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LAWFUL DISCRIMINATION IN UTILITY RATEMAKING

Part 1. Classifying Customers within Territorial Boundaries

Kara A. Millonzi

This bulletin is the first of a two-part series examining constraints on the power of local government–owned utilities to classify their customers for the purposes of charging different rents, rates, fees, charges, and penalties for utility services. Part 1 explores the ability to discriminate among various types of customers whose properties lie within the local government's territorial boundaries. Part 2 focuses on the classification of utility customers whose properties lie outside those territorial boundaries.

Introduction

North Carolina grants local governments significant flexibility in both providing and financing water and sewer services.[1] As a result, there is considerable variation in the organizational and revenue structures of the state's public utilities.[2] Traditionally, local government units substantially relied on local property and sales taxes to fund their water and sewer utilities. In fact, the local sales taxes the General Assembly authorized in 1983 (Article 40 One-half Cent Tax) and 1986 (Article 42 One-half Cent Tax) were partially earmarked for that purpose. Cities were required to use 40 percent of the tax proceeds for water and sewer capital improvements or debt service

Kara Millonzi is a faculty member of the School of Government. She specializes in issues related to the law of local government finance.

1. Carolina Water Serv., Inc. of N.C. v. Town of Pine Knoll Shores, 145 N.C. App. 686, 689, 551 S.E.2d 558, 560 (2001) ("Numerous United States Supreme Court cases, as well as cases decided in North Carolina, pronounce public policy in favor of broad discretion for municipalities regarding the construction and operation of their own utilities.").

2. For example, counties can establish water and sewer districts (N.C. GEN STAT. § 162A, Art. 6 (2005) (hereinafter G.S.)); counties, or two or more political subdivisions (such as cities, towns, incorporated villages, or sanitary districts), can organize water and sewer authorities (G.S. 162A, Art. 1); any two or more political subdivisions in a county can petition the board of commissioners to create a metropolitan water or sewer district (G.S. 162A, Arts. 4 and 5); the Commission for Health Services can create a sanitary district to operate sewage collection, treatment, and disposal systems and water supply systems for the purpose of preserving and

during the first five years of the levy and 30 percent in the subsequent five years.[3] Recently, however, most municipalities have moved to a utility-based approach to financing their systems, in part because of citizen resistance to property and sales tax increases and in part because federal incentive grant programs generally require utilities to be supported by user charges.[4] Under this approach, utilities are self-supporting (or largely self-supporting) and finance their operations by some combination of rates, rents, and fees charged to customers and properties served by the utility.

Under this method of financing, local governments in North Carolina operate water and sewer systems as *public enterprises*. Both cities (municipalities)[5] and counties[6] are entitled to own and operate "water supply and distribution systems" and "sewage collection and disposal systems" as public enterprises. They also can "revise from time to time schedules of rents, rates, fees, charges, and penalties for the use of or the services furnished by any public enterprise."[7] Local government units may include in such rates and charges the capital costs associated with actual or anticipated growth, as well as operating expenses and depreciation.[8] Cities and counties are authorized to impose impact fees, connection fees, and recurring operational charges with both fixed and variable components.[9] They also can, under certain circumstances, impose special assessments on *benefited properties* (properties that receive a particular benefit from a utility construction or improvement project)[10] and can "require land owners to connect to their [utility] systems or else pay an availability fee."[11]

With all this flexibility, local government units face difficult questions about who should pay and how much. Cities and counties "have tended to adopt policies that relate elements of system cost to particular revenue measures."[12] For example, local government units may assess user charges and availability fees to fund operational elements of water and sewer systems; and they may impose impact fees or special assessments for capital improvements or extension of utility lines.[13] Many cities and counties also have implemented various *block-rate structures*—either charging increased (increasing-block) or decreased (decreasing-block) rates based on additional units of usage.[14] Finally, most cities and counties have categorized consumers into various classes for purposes of setting rate schedules that closely track the costs of providing services or other utility-related factors. These revenue structures are not mutually exclusive—nearly all local government units employ all three.[15]

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promoting public health and welfare, without regard for county or municipal boundary lines (G.S. 130A, Art. 2, Pt. 2); and, of course, cities can grant franchises to privately owned public utility corporations (G.S. 160A-319), or such corporations can petition the Public Utilities Commission to provide services in a designated area (G.S. 62, Art. 6).

3. G.S. 105-487(b) (repealed 1998); G.S. 105-504 (repealed 1998).

4. Over the years, North Carolina's Local Government Commission also has encouraged local government–owned utilities to become self-supporting.

5. G.S. 160A-311 *et seq*. Cities also can establish public enterprises to provide transmission and distribution of electric power generation; production, transmission, and distribution of gas; public transportation systems; solid waste collection and disposal systems and facilities; cable television systems; off-street parking facilities and systems; airports; and stormwater management programs. G.S. 160A-311.

6. G.S. 153A-274 *et seq*. Counties too can establish public enterprises for solid waste collection and disposal systems and facilities, airports, off-street parking facilities, public transportation systems, and stormwater management programs. G.S. 153A-274.

7. G.S. 160A-314(a) (cities); G.S. 153A-277(a) (counties). The statutes' references to rates, rents, charges, fees, and penalties reflect the various types of charges that can be collected and include impact fees, connection fees, late fees, and user fees. For purposes of the principles discussed in this article, unless otherwise indicated, the terms are used interchangeably and encompass all the various types of charges associated with the construction, maintenance, and operation of utility systems.

