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LAWFUL DISCRIMINATION IN UTILITY RATEMAKING

Part 2. Classifying Extraterritorial Customers

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This bulletin is the second 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,

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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, disposal systems, and water supply systems for the purpose of preserving and 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).

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 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 new 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.

Of course, rate schedules are influenced by the policy prerogatives of a local government unit's governing board. Consequently, the numbers and types of classifications vary greatly among North Carolina's local government units. A local government that wishes to promote conservation is likely to impose a different rate structure than one hoping to foster commercial or industrial

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 generation, transmission, and distribution of electric power; production, transmission, and distribution of natural 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.

development. Governments also may configure fees so as to encourage or discourage annexation of extraterritorial property.

Although local government units have broad discretion to accomplish these and other goals, there are some constraints on the ability to set utility rates, rents, fees, and charges. This bulletin explores one such constraint—namely, the ability to lawfully discriminate with respect to utility fees charged various "classes" of consumers whose properties lie outside the territorial boundaries of the local government. The bulletin 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.[15] The bulletin examines whether the constitutional and common law utility constraints on rates charged to customers living within a government unit's boundaries apply to nonresident customers as well. Concluding that these constraints very likely do not apply to extraterritorial customers, the section then explores whether other factors limit the ability of local governments to establish different rates for nonresident customers than for resident customers and to charge different rates among various groups of similarly situated nonresident customers.

Extraterritorial Classification

Municipalities are authorized to provide utility services to properties that lie beyond their territorial borders,[16] although they are under no duty to do so.[17] Municipalities often extend utility services outside their borders, "either because [it is] necessary to the effective operation of the improvement within the [governmental unit] or to provide services for a profit beyond the [territorial] limits."[18] Section 160A-314 of the North Carolina General Statutes (hereinafter G.S.) authorizes municipalities to adopt different user fee rate schedules for services provided extraterritorially.[19] And most municipalities charge nonresidents rates that are significantly higher than those imposed on resident customers. According to the North Carolina League of Municipalities, the median bill for outside water and sewer customers is 195–196 percent higher than that for inside customers.[20] Municipalities, however, receive little guidance about what factors they may consider in developing rates for extraterritorial customers. Part I of this series (*Local Finance Bulletin* No. 33) discusses both the constitutional and the common law utility principles that govern utility rate classifications within the municipality. Questions naturally arise about whether governmental units are bound by these same constraints (requiring rates to be nondiscriminatory and reasonable) in setting rates for extraterritorial customers. And, if not, whether there are any limits as to what rates can be charged and to whom?

Atlantic Construction Company v. City of Raleigh

The North Carolina Supreme Court addressed these questions in *Atlantic Construction Company v. City of Raleigh*.[21] In 1947 Raleigh adopted an ordinance implementing a $100 fee for connecting a sewer main located outside the city to the city's sewerage system. No fee was required for connections made to city residents' properties. The plaintiffs, owners of property outside the corporate limits, challenged the validity of the connection fee. Specifically, they claimed that the fee was *discriminatory*—because similarly situated nonresidents who had made sewer connections prior to the effective date of the ordinance were not required to pay any fee—and *unreasonable*—because it had no basis in cost and was charged regardless of the number of outlets, size of pipes, or number of persons or families served.

Construing the rate statute then in effect (G.S. 160-256),[22] the court held that "a city is free to

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

16. G.S. §160A-312.

17. City of Randleman v. Hinshaw, 2 N.C. App. 381, 163 S.E.2d 95 (1968) ("A municipality which operates its own water and sewer system is under no duty to furnish water or sewer service to persons outside its limits. It has the discretionary power, however, to engage in this undertaking."). Counties, likewise, are permitted but not required to provide services extraterritorially. G.S. 153A-275.

18. R.H. Eakley v. City of Raleigh, 252 N.C. 683, 688, 114 S.E.2d 777, 782 (N.C. 1960).

19. Analogously, G.S. 153A-277 authorizes counties to set different extraterritorial user rates.

20. North Carolina League of Municipalities & Environmental Law Center, UNC Chapel Hill, North Carolina Water & Sewer Rates and Rate Structures 2–3 (2005), http://www.efc.unc.edu/projects/NCWaterRates.html.

21. 230 N.C. 365, 53 S.E.2d 165 (1949).

