Lakes and from ground water is not drinkable without treatment. The use of water also creates wastewater, which must be treated before being released back into Michigan's fresh water sources; otherwise further pollution of Michigan's fresh water will occur. According to the MDEQ, withdrawal of water for the public water supply is approximately 10% of the total recorded withdrawal.

Michigan's public water supply, withdrawal and treatment is largely operated by public entities. Unlike other public utilities, such as gas and electric operated by private companies, municipal water and sewer systems are not subject to oversight by the Michigan Public Service Commission ("MPSC"). The MPSC's role is to review and oversee private utilities and ensure fair and reasonable rates are being charged to customers. The MPSC addresses rate changes and policy adjustments through an administrative hearing system where experienced MPSC staff, consultants, and interested parties provide input.

Since the MPSC has no role in regulating public water and sewer systems, the construction, operation, and financing of public water and sewer systems is administered by over 1,500 different governmental boards, including city councils, township boards, authority boards, and county commissions.

The decision-makers are generally elected officials of these entities. They have limited knowledge or experience in water and sewer utility operation and finance. They are also influenced by political considerations that may not be in the best interest of all customers served by the utility or in the best interest of the operational and financial health of the utility in the long-term.

There is nothing inherently wrong with this process but achieving the correct results requires consideration by the decision-makers of multiple legal and public policy issues to ensure that all customers of the utility are treated fairly and reasonably. Ultimately, the test of reasonableness is based upon review of the rates paid by customers for water and sewer service.

Federal Construction Grant Funding

During the 1970s and 1980s, the EPA administrated a federally-funded construction grant program. Under that program, more than \$60 billion of federal funds were provided to construct public sewer treatment projects. These projects, which constituted a significant contribution to the nation's sewer

infrastructure, included sewage treatment plants, pumping stations, collection and intercept sewers, rehabilitation of sewage systems, and the control of combined sewer overflows.

During that time, neighboring municipalities were encouraged to share water and sewer services or develop regional water and sewer systems. This provided additional perceived benefit from the use of federal funds. The construction grants brought many neighboring townships and cities to create a relationship for administration of joint water and sewer service. The relationships were typically based upon long-term (30-plus years) contracts.

Disputes over the total rates paid by the customers of a public water or sewer utility are not new. But many contracts from the 1970s and 1980s have expired or are expiring, causing negotiations about the terms of renewal, including rates. Moreover, systems built during that time are becoming old and worn-out, requiring vast amounts of expensive replacement infrastructure. Replacement infrastructure can cost millions of dollars of new capital investment. This forces rate increases, but too often these rate increases are allocated incorrectly among the various customer classes, which causes one customer or group of customers to subsidize another. These increased costs are being paid by the current generation of customers, since the past customers have frequently been charged insufficient rates to replace and repair the systems they have enjoyed for many years. The need for greatly increased funding, without the availability of similar grant funding today, often causes municipal utilities to attempt to foist an unfair portion of the costs on the customers outside the municipality.

CIRCUMSTANCES THAT CREATE CONFLICT

Scope of Service Historically Provided

If the water and sewer utility is owned by your neighboring city or village, decisions were often made by past boards and councils establishing what level of water and sewer service would be available. These decisions directly impact the availability of water and sewer services to townships today. Some cities and villages were cooperative in providing water and sewer services to adjacent townships under contracts that specified the rates that would be charged for such service. In other instances, cities and villages denied water and sewer services to surrounding townships, unless they agreed to annexations or Act 425 agreements. The parameters established long ago between the municipalities typically limit what potential avenues may be taken going forward to address water and sewer service issues and rate issues.

Contracts

Many townships have contracts that allow cities and villages to provide water and sewer service to township residents. Except for some form contracts created by Rural Development (see Form RD 442-30), the terms and conditions of these contracts address similar topics, but the substantive content varies widely among such service contracts. Most contracts address the service territory, the terms for expansion, the scope of water or sewer service provided, capacity limits, rate methodology, and miscellaneous terms under which the service is provided to the receiving township. Some of these contracts also include requirements for Act 425 agreements or annexation.