8. Town of Spring Hope v. Bissette, 53 N.C. App. 210, 280 S.E.2d 490 (1981), *aff'd* 305 N.C. 248, 287 S.E.2d 851 (1982).

9. G.S. 160A-314; G.S. 153A-277.

10. G.S. 160A, Art. 10 (cities); G.S. 153A, Art. 9 (counties).

11. Carolina Water Serv., Inc. of N.C. v. Town of Pine Knoll Shores, 145 N.C. App. 686, 689, 551 S.E.2d 558, 560 (2001); *see* G.S. 160A-317 (cities); G.S. 153A-284 (counties).

12. Warren Jake Wicker, *Water and Wastewater Services, in* MUNICIPAL GOVERNMENT IN NORTH CAROLINA 704 (David M. Lawrence and Warren Jack Wicker eds. 1996).

13. *Id*.

14. *See* Jeff Hughes, *The Painful Art of Setting Water and Sewer Rates*, POPULAR GOVERNMENT, Spring/Summer 2005, at 9–10.

15. *See generally* Township of Raccoon v. Municipal Water Auth. of Borough of Aliquippa, 597 A.2d 757 (Pa. Commw. 1991) (noting that the "costs of operating a water utility [are generally grouped] into three types: consumer-related costs; demand-related costs and commodity-related costs").

As the court explained, "[c]ustomer-related costs are associated with servicing consumers irrespective of the amount of water used. They include meter reading, billing, accounting, office space and a portion of the general administrative costs. Demand-related costs are associated with providing facilities to meet the peak rates of use placed

Of course, rate schedules are influenced by the policy prerogatives of a local government's governing board. Consequently, the numbers and types of classifications vary greatly among North Carolina's cites and counties. A local government that wishes to promote conservation is likely to impose a different rate structure than one hoping to foster commercial or industrial development. Governments also may configure rates so as to encourage or discourage annexation of extraterritorial property.

Although local governments have broad discretion to accomplish these and other goals, there are some constraints on their power to set utility rates, rents, fees, and charges. Part I of this bulletin explores one such constraint—namely, the ability to lawfully discriminate with respect to fees charged to various classes of utility consumers within their territorial boundaries—and sets forth the constitutional and general common law principles that govern utility rate-setting. It focuses on municipalities because they are the most common providers of government-owned utilities, but, unless otherwise indicated, the same general principles apply to county-owned utilities.[16] (Part 2 of the series focuses on the classification of customers who receive utility services extraterritorially.)

The North Carolina General Statutes clearly allow different schedules of rates for various classes of consumers, but they provide little clear guidance on the differentiating factors needed to justify separate classifications. Although there are few bright-line rules, the courts have generally upheld rate classifications that have a rational, utility-based reason for their distinctions.

Constitutional and Common Law Constraints on Rate-Setting within Territorial Boundaries

When municipalities offer utility services to their residents, they are considered public utilities. Although they are not, like privately owned utility companies, subject to regulation by the Public Utilities Commission,[17] under the common law they owe "the duty of equal service" to customers located within their territorial boundaries.[18] Further, as both public utilities and state actors, their rate-setting for water and sewer services must conform to both common law utility principles and to the Equal Protection Clause of the U.S. Constitution (as well as to states' equal protection clauses).[19] Cities must charge rates, rents, fees, and charges that are (1) reasonably related to the value of the services either actually consumed or readily available for consumption (the reasonableness principle)[20] and (2) roughly equal for similarly situated groups of consumers (the nondiscrimination principle).[21]

With respect to the rates charged, however, courts have held that " 'a distinction may be made between different customers or classes of customers [based on] . . . material conditions which distinguish them from each other or from other classes.' "[22] In other words, a lack of homogeneity in the rates charged by a government-owned utility does not necessarily violate the Equal Protection Clause or utility principles.[23] As one court has stated, " '[p]erfect equality among users is not the standard of municipal duty in fixing [utility] rates.' "[24] To be unlawful, discrimination among utility consumers must draw an unfair line or strike an unfair balance between those

on the system by the consumers. These costs include capital charges and operating and maintenance costs. Commodity-related costs are costs that tend to vary with the quantity of water produced and sold." *Id*. at 768, n.5.

16. Many of the principles regarding the ability to discriminate among classes of customers in setting user charges also apply to the other public enterprises authorized under G.S. 160A-311 *et seq*. and G.S. 153A-274 *et seq*. Other public enterprises have additional limitations that are beyond the scope of this bulletin.

17. *See* Dale v. City of Morganton, 270 N.C. 567, 155 S.E.2d 136 (1967).

18. Carolina Water Serv., Inc. of N.C. v. Town of Atlantic Beach, 121 N.C. App. 23, 28, 464 S.E.2d 317, 321 (1995).

19. U.S. CONST. Amend. IX ("No state shall . . . deny to any person within its jurisdiction the equal protection of the laws."); N.C. CONST., Art. I, §19 ("No person shall be denied the equal protection of the laws; nor shall any person be subjected to discrimination by the State because of race, color, religion, or national origin.").

20. *See, e.g*., Shepherd v. City of Wentzville, 645 S.W.2d 130, 133 (Mo. Ct. App. 1983) ("[C]ourts . . . have equitable jurisdiction to prevent a municipality from enforcing public utility charges that are 'clearly, palpably and grossly unreasonable.' ") (citation omitted).

21. *See, e.g*., *In re* Lower Cape Fear Water and Sewer Auth., 329 N.C. 675, 677, 407 S.E.2d 155, 157 (1991) (citing Paper Co. v. Sanitary Dist., 232 N.C. 421, 61 S.E.2d 378 (1950)).