22. G.S. 160-256 provided in relevant part that "The governing body, or such board or body which has the management and control . . . may fix such uniform rents or

establish by contract or by ordinance such fees and charges for services rendered to residents outside its corporate limits as it may deem reasonable and proper."[23] The court reasoned that a municipality has no legal right to compel nonresidents to utilize its utility services and, conversely, that nonresidents are not in a position to compel the city to provide the services to them. Thus, the nature of the relationship between the city as utility provider and its nonresident customers is purely voluntary, governed only by their agreements. Accordingly, the plaintiffs were in no position, after voluntarily choosing to connect to the sewerage system, to challenge the validity of the city's fee schedule, even if the amount charged was excessive.

Contract Principles Govern Extraterritorial Ratemaking

The *Atlantic Construction* holding that municipally owned utilities can charge nonresident customers different rates than resident customers and that contract principles govern the relationship between the utilities and nonresident customers is not controversial. It is clear that nonresidents have no constitutional rights to the utility services provided by a municipality. Thus, any rules or remedies are matters of state law,[24] and North Carolina law explicitly authorizes "different schedules [of rents, rates, fees, charges, and penalties] . . . for services provided outside the corporate limits of the city" than for those charged to resident customers.[25] Furthermore, a majority of courts addressing this issue have concluded that absent explicit statutory language to the contrary, "a municipality is under no duty to furnish [utility services] to nonresidents in the absence of [a] contractual" responsibility.[26] It naturally follows that the nature of the relationship is governed by the contractual agreement.

Judicial Review of Extraterritorial Ratemaking

Arguably, however, *Atlantic Construction* also establishes that in North Carolina the reasonableness of the (contractually negotiated) rates charged to nonresidents is not a matter for judicial review; therefore, such rates are subject to no limitations (aside from those imposed by the basic contract law governing arm's length bargaining, proper formation, and execution). In fact, several state courts have cited *Atlantic Construction* to support this proposition;[27] and subsequent North Carolina decisions, although they do not address ratemaking directly, are consistent with this interpretation. In *Honey Properties, Inc. v. City of Gastonia*,[28] for example, the plaintiff, owner of a restaurant located outside the municipal boundaries of the city, entered into a contractual agreement with the city allowing the restaurant to be connected to the city's sewer system. In exchange, the parties agreed that the plaintiff's sewer lines and corresponding rights of way would become property of the city at any subsequent annexation of the territory encompassing the plaintiff's property. After executing the agreement, the plaintiff connected his property to the city sewer system; but after the city annexed his real estate, he sued for compensation for the sewer lines that had become city property. The North Carolina Supreme Court rejected his claim, holding that the nature of the relationship between the plaintiff and the city was "purely a matter of contract, on such terms as the

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rates . . . . Provided, however, that for service supplied outside the corporate limits of the city, the governing body, board or body . . . may fix a different rate" than that assessed within the corporate limits. This statute was repealed in 1971 and replaced with G.S. 160A-314.

23. *Atlantic Construction*, 230 N.C. at 369, 53 S.E.2d at 168.

24. *See* West Capital Assoc. Ltd. v. City of Annapolis, 677 A.2d 655 (Md. Ct. Spec. App. 1996).

25. G.S. 160A-314; *see also* G.S. 153A-277 (authorizing counties to charge different rates extraterritorially).

26. Rehm v. City of Batavia, 125 N.E.2d 831, 834 (Ill. App. Ct. 1955). *See generally* Bleick v. City of Papillon, 365 N.W.2d 405, 407 (Neb. 1985) ("The great majority of the cases support the rule that [publicly owned] utilities generally may discriminate, in respect to rates, between consumers within and those outside the municipalities primarily served.").

27. *See, e.g.*, Handy v. City of Rutland, 598 A.2d 114 (Vt. 1991) (citing *Atlantic Construction* for proposition that "the reasonableness of extraterritorial sewer or water rates is not subject to judicial review"); Payson Sanitary Dist. of Gila County v. Zimmerman, 581 P.2d 1148 (Ariz. Ct. App. 1978) (citing *Atlantic Construction* for proposition that a sanitary district's "relationship to subscribers beyond its limits arises only through contract and the reasonableness or unreasonableness of its charges for access to its system is not subject to judicial review"); City of Texarkana v. Wiggins, 246 S.W.2d 622 (Tex. 1952) (Calvert, J. dissenting) (citing *Atlantic Construction* as in accord with the "overwhelming weight of authority" that reasonableness of rates charged to nonresidents is not judicially reviewable).