Retail Service by Adjacent Municipality

Some townships have consented to allow another municipal entity, potentially a city or utility authority, to operate a water and sewer system within the township's boundaries. These agreements are essentially franchise/consent agreements that allow another municipality's public utility to operate and service customers within the township. It is similar to the agreements entered into with gas and electric companies. There are positives and negatives to such an arrangement, but generally it removes the township from the strain of managing its own water and sewer systems. It also allows customers in the township to generally be treated similarly to customers in the other jurisdictions. This can avoid some of the rate issues discussed later.

Authority

Several statutes authorize cities, villages, and townships to establish an authority to provide water and sewer service to a regional area. An authority is a separate governmental entity that operates according to its incorporation documents. Townships typically become involved with authorities in two ways: (i) a township and various other municipal entities agree to become members in an authority; or (ii) a township contracts for water and sewer service from an authority incorporated by other municipal entities. In the first instance, a township that holds a member interest in a regional authority should have representatives appointed to an authority board that make decisions that are fair and equitable for all members. In these situations, the township has fair representation and inequitable treatment is typically minimized. In the second instance, the township has a contract for service. In this arrangement, an Act 425 Agreement or annexation will not be the concern, but proper operation, financial planning, and rate setting remain valid concerns.

Act 425 Agreements

In Michigan, Act 425 authorizes local governments to conditionally transfer property from one jurisdiction to another for the purpose of economic development. Unlike annexation, the conditional transfer of property is subject to the terms and conditions of the agreement negotiated between the communities (commonly referred to as an Act 425 agreement). Although the property may be conditionally transferred to the municipality owning the utility, the agreement allows for the sharing of property taxes and negotiated city services. Thus, the property can receive water and sewer service, but in return, the township maintains a means to generate tax revenue and other benefits from the shared property. The agreements are limited to a period of 50 years and a 50-year renewal. At the conclusion of that term, the agreement must determine whether the property remains within the city or reverts back to the township.

Annexation

Annexation policy is intertwined with water and sewer service. The relationship between the two is dependent upon the owning utility's policies about neighboring governments. Whether water and sewer service is available to a property is the single-greatest consideration as to whether annexation will be granted by the State Boundary Commission. Thus, by providing water and sewer service through one of the means previously discussed, a township may limit future annexations of its territory. But cities and villages with little interest in governmental cooperation will only provide water and sewer service through annexation into its jurisdictional boundary. Many cities have regularly required annexation over the decades, using their water or sewer service as leverage to increase their boundaries (and their tax base) at the expense of surrounding townships.

CURRENT TRENDS AFFECTING RATE INCREASES AND CONSIDERATIONS FOR AGREEMENT RENEWALS

Population Decline/Stagnant Growth

The economic recession in 2008 heavily impacted Michigan. Many communities saw population declines or stagnant growth as jobs disappeared and people moved out of the area to find work. Many public water and sewer utilities were designed in the 1970s and 1980s based on population growth assumptions. Utilities were often overbuilt based on expected demand in the future that never materialized. Utilities with rates established prior to 2008 were based on the current number of customers in the area. The population declines that occurred after the 2008 recession have created an upward pressure on rates. The loss of customers means that the remaining customers must pay a larger part of the fixed costs of the utilities. These are costs that exist to maintain the utility regardless of

whether it operates at 50% capacity or 75% capacity.

Without a rate increase, there is less rate revenue to operate the utilities. If rate increases are not imposed, the operation and maintenance expenses must be sustained. The first area that receives a reduction in spending is replacement and improvement of infrastructure, which compounds potential upward pressure on rates in future years.

The impacts of the 2008 recession and necessary cutbacks are now being realized with substantial rate increases for numerous communities. The rate increases must be allocated fairly and reasonably among the utilities' customer classes, however.

Capital Improvement Plans ("CIP")

Despite the recent asset management program requiring CIP, cities and villages were already required under the Michigan Planning Enabling Act to prepare CIP. See MCL 125.3865. Townships were also required to have a CIP if they operated a water supply or sewage disposal system.

Under the Act, CIP is required to be prepared annually. The Planning Enabling Act requires the community to address its public structures and improvements in a list as to how the community will build and finance such new structures or improvements over the next 6-year period.