22. Louisville & Jefferson County Metro. Sewer Dist. v. Harvester Co., 211 S.W.2d 122, 126 (Ky. Ct. App. 1948).

23. *See generally* General Textile Printing & Processing Corp. v. City of Rocky Mount, 908 F. Supp. 1295 (E.D.N.C. 1995).

24. Brittany Park Apartments v. Harrison Charter Twp., 443 N.W.2d 161, 163 (Mich. 1989) ("The word reasonable is ' "not subject to mathematical computation with scientific exactitude but depends upon a comprehensive examination of all factors involved, having in mind the objective sought to be attained in its use." ' ") (citations omitted).

in like circumstances having equal rights and privileges.[25]

North Carolina General Statutes Sections 160A-314 and 153A-277 expressly authorize cities and counties to charge different rates for different "classes of service."[26] And, because rate-making is a legislative function, the rate decisions of municipalities are presumed legal. A party challenging municipal water and sewer rate classifications bears the burden of proving that the rates are unreasonable or lacking in uniformity with respect to the services rendered. The standard of review is very deferential to municipalities—utility rate classifications will be upheld if they are rationally related to legitimate government purposes.[27]

Lawful Classifications

Cost Differentials

What, then, constitutes a proper classification? As noted above, there are no bright-line rules, though a few general patterns have emerged. Clearly, varying rates or other fees according to differences in the costs of delivery is lawful;[28] and, indeed, most classifications can be tied to a cost differential.[29] Courts, for example, have upheld late fees on overdue utility bills because the class of consumers who do not pay their bills on time impose additional administrative costs.[30] Early sign-up incentive programs, likewise, have been upheld because the class of consumers who commit to utility services upfront reduce the overall planning costs associated with constructing or extending utility services.[31]

Customers also may be categorized according to whether they have contributed to the costs of constructing the utility systems. In fact, municipalities that use some tax monies to construct or maintain utility systems commonly employ this justification to charge lower rates to their resident, taxpaying customers than to their nonresident customers. The same rationale applies to those who contribute other than as taxpayers. In *Goldman and ABG Corporation v. Town of Plainfield*,[32] for example, the Vermont Supreme Court upheld a town's utility rate scheme under which a college located in the town paid lower water and sewer rates because it had contributed substantial funds to construct the sewer system. Likewise, in *In re Lower Cape Fear Water and Sewer Authority*,[33] the North Carolina Supreme Court held that a local water and sewer authority that received a sizeable loan from the county to help construct its facilities could charge the county a different rate than it charged other members. Differences in the costs of delivery also have been found valid bases for classifications, even when they resulted in denial of services to some residents.[34]

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25. *See generally id.*; Rustlewood Ass'n v. Mason County, 981 P.2d 7 (Wash. Ct. App. 1999) (holding that surcharge imposing different rates for customers within the same class was invalid).

26. Counties also are allowed to charge different rates "for the same class of service in different areas of the county." G.S. 153A-277(a).

27. Town of Spring Hope v. Bissette, 53 N.C. App. 210, 212–13, 280 S.E.2d 490, 492 (1981), *aff'd*, 305 N.C. 248, 287 S.E.2d 851 (1982) ("Under this broad, unfettered grant of authority, the setting of [utility rates] is a matter of the judgment and discretion of [local government] authorities not to be invalidated by the courts absent some showing of arbitrary or discriminatory action."). Nonetheless, as discussed in the next section, many courts require that rate classifications be related to a utility purpose.

28. *See*, *e.g*., Town Bd. of Town of Poughkeepsie, on Behalf of Arlington Water Dist. v. City of Poughkeepsie, 255 N.Y.S.2d 549, 552 (N.Y. App. Div. 1964) ("Rates may also vary according to differences in cost of delivery. Such variance in rates is permissible even if enabling legislation is general and does not specifically authorize a variance; the right is deemed included.") (citation omitted); *see cf.* Iroquois Props. v. City of East Lansing, 408 N.W.2d 495 (Mich. Ct. App. 1987) (holding that classifications of consumers according to access to curbside collection and the amount of solid waste generated were valid because they were related to the costs of providing the service); Drake v. Town of Boonton, 254 A.2d 151 (N.J. Super. Ct. Law Div. 1969) (holding that it is permissible to charge different rates among resident customers based on different costs involved in delivering utility services).

29. Neither the Equal Protection Clause nor common law utility principles mandate "[e]xact congruence between the cost of the services provided and the rates charged to particular customers." Frontier Ins. Co. v. Town Bd. of Town of Thompson, 2001 N.Y. Slip Op. 06506 (N.Y. App. Div., July 26, 2001) (holding that law calculating sewer rents on a point system, with different categories of property having varying rent points and debt points assigned to them, and additional rent points imposed for commercial office and small store buildings over a certain assessed value, does not violate the Equal Protection Clause).

30. Guste v. Council of the City of New Orleans, 309 So. 2d 290 (La. 1975).

31. *See generally* Carolina Water Serv., Inc. v. Town of Atlantic Beach, 121 N.C. App. 23, 464 S.E.2d 317 (1995).

32. 762 A.2d 854 (Vt. 2000).

33. 329 N.C. 675, 407 S.E.2d 155 (1991).

34. *See e.g*., Sunset Cay, LLC v. City of Folly Beach, 593 S.E.2d 462 (S.C. 2004) (holding that proscribing all future expansion of sewer system beyond designated central commercial districts was lawful because it bore a reasonable relationship to the legislative purpose of allocating limited financial resources).