28. 252 N.C. 567, 114 S.E.2d 344 (1960).

City was willing to grant and the plaintiff was willing to accept."[29]

Moreover, the opinion in *Atlantic Construction* cited *Childs v. City of Columbia* and *City of Phoenix v. Kasun*[30]—both of which hold that courts are prohibited from reviewing the reasonableness of rates charged to nonresidents.[31] In *Childs,* plaintiffs brought suit to enjoin a city from charging a nonresident excessive user charges for water service. They argued that the city had a statutory duty to sell its excess water supply to nonresidents and, commensurately, to charge reasonable fees for providing the service. The South Carolina Supreme Court rejected the plaintiffs' claim, emphasizing that to the extent there was a duty it was owed solely to city residents. Thus, according to the court,

> it is . . . perfectly obvious that the duty to sell the excess of its water supply did not import an obligation to make a contract with any particular person at a reasonable price; but, on the contrary, did import an obligation to sell its surplus water for the sole benefit of the city at the highest price obtainable. It was a duty not owed to outsiders, but exclusively to inhabitants and taxpayers of the city. It follows that the plaintiff as a mere nonresident had no rights whatever against the city, except such as he may have acquired by contract. In other words, the city was under no public duty to furnish water to the plaintiff at reasonable rates or to furnish it at all . . . .[32]

Likewise, in *Kasun*, plaintiffs sought to enjoin enforcement of a city ordinance increasing the water rates of consumers outside the city limits. The Arizona Supreme Court held that it was without jurisdiction to determine the reasonableness or unreasonableness of the new charges. The court reasoned that the city could not compel the plaintiffs to purchase its water and that, in furnishing the service, the city was not acting in its public capacity and, therefore, owed no public duty to the nonresident customers. As the court explained, absent the duty to serve nonresidents, there was no requirement that the fees charged be reasonable.

Finally, even outside the parameters of *Atlantic Construction*, the North Carolina Supreme Court has held that a municipality does not assume the obligations of a public service corporation toward nonresident customers. In *Fulgham v. Town of Selma*,[33] the town entered into an agreement to supply the nonresident plaintiffs with water, using water mains the latter had installed outside the corporate limits. The municipality subsequently terminated their water supply and the plaintiffs initiated suit, alleging that although the town was under no duty to provide water services extraterritorially, once it had undertaken this function it owed a duty to nonresidents to continue. The court rejected the plaintiffs' claim, holding that the town had the discretion to determine when and where to provide utility services outside its municipal boundaries.[34]

Courts in several other jurisdictions also have declined jurisdiction to review the reasonableness of rates charged to nonresidents, even when presented with considerable evidence that the municipalities had no rational basis for their extraterritorial fee structures.[35] There are a number of rationales justifying this position. Some courts focus on the bargaining aspect of the contractual relationship and assume that, absent evidence to the contrary, "the language of a contract between competent persons accurately reflects the intentions of the parties."[36] Because of their ability to bargain, nonresidents do not need the same protection as residents, who have no effective input into the ratemaking process.[37] Thus, in *Fairway Manor, Inc. v. Board of Commissioners of Summit County*,[38] the Ohio

29. *Id*. at 571, 114 S.E.2d at 347; *see also* Town of West Jefferson v. Edwards, 74 N.C. App. 377, 385, 329 S.E.2d 407, 413 (1985) ("A city may fix the terms upon which water and sewer service is rendered outside the city limits."); *see cf.* Mulberry-Fairplains Water Assoc., Inc. v. Town of North Wilkesboro, 105 N.C. App. 258, 412 S.E.2d 910 (1992) (holding that nonresident defendant was bound by contractual agreement with municipality for water service).

30. *Childs*, 70 S.E. 296 (S.C. 1911); *Kasun*, 97 P.2d 210 (Ariz. 1939).

31. *Atlantic Construction*, 230 N.C. at 369, 53 S.E.2d at 168.

32. *Childs*, 70 S.E. at 298.

33. 238 N.C. 100, 76 S.E.2d 368 (1953).

34. *Accord* Southside Trust v. Town of Fuquay-Varina, 69 Fed. App'x. 136 (4th Cir. 2003) (holding that municipality has no obligation under North Carolina law to continue to provide utility services to out-of-town customers outside of its contractual obligations with the out-of-town customers).