Some communities that attempt to create capital improvement funds face difficulty increasing rates as customers often see it as a "slush" fund or fund balance that should be diminished prior to instituting a rate increase. This creates political influence that bears down on the legislative bodies considering rate increases, often making it more difficult to get an appropriate level of rate increase instituted. The shortfall has the potential to cause other issues. As the infrastructure ages, operation and maintenance expenses can increase due to lost water or excessive inflow and infiltration.

A properly administrated CIP that is incorporated into a rate has the potential to cause an upward rate increase. But because the expenses are often viewed as non-mandatory, legislative bodies defer rate increases that would fund CIP. The result over an extended period of time creates artificially low rates that ultimately are unsustainable in light of aging and failing utility systems. The customers of the utility then experience significant upward rate pressure, and such increases can be erroneously shifted to the wrong customer classes.

Asset Management Plans ("AMPs")

Some of the above issues can be addressed by mandatory asset management plans. The requirement for asset management programs was established under Michigan's Safe Drinking Water Act, MCL 325.1005, et seq. According to the rules promulgated thereunder, water supply utilities that serve more than 1,000 people shall implement an asset management program by January 1, 2018. Those water supply utilities serving 1,000 people or fewer are required to prepare a CIP that identifies waterworks systems needs for 5-year and 20-year planning periods. The utility shall begin to prepare a CIP by January 1, 2016.

An asset management program identifies the desired level of service at the lowest life cycle cost for rehabilitating, repairing, or replacing the "assets" associated with the waterworks system. AMPs are necessary to assure sustainability because assets are degrading faster than repairs. AMPs are centered on the current state of the assets; the required sustainable level of service; the assets critical to sustained performance; the minimum life-cycle costs; and the best long-term funding strategy.

The assets that are addressed include intakes/wells; treatment equipment; pumps, pipes and appurtenances; tanks; buildings and land; tools; people; and controls and computer systems.

An AMP must include:

- Inventory of assets
- Criticality assessment (likelihood of asset failure and consequences thereof)
- Level of service goals
- Capital improvement plan (identifying 5 and 20 year needs, prioritizing assets, projecting costs)
- Funding structure and rate methodology

The impact on rates depends on the individual AMP's "funding structure and rate methodology," which determines if there is enough funding available to maintain assets in a degree that meets level of service goals. If the costs identified in the capital improvement plan (plus the system's operating budget) exceed available funding, some of the expenses related to capital improvements may be funded out of the system's revenues, meaning the rate structure will be restructured or raised.

There is no "one size fits all" answer to how AMPs increase rates, it all depends on the system in question – how many assets are within that system, the condition of those assets, the level at which the system wishes to provide service, the timeframe within which repairs must take place, and the funding currently available to that system.

These requirements are also being placed in conditions in newly issued discharge permits. This increases the stakes for an owning municipality as failure to properly raise rates consistent with the AMP could pose implications with revocation or non-renewal of the discharge permit.

Financing New Improvements/Extensions

A hotly contested issue with all of the infrastructure improvements caused by aging infrastructure or extensions to serve growing areas in townships is who should pay? Some rates charged to townships already include a capital component that was earmarked for aging infrastructure. Requiring the township to pay additional capital costs through rates or one-time assessments results in double charging the township—a result typically caused by poor management of the utility. On the other hand, owner municipalities are often unwilling to take on the capital costs and debt to build new extensions or improvements solely caused by township growth and development. In these instances, the parties need to determine whether the township buys into the asset and becomes part owner or continues to pay through rates.

Significantly, if capital reserves were not properly maintained, there are multiple options for the owning municipality that does not pose harm to a township receiving service. The owning municipality would be able to secure grants or issue bonds to finance the improvements. There are also loans available through state agencies. The rates would only be required to then pay the debt service on those financing instruments.

A township could also contribute directly through development or capital contribution fees. This allows the township to essentially purchase capacity in the system. The township could similarly pay for these costs through grants, loans, or bonds. The township could also initiate a special assessment for those customers that benefit from the water/sewer service.