Other Utility Factors

Cost differentials are not the only valid considerations. Municipalities can classify customers and charge different rates "based upon such factors as . . . the purpose for which the service or the product is received, the quantity or the amount received, the different character of the service furnished, the time of its use or any other matter which presents a substantial ground of distinction."[35] Thus, classifying customers according to when they connect to water or sewer systems and charging different connection fees to "newer" customers than to "older" customers is proper.[36] Municipalities clearly have the flexibility to change their fee structures over time, which will always cause some rate disparities among otherwise similarly situated customers. (A few courts, though, have held that municipalities cannot impose the total burden of financing improvements to utility systems on new users unless the improvements were solely necessitated by the new connections.[37])

Several courts have held that municipalities can charge different rates based on the purposes for which the utility services are used. In *Bloomington Country Club, Inc. v. City of Bloomington Water & Wastewater Utilities*,[38] the Indiana Court of Appeals held that application of a higher water rate to the class of customers using water for irrigation (as measured by a separate meter) did not violate the constitutional, statutory, or common law mandate that utility rates be rendered in a nondiscriminatory, reasonable manner.[39] Similarly, charging lower rates for "domestic purposes," as opposed to industrial or commercial purposes, has been held to be a valid classification.[40] And, of course, municipalities can charge customers different rates based on levels of consumption or on measures of stress (wear and tear) to the utility system.[41]

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35. Wall v. City of Durham, 41 N.C. App. 649, 659, 255 S.E.2d 739, 745 (1979).

36. R & C Robertson, Inc. v. Township of Avon, 184 N.W.2d 261 (Mich. Ct. App. 1970); *see also* Loup-Miller Constr. Co. v. City and County of Denver, 676 P.2d 1170 (Colo. 1984) (noting that because "new connections are more directly related to the need for increased capacity than old connections, there is a rational basis" for charging higher rates for new connections); Airwick Indus., Inc. v. Carlstadt Sewerage Auth., 270 A.2d 18 (N.J. 1970) (holding that a sewerage connection charge that increases in each of three years was permissible because connected property was paying for debt service); Hartman v. Aurora Sanitary Dist., 177 N.E.2d 214 (Ill. 1961) (noting that when all sewer users pay for the maintenance of an existing plant, it is fair that new users be made to pay for needed new capacity); Crownhill Homes, Inc. v. City of San Antonio, 433 S.W.2d 448 (Tex. App. 1968) (holding that it is not improper discrimination between old and new customers for a city to discontinue the practice of reimbursing developers for construction of water mains).

37. *See* Contractors & Builders Ass'n v. City of Dunedin, 329 So. 2d 314 (Fla. 1976) (holding that it is permissible to place the cost of system expansion on new users, but that it is not permissible to place the cost of replacing all existing facilities on new users); Strahan v. City of Aurora, 311 N.E.2d 876 (Ohio Com.Pl. 1973) (holding that ordinance authorizing a $550 tap-in charge to construct a water system and waiving it for properties with existing inhabitable structures as of a specific date but assessing it on other properties was discriminatory and unconstitutional); *see cf.* Beauty Built Constr. Corp. v. City of Warren, 134 N.W.2d 214 (Mich. 1965) (holding that a sewerage connection tap fee that discriminated between buildings already constructed but not connected and buildings not yet constructed was based on an invalid classification).

38. 827 N.E.2d 1213 (Ind. Ct. App. 2005).

39. *See also* Shawnee Hills Mobile Homes, Inc. v. Rural Water Dist. No. 6, 537 P.2d 210 (Kan. 1975) (emphasizing that it is proper to consider what water is used for in developing a rate schedule); Land v. City of Grandville, 141 N.W.2d 370 (Mich. Ct. App. 1966) ("The use made of the property is an important factor to be considered in determining the proper applicable rates."). *But see* Theatre Control Corp. v. City of Detroit, 113 N.W.2d 783 (Mich. 1962) (holding that an extra charge for water used in noncirculating air-conditioning equipment was unreasonable because there was no rational basis for classification).

40. *See*, *e.g.*, Crosby v. City Council of Montgomery, 18 So. 723 (Ala. 1895); *see cf.* Barnhill Sanitation Serv., Inc. v. Gaston County, 87 N.C. App. 532, 362 S.E.2d 161 (1987) (upholding ordinance charging a volume-based fee for use of landfill by all commercial, industrial, and municipal haulers of solid waste while charging no fee for individuals who brought their waste to the landfill directly because "the class of garbage haulers, whose volume of garbage delivered to the landfill is substantially more than private citizens, perfectly justifies a reasonable distinction in the fees charged").

41. *See*, *e.g.*, State *ex rel*. North Carolina Utilities Commission v. Municipal Corporations of Scotland Neck, 11 P.U.R.3d 450, 90 S.E.2d 519 (N.C. 1955) (holding that evidence regarding the load factors of the protesting municipalities and the industrial user was sufficient to justify placing them in different classifications); Krupp v. Breckenridge Sanitation Dist., 1 P.3d 178 (Colo. Ct. App. 2000) (affirming sanitation district's determination that mandatory sewage plant investment fee (connection fee) for each unit in a triplex could be approximately 80 percent higher than for each unit in a duplex building because of differences in stress on utility systems).