Rate Increases

Rates are charged on a per unit basis. A rate includes certain fixed components and certain variable components. This is typically discussed as the rate design. The fixed components are charged to each customer within the same customer class at the same rate. The fixed components do not change based on usage of water/sewer. Variable components are often referred to as the commodity component of the rate. Typically, the commodity component of the rate is established per 1,000 gallons or per 1,000 cubic feet. This portion of the rate changes based on the volume of usage.

Regardless of the individual component parts of the rate charged, townships can simplify their concerns by looking at the total result of a rate. For instance, a quarterly bill may show a \$16.00 ready to serve charge and \$34.00 commodity charge based on use of 10,000 gallons. The total bill of \$50.00 can be expressed in a per 1,000 gallon charge as \$5.00. The cost to the township of \$5.00 per 1,000 gallons should be compared against the cost to serve the township. This measurement will show whether the township's cost for water service exceeds the actual cost for the utility to provide the service to the township.

Actual Cost of Service

Actual cost of service can be calculated by the owner/operator of the utility and its staff. Other times consultants use the methodology outlined by the American Water Works Association (AWWA) and the Water Environment Federation (WEF) to calculate actual cost of service and then design a rate for the utility. The important point for any township evaluating the rates being charged by another water/sewer utility is the differential between the actual cost of service and the rate charged. This can be an excellent indicator as to whether the township is paying a fair and reasonable rate.

1.5 or 2 Times In-City Rates

Some contracts require township customers to pay double the in-city rates; many other contracts allow extraterritorial multiples of 1.5 or 1.25, and still other contracts charge the same rates both within and outside the city.

This lack of uniformity in water and sewer rates across the state causes confusion and uncertainty for many township officials who are trying to properly represent their constituents in negotiating water and sewer contracts with cities and villages. Cities and villages often incorrectly claim that the few existing contracts with double water rates are a precedent for charging double rates in their own communities. Such an argument misinterprets the history of double water rates in Michigan. It also overlooks the effect of various provisions of the Michigan Constitution, which prohibit water and sewer rates that are unreasonable, discriminatory, and not based on the actual costs of providing water and sewer service.

The original authority for water contracts with double rates was an old statute repealed in 1981. MCL 123.141, which allows one municipality to contract for the sale of water to residents of a second municipality, formerly authorized the selling municipalities to charge double rates to extraterritorial customers. In 1981, the Legislature amended MCL 123.141 to remove the authorization for double

water rates. Instead, the Legislature required municipal water sellers to charge all water customers—both inside and outside the municipality—rates based upon the selling municipality’s cost of service. Although the statute was amended more than 30 years ago, there are still some water contracts executed under the old law that impose double water rates (since water contracts frequently have 30-plus year terms).

Headlee Amendment’s Limitation on Excessive Rates

The Headlee Amendment, among other constitutional provisions, requires that any tax increases must be approved by the voters. In a 1998 case involving the City of Lansing, the Supreme Court held that Headlee also prohibits municipal utility charges that are really “disguised taxes.” In the Lansing case, the Court held that the city’s “storm water service fee” added to the city’s sewer rates was invalid because it was actually a “tax” that violated the Headlee Amendment. The Court in the Lansing case explained that rates, charges or fees may violate Headlee when they are (1) not proportionate to the necessary costs of providing the service; or (2) imposed to raise revenue rather than for a regulatory purpose; or (3) they are not voluntary.

Similarly, excessive water and sewer rates are disguised “taxes” because (1) the rates are not proportional to the costs of water and sewer service, and (2) they serve a revenue-raising purpose, rather than a regulatory purpose. Arbitrary or excessive water and sewer rates for township customers violate Headlee when they are not based on any differences in the costs to serve city water and sewer customers as compared to township water and sewer customers. Rather, they serve only to increase the city’s revenues. As a result, rates exceeding the actual cost of service are disguised “taxes” that violate the Headlee Amendment.

Due Process and Equal Protection Limitations on Excessive Rates

The constitutional guarantees of Due Process and Equal Protection also preclude cities and villages from setting unreasonable, discriminatory, and arbitrary water and sewer rates. A municipality is constitutionally prohibited from arbitrary discrimination among its water and sewer customers.

According to a 1997 Court of Appeals case involving the *Village of Goodrich*, a municipality may not charge extraterritorial utility customers higher rates than customers within the municipality unless it can demonstrate that the higher rates are based on costs of service and the rates do not subsidize the municipality’s water and sewer customers. Although the *Goodrich* case involved sewer service, rather than water service, the same constitutional principles apply to both services.

Excessive water and sewer rates for township customers constitute rate discrimination. A city may not discriminate against nonresidents. Such discrimination is especially egregious when nonresidents (and non-voters) of the City have no political access or control at the ballot box over the city government that is discriminating against them.

Federal/State Water and Sewer Grant/Loan Requirements

It is rare to see cities and villages charging township residents double rates for sewer service. This is because a substantial portion of the city and village sewer systems in this state were funded by federal grants under the Federal Water Pollution Control Act. That Act required “user charge systems,” mandating that “each recipient of waste treatment services” must “pay its proportionate share ... of the costs of operation and maintenance (including replacement) of any waste treatment services.” Thus, such a city or village’s sewer rates must be computed on the same terms both within and outside the city or village.

Up-Front Connection or Tap Fees

The same rules described above apply to connection fees or other up-front fees charged to access a water or sewer system. The proper purpose of these fees is to defray a portion of the capital cost of the utility system or the cost of connecting service to the new customer. If the fees are set at levels far in excess of those costs, they will likely be found to be unlawful “taxes” or discriminatory fees. For example, in a 2002 Court of Appeals case involving *Frankenmuth Township*, the Court set aside a \$7,500 “connection fee” charged to new customers of the township water system. The water system itself was already paid for, and did not need to be expanded to serve the new customers. Instead, the township planned to hold the “connection fee” revenues for future repairs and maintenance of the system. The *Frankenmuth* case held that, since the “connection fees” were not proportional to the township’s cost of extending service to the new customers, they were unlawful “taxes.” Similarly, there are many city and village water and sewer systems that were paid for with state and federal funds. Those municipalities sometimes attempt to charge new customers for water or sewer service based on the original cost of the system, even though it was paid for largely by state or federal funds. When those fees exceed the actual cost of serving the additional customers, just as in *Frankenmuth*, the fees are unlawful “taxes.”

Rate Analyst

A rate analyst is an individual or corporation with background training in finance, business, or accounting. The individual uses skills learned from their degrees coupled with special expertise in valuing the costs to operate a water or sewer utility for various customer classes. For any prospective consultants in Michigan, a township should ensure that the consultant ascribes to the methodologies used by the AWWA and WEF. A rate analyst is typically an individual with extensive experience in pricing and marketing utility services, including water, sewer, electric and telecommunications.

A rate analyst can be hired and brought into a contentious situation to educate the utility owner and operator and explain the concept of cost of service. A recognized rate analyst can often help to negotiate disputes between municipalities involved in water and sewer service contracts. The rate analyst will also be able to provide input on rate design and financial projections ensuring the health of the utility moving forward.

In a community that does not use outside rate consultants, rates are typically 10% to 20% lower than necessary to meet revenue requirements and future CIP. With that in mind, there is the potential an outside rate consultant will recommend some form of rate increase for all customers of the utility. Significantly, however, the rate consultant will be able to allocate the increases appropriately. Outside municipal customers should not be subsidizing inside customers. Both customer classes should pay their fair share based on the cost of service of each customer class.

There is a cost to hiring a rate consultant. Depending on the scope of the work requested, costs can range from \$5,000 to \$30,000 for small to moderate sized systems. Larger systems, such as Detroit, may cost much more. If the community has multiple municipalities, those municipalities may decide to share the costs of the consultant. Otherwise, the consultant's fees can be paid through rate revenue. Often, the benefit to the utility and its customers received from a rate consultant far outweighs the cost of the rate consultant.

Rate analysis can help avoid inaccurate or misallocated rates and rate disputes from large wholesale or retail customers, such as townships. Rate calculations offered by an expert in the industry also allow the decision-makers to make sound decisions based on calculations. Further, it provides a basis to explain to complaining customers the need for any rate increases and the areas funded by such increases.

— Christopher Patterson

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