Unlawful Classifications

Nonutility Considerations

Despite the wide latitude afforded municipalities in setting utility rates, not all classifications are legal. Courts routinely have rejected rate differentials not based on the type of considerations privately owned utilities normally contemplate when setting rates. In *Dale v. City of Morganton*,[42] the North Carolina Court of Appeals held that the city's right to refuse a service it renders in its capacity as a utility provider must be determined separately from the functions it performs in its role as a unit of government. In that case, the city had supplied electricity and water to a certain house in a newly annexed area but later inspected the dwelling and found it unfit for human habitation. It subsequently cut off the electricity supply to the house and refused to reconnect the service. In its review of a challenge to the city's actions, the court held that a city could not deprive an inhabitant, "otherwise entitled thereto, of light, water or other utility service as a means of compelling obedience to its police regulations, however valid and otherwise enforceable those regulations may be."[43]

Ability to Pay

The same rationale probably also prohibits municipalities from charging utility rates according to income levels or ability to pay. Redistribution of income is not a valid utility rate-making function. Thus, municipalities cannot charge lower rates to older customers or those on fixed incomes. Municipalities may, however, approximate the same result by charging different rates based on the size of the residential unit or the number of bedrooms or bathrooms.[44] The difference between such classifications and one based solely on income levels is that these classifications bear some relationship to consumption, which is a valid consideration for public utility rate-setting.[45] Similarly, courts have held that underbilling utility customers—that is, charging certain customers less than other similarly situated customers (even inadvertently)—amounts to prohibited discrimination.[46]

Bundling of Services

Finally, courts have been reluctant to allow municipalities to classify residents based on whether they purchase multiple utility services or a single utility service. In *Town of Taylorsville v. Modern Cleaners*,[47] the North Carolina Court of Appeals held that imposing higher rates on users of sewer services than on users of both sewer and water services was arbitrary and discriminatory because it was not justified by a utility-based factor, such as a cost difference in providing the services. The court noted that " '[r]ates may be fixed in view of dissimilarities in conditions of service, but there must be some reasonable proportion between the variance in the conditions and the variances in the charges. Classification must be based on substantial difference.' "[48]

The Special Problem of Multiunit Residential Dwellings

The lawfulness (or unlawfulness) of the foregoing classifications may seem obvious in light of the principles involved, but the difficulty lies at the margins. How, for example, should municipalities classify customers when tensions exist between cost

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42. 270 N.C. 567, 155 S.E.2d 136 (1967).

43. *Id*. at 573; 155 S.E.2d at 142; *see also Barnhill*, 87 N.C. App. at 539, 362 S.E.2d at 166 (" 'The equal protection clauses of the United States and North Carolina Constitutions impose upon law-making bodies the requirements that any legislative classification "be based on differences that are reasonably related to the purposes of the Act in which it is found." ' " (citations omitted); Kliks v. Dalles City, 335 P.2d 366, 375 (Or. 1959) ("Although a city may operate its utility for profit and may use the profit for any purpose it sees fit within the powers granted to it, the prices which it charges various customers for water or other utility service must be related to its function as a seller of a commodity or service and not to its function as a taxing authority."). *But see* Fort Collins Motor Homes, Inc. v. City of Fort Collins, 496 P.2d 1074 (Colo. Ct. App. 1972) (holding that charging lower rates for charitable institutions and public schools is permitted).

44. The premise being that older or poorer customers are likely to live in smaller dwelling units.

45. *See* Boynton v. City of Lakeport Mun. Sewer Dist. No. 1, 104 Cal. Rptr. 409 (Cal. Ct. App. 1972) (concluding that municipalities can charge higher rates to persons who place a greater burden on water and sewer systems).

46. City of Wilson v. Carolina Builders of Wilson, Inc., 94 N.C. App. 117, 379 S.E.2d 712 (1989); *see cf.* State *ex rel*. Utils. Comm'n v. Mead Corp., 238 N.C. 451, 78 S.E.2d 290 (1953) (holding that public utility provider could not charge parent company less for electric power unless there was some utility-based distinction to justify a different rate).

47. 34 N.C. App. 146, 237 S.E.2d 484 (1977); *see also* Ricks v. Town of Selma, 99 N.C. App. 82, 392 S.E.2d 437 (1990) (noting that towns cannot discriminate between customers who use both water and sewer services and those who use only one utility service).

48. *Modern Cleaners*, 34 N.C. App. at 149, 237 S.E.2d at 486.

differentials and other utility factors? Consider, for example, utilities' classification of multiunit residential dwellings (for example, apartments and condominiums). To fully understand the difficulty of this classification, it is important to know that many multiunit dwellings are served by a single, master pipe through which all individual units are connected to a municipality's water system and that water flow is measured by a single, master meter.[49] Most utilities charge a fixed minimum fee plus a variable fee based on the consumption measured by the master meter. The courts are split over whether apartments and other multiunit residential dwellings should be classified as aggregations of single-family residences or as single commercial units for purposes of water and sewer charges. In fact, as discussed below, the law seems to provide sufficient flexibility for municipalities to choose either approach.

Multiunit Residential Dwellings Classified as Commercial Entities

Some courts have held that classifying multiunit residential dwellings as individual residential units and charging each unit a minimum fixed fee while charging other commercial structures a single fixed fee per meter violates both the nondiscrimination utility principle and the constitutional guarantee of equal protection.[50] Their rationale is that the costs of providing water services to a multiunit residential dwelling served by a single meter are identical to the costs of serving any commercial structure served by a single meter. Thus, it unfairly discriminates against multiunit residential dwellings by categorizing them as aggregations of individual units and charging multiple minimum fees. According to the Supreme Court of Oregon in *Kliks v. Dalles City*,[51] classifying apartment buildings in the same category as single-family residences and charging multiple minimum fees based on the number of units is arbitrary and unreasonable when water is furnished to apartment buildings, as it is to other commercial structures such as hotels and motels, through a single meter because the service requires the preparation of only one (monthly) bill and the maintenance and service of only one connection. The court reasoned that "[u]nless it costs a utility [more or] less to serve a given class of customers, it [is not] proper" to treat them differently.[52]

Multiunit Residential Dwellings Classified as Single-Family Residences

The majority of courts, however, have sanctioned the classification of each unit of a multiunit residential dwelling as an individual unit and the practice of charging multiple minimum fixed fees.[53] The "charge is not tied to the amount of water actually used [or to the cost of providing the water] but to the number of family units actually served, for the purpose of allocating fixed costs of billing the water system equally among the residential units on the system."[54] Some courts even have upheld municipal ordinances that divide the total amount of consumption measured by the master meter by the number of units and charge each unit an average variable cost per billing period.[55] Rejecting the *Kliks* rationale, most courts find it "entirely reasonable to adopt a classification which takes account of the ultimate consumer, rather than a classification limited solely to a consideration of the utility's operating cost."[56] Furthermore, the

49. Note that the terms *master meter* and *master pipe* often are used interchangeably.

50. *See* Wildwood Condo. Phase I v. City of Fairfield, Ohio, 1981 WL 5185 (Ohio Ct. App. Aug. 26, 1981); *see also* Apartment Ass'n of Metro. Pittsburgh v. Municipal Auth. of the Borough of West View, Water Dep't, 1983 WL 241 (Pa. Com.Pl. Feb. 19, 1983) (rejecting ordinance that charged customers whose premises are served by separate meters according to the size of the meter but charged customers whose premises are served by a single meter according to the multiple minimum billing method). *See generally* Pinetree Assocs. v. Ephraim City, 67 P.3d 462 (Utah 2003) (holding that the city could not assess separate monthly minimum charges to individual condominium units because the ordinance required charges for each customer to be based on delivered amounts "measured" (by running through a measuring device such as a meter), and water for each unit was not so measured).

51. 335 P.2d 366 (Or. 1959).

52. *Id*. at 376 (internal quotations omitted).

53. *See* Oradell Vill. v. Township of Wayne, 235 A.2d 905 (N.J. Sup. Ct. 1967) (stating that "[t]he great weight of authority supports such a classification").

54. Robert Randall Co. v. City of Beaverton, 682 P.2d 818 (Or. Ct. App. 1984) (distinguishing *Kliks* and holding that city could charge multiple minimum fees to apartment buildings served by a single meter to recover monthly fixed costs).

55. *See*, *e.g*., McDonald Mobile Homes, Inc. v. Village of Swansea, 371 N.E.2d 1155 (Ill. App. Ct. 1977).

56. *Oradell Village*, 235 A.2d at 908; *see also* Marriot v. Springfield Sanitary Dist., 357 N.E.2d 666 (Ill. App. Ct. 1976) (holding that it is reasonable to classify properties as dwelling or nondwelling units); Piscataway Apt. Ass'n v. Township of Piscataway, 328 A.2d 608 (N.J. 1974) (holding that municipally owned sewer utility may reasonably charge the same fee per residential dwelling unit, whether that unit is within an apartment or is a single-family house and even if

capacity of many utility systems is calculated according to projected consumption, which often is tied to population rather than to the type of structures served.[57] The Michigan Supreme Court's opinion in *Brittany Park Apartments v. Harrison Township*[58] is illustrative. The court held that an ordinance charging multiple minimum rates for water and sewage services provided to multiunit residential structures was rationally related to the town's rate scheme, whereby classifications were "based not on the structure to which water is pumped, but on the type of occupant and the purpose and nature of its use."[59] The court reasoned that "the apartment owner is paying as agent for all of the individual residential units within his building. In light of this reality, he has the same standing and is paying at the same rate as the owner of a block of individual homes who has each home metered in his, the owner's name."[60] In fact, some courts have concluded that to "classify an apartment house as a quantity consumer" would discriminate against owners of single-family residences.[61]

The same rationale has led other courts to sanction classifying hotels and motels in a different category from multiunit residential dwellings. In *Caldwell v. City of Abilene*,[62] the city assigned apartment buildings to a residential classification, whereas it placed hotels, tourist camps, motels, and other places where itinerant trade is predominant in an industrial classification. The city charged each unit in the residential classification a monthly minimum fee but charged premises in the industrial classification only one fee per meter. The Texas Court of Civil Appeals ruled that such a rate classification scheme was valid, noting that

> [t]he fact that the city furnishes its water and sewerage disposal service to hotels and tourist camps and other places where itinerant trade is predominant under an industrial classification with only one minimum charge, even though some of the units in some of these places are used as family units, is obviously a discrimination against appellants. In our opinion, however, such discrimination is not, under the facts and circumstances in evidence in this case, an arbitrary and unreasonable one.[63]

North Carolina Precedent

Whether North Carolina local governments can classify a multiunit dwelling as an aggregation of residential units for the purpose of setting utility rates is not entirely clear. A 1909 North Carolina Supreme Court case, *Thompson v. City of Goldsboro*,[64] is cited by other jurisdictions as following the majority rule. In that case, the plaintiff owned a lot on which stood three tenement houses, each occupied by a separate family. Water was supplied to all three houses through a single pipe with a master meter to measure the flow. The city passed an ordinance that based water rates on consumption per cubic foot—with the unit cost gradually decreasing as larger quantities were used (declining-block)—and imposed a mini-

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there is evidence that apartment users generate less sewage flow than single-family residences); Land v. City of Grandville, 141 N.W.2d 370, 375 (Mich. Ct. App. 1966) ("The use made of the property is an important factor to be considered in determining the proper applicable rates.").

57. *See Land*, 141 N.W.2d at 372–73 (upholding classification of multiunit dwellings in same category as single-family residences because "[t]he capacity of the sewage plant was predicated upon the average amount of contribution by the average individual residing in the community").

58. 443 N.W.2d 161 (Mich. 1989).

59. *Id*. at 164; *see also* Lewis v. Mayor and City Council of Cumberland, 54 A.2d 319 (Md. Ct. Spec. App. 1947) (holding that classification based on family as consumer unit, instead of on type of structure, is valid).

60. *Brittany Park Apts*., 443 N.W.2d. at 164–65.

61. Land v. City of Grandville, 141 N.W.2d 370, 377 (Mich. Ct. App. 1966); *see also* Sheperd v. City of Wentzville, 645 S.W.2d 130 (Mo. Ct. App. 1983) ("To treat the multiple-complex residential units, be they two family, eight family, or more, in the commercial classification with hotels, motels and tourist camps would discriminate against the single residential dwelling."); Kennedy v. City of Ukiah, 138 Cal. Rptr. 207 (Cal. Ct. App. Apr. 14, 1977) ("But for the imposition of [the multiple minimum] charge . . . multiple dwelling unit residents would escape the imposition of a monthly minimum charge almost entirely.").

62. 260 S.W.2d 712 (Tex. App. 1953).

63. *Id*. at 714; *see also* Okla. City Hotel & Motor Hotel Ass'n v. Okla. City, 531 P.2d 316 (Okla. 1974) (holding that it is reasonable to distinguish motels and hotels from apartment buildings and mobile home parks because the use made of water is an appropriate factor to be considered in establishing water and sewer rates); Reimer v. City of O'Neill, 201 N.W.2d 706 (Neb. 1972) (holding that a city water and sewer rate schedule that differentiates between apartments and mobile home parks on the one hand and motels and hotels on the other, when both are served by a single meter, does not constitute unlawful discrimination); St. Clair v. Harris County Water Control & Improvement Dist. No. 21, 474 S.W.2d 545 (Tex. App. 1971) (holding that applying minimum charge to individual units in apartment complexes, businesses, mobile home parks, and multiple occupant residences but not to motels, hospitals, laundromats, car washes, and filling stations was reasonable).

64. 151 N.C. 189, 65 S.E. 901 (1909).

mum charge of $0.60.[65] The court upheld the city's minimum charge of $1.80 per month ($0.60 multiplied by the three tenement houses), concluding that the ordinance "clearly contemplate[d] that each householder using the water and occupying a separate house, either as tenant or owner, shall be considered a consumer, and, as such liable to the minimum charge of 60 cents."[66] In so holding, the court stressed the city's obvious intent to base its utility charges on consumer units.

Approximately seventy years later, in *Wall v. City of Durham*,[67] the North Carolina Court of Appeals implicitly rejected the *Thompson* Court's reasoning, instead adopting the minority view that classifications must be based on cost differentials. The city employed a "decapping" procedure whereby it divided the water usage measured by a master meter serving multiunit residential dwellings by the number of units served. The charge for the quantity resulting from this division was then calculated and multiplied by the number of apartments served through the meter; the result was the total monthly charge. (At one time Durham additionally charged multiple minimum fixed fees but subsequently abandoned that practice.) The court held that there was no legitimate basis for charging a higher total rate to multiunit residential dwellings than to other structures that received water service through a single pipe. In so holding, the court focused solely on the cost differential (or lack thereof) of providing the water services: "the delivery of water to a meter serving a number of apartment units costs the city of Durham no more than delivery of this same quantity of water to a meter serving a different user of water whether an industry, a store, a motel, an office building, a university, or any other type of user."[68] Thus, according to the court, the city's decapping procedure subjected owners of multiunit residential dwellings to a higher rate schedule than that imposed on other similarly situated customers. It stated that the "statutory authority of a city to fix and enforce rates for public services furnished by it and to classify its customers is not a license to discriminate among customers of essentially the same character and services."[69] The rhetoric of *Wall*—that it is proper to base classifications only on cost differentials in providing services—appears irreconcilable with the rhetoric of *Thompson*—that it is proper to base classifications on "consumer units." However, the fact that *Thompson* involved three single-family residential structures served by a single meter rather than a subdivided "commercial" structure is a potentially distinguishing factor.

A separate panel of the court of appeals took a different tack (consistent with the holding in *Thompson*) in *Bogue Shores Homeowners Association, Inc. v. Town of Atlantic Beach*.[70] In that case, the town adopted an ordinance incorporating a multirate schedule that established a minimum monthly rate for single residential or commercial users that was based on the size of the customer's meter. The ordinance also established a rate for customers with multiple units served by a single service line, such as condominium and apartment complexes and hotels and motels. The monthly minimum for the latter customers was based, not on the size of the meter, but on the number of units in the development. In holding that the monthly minimum charge was not discriminatory or arbitrary, the court did not focus on the costs of providing the water services to the various structures, as it had in *Wall*. (The opinion did not cite *Wall*.) Instead, it focused on the purpose for which the water services were used. Specifically, the court noted that "multiple unit residential customers are analogous to residential customers living in houses with regard to the cooking, bathing, and laundry uses associated with long-term residence."[71] In fact, the court reasoned, if the city were to charge multiunit residential structures according to the size of the meter rather than the number of units, it would unfairly discriminate against single residential customers because it would force them to pay an unfair portion of the overall cost of water service.

Where, then, does that leave North Carolina municipalities? Based on the precedents in *Thompson* and *Bogue Shores*, it seems likely that municipalities safely can classify multiunit residential dwellings as aggregations of single-family units and charge multiple minimum fees. This is true even if there is no difference in the cost of serving multiunit residential structures and other commercial entities.[72] The rationale of the court in *Bogue Shores*—namely, that the purpose for which the utility services are used is a valid consideration in setting rate classifications—undercuts the holding in *Wall* that classifications

65. The ordinance also required that "each consumer" be supplied with a separate pipe. The municipal board of public works, however, allowed water to be supplied to several houses through one pipe if installing separate pipes would constitute a financial hardship.

66. *Id*. at 189, 65 S.E. at 902.

67. 41 N.C. App. 649, 255 S.E.2d 739 (1979). The court, however, did not distinguish or otherwise reference *Thompson*.

68. *Id*. at 655, 255 S.E.2d at 743.

69. *Id*. at 659, 255 S.E.2d at 745.

70. 109 N.C. App. 549, 428 S.E.2d 258 (1993).

71. *Id*. at 555, 428 S.E. at 262.

72. Recall that this issue was not before the court in *Wall*.

must be based on cost differentials. Furthermore, the holding in *Wall* is inconsistent with those of the majority of courts in other jurisdictions, which have routinely held that "[m]any factors are properly considered in determining the reasonableness of a classification and there is no one factor which is of itself controlling to the exclusion of all others."[73]

At the same time, because *Wall* was not overruled by *Bogue Shores*,[74] North Carolina courts should uphold classifications of multiunit residential dwellings as individual units if municipalities can point to cost differentials in serving residential structures, as opposed to other commercial entities. For example, municipalities may be able to take into consideration "the use of water for the irrigation of apartment house lawns, common laundry facilities, automobile washing facilities and other types of use which some, but not all, apartment houses will require" as factors that distinguish apartment buildings from other commercial structures.[75]

Moreover, as the decisions in *Wall* and *Bogue Shores* illustrate, the reality is that "[t]he interest[s] and needs of the numerous [utility] users served by a city are such that it is improbable, if not impossible, that any classification or rate basis could be devised which would not in some way discriminate against some of the users."[76] For that reason, municipalities are likely to retain the flexibility to classify multiunit residential dwellings in any number of ways. In *Flatley v. City of Malden*,[77] for example, the Massachusetts Court of Appeals upheld a municipal ordinance classifying apartment buildings as commercial structures instead of individual residential units. Because the city employed an increasing-block rate structure, this classification resulted in a higher per-unit rate for apartment dwellers as compared to inhabitants of single-family residences. The court nevertheless determined that the classification was not impermissibly discriminatory, noting that only installing individual meters in each apartment unit "could place apartment dwellers on exactly the same footing as residents of single family homes."[78]

The courts further have sanctioned various hybrid approaches—such as requiring each unit in multiunit dwellings to pay a minimum fee but allowing the multiunit dwelling to combine all water usage in excess of the aggregate minimum to take advantage of a declining-block rate fee structure.[79] The important point to remember is that not every type of discrimination is condemned—only discrimination that is arbitrary and without a reasonable justification.

Conclusion

Water, sewer, and other utilities are a major source of revenue for many local governments across North Carolina. Cities and counties have a good deal of discretion in setting rates, rents, fees, and charges to accomplish their policy and financial goals. And many factors influence rate decisions—ranging from the costs of providing the services to environmental concerns to competition with privately owned utilities. In addition to these considerations, local government officials must be mindful of a few basic principles when establishing classes of customers for the purpose of charging different utility rates for properties located within the city's territorial boundaries.

Cities and counties have the ability to charge different rates for providing utility services to different classes of customers. They can base distinctions among various consumers and properties on differences in the costs of providing the services, differences in the character of the services furnished, differences in the quantity of services provided, and—it appears likely—even differences in the purposes for which the services are used. Even when there is a tension among the various rationales for a utility rate structure, municipalities probably can make classification decisions based on one or more factors to the exclusion of others if doing so serves their policy or other goals. In short, a classification will be upheld if there is a rational, utility-based reason for the distinction it establishes.

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73. City of Kermit v. Rush, 351 S.W.2d 598, 600 (Tex. App. 1961); Lewis v. Mayor and City Council of Cumberland, 54 A.2d 319 (Md. Ct. App. 1947) ("The rate is compensation for the service rendered and an equitable determination of the price to be paid does not look alone to the quantity used by each consumer. The nature of the use, and the benefit obtained from it, the number of persons who want it for such use, and, in the case of a city, the effect of a certain method of determining prices upon the revenues to be obtained by the city and upon the interests of property holders are all to be considered.") (internal quotations omitted).

74. A panel of the court of appeals cannot overrule the decision of another panel. *See* In the Matter of the Appeal from the Civil Penalty Assessed for Violations of the Sedimentation Pollution Control Act, 324 N.C. 373, 379 S.E.2d 30 (1989).

75. Land v. City of Grandville, 141 N.W.2d 370, 376 (Mich. Ct. App. 1966).

76. City of Kermit v. Rush, 351 S.W.2d 598 (Tex. App. 1961).

77. 660 N.E.2d 704 (Mass. Ct. App. 1996).

78. *Id*. at 705.

79. *See*, *e.g*., Brittany Park Apartments v. Harrison Charter Twp., 443 N.W.2d 161 (Mich. 1989).

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