35. *See, e.g.*, Bleick v. City of Papillion, 365 N.W.2d 405 (Neb. 1985) (holding that city's furnishing of sewer services to nonresidents is contractual and permissive and statutory provisions requiring city to furnish service subject to reasonable rules apply only to residents).

36. *See, e.g.*, Fairway Manor, Inc. v. Bd. of Comm'rs of Summit County, 521 N.E.2d 818, 821 (Ohio 1988).

37. *See* Township of Raccoon v. Municipal Water Auth. of the Borough of Aliquippa, 597 A.2d 757, 762 (Pa. 1991) (noting that the requirement of reasonable and uniform rates not needed when rates subject to contractual negotiations); *Bleick*, 365 N.W.2d at 406 (holding that statutory provisions requiring the city to furnish service "'subject to reasonable rules and regulations,' apply only to residents of the city").

38. 521 N.E.2d 818 (Ohio 1988).

Supreme Court, in holding that the rates charged to nonresident customers were not judicially reviewable, stated that

> [w]here water rates are set forth in a contract, the fact that the rates contained therein are higher than those charged to similarly situated customers in the same class does not constitute a basis for judicial reform of the contract. . . . [I]t will be presumed that the higher rates were arrived at through the normal give and take of contractual negotiation.[39]

In that case, the City of Akron entered into a contract with a condominium developer to supply water to the developer's property outside the city's boundaries. The contract provided for rates that were up to 105 percent higher than the rates charged to city residents. The condominium developer refused to pay, claiming, inter alia, that the fee schedule was unreasonable and discriminatory because another, similarly situated nonresident only paid 10 percent more than city residents. In reversing the lower court's ruling in favor of the developer, the court noted that its own role was "strictly limited to protecting residents of the municipality."[40] The court found nothing inherently unfair in basing a nonresident contractual rate on the value of the service to the customer and concluded that the lack of difference in the cost of delivering the service to its various nonresident customers did not affect the validity of the contract rate.

Other courts reason that when municipalities provide a service extraterritorially they are akin to private corporations and owe no public duty to charge reasonable and nondiscriminatory rates. According to the Kentucky Court of Appeals in *Davisworth v. City of Lexington*,[41]

> [i]f then, the City may discontinue the service altogether, it clearly may fix in its own discretion the charges to be paid by those who wish its continuance. At this point the contention may be made that a municipality is a public corporation and not a private individual, and the public interest requires that all of its acts be reasonable and non-discriminatory. This is true insofar as the City is performing a function for its inhabitants, who constitute its limited public to whom its duties are owed. It owes no public duty to non-inhabitants.[42]

The fact that the nonresident plaintiffs had spent a substantial amount of money to connect with the city sewer system did not change the result.[43]

The rule suggested by *Atlantic Construction*, however, is not universal. Not all courts decline to review extraterritorial rates charged by municipalities. In fact, several courts note that "[al]though the yardstick for measuring the reasonableness of a city's extraterritorial rates may be different from that used to measure the reasonableness of resident rates, the reasonableness of any rate imposed by the city is open to judicial review."[44] There are a number of justifications provided in favor of judicial review of rates, even though the nature of the relationship between the municipality and its nonresident customers appears, on its face, to be purely contractual. A few courts reject the notion that because a municipality can refuse to serve nonresidents it follows that it may do so on any such terms as it chooses to impose, reasoning that utility customers are at the mercy of a monopoly, regardless of the character of ownership.[45] Thus, nonresidents need the same level of protection against unreasonable and discriminatory rates that is afforded to residents under the common law.[46] Other courts that engage in judicial review maintain that even though municipalities furnish services to nonresidents pursuant to contractual agreements (as opposed to under statutory provisions), the character of their services are analogous to that of public utilities; thus, they owe a public duty to all their customers, particularly when providing essential domestic water and sewer services.[47] In *Elliott v. City of Pacific Grove*,[48] for example, a California

39. *Id.* at 821.

40. *Id.* at 820.

41. 224 S.W.2d 649 (Ky. Ct. App. 1949).

42. *Id.* at 652; *see also* City of Phoenix v. Kasun, 97 P.2d 210, 213 (Ariz. 1939) ("[T]he fact that a business or enterprise is, generally speaking, a public utility does not make every service performed or rendered by those owning or operating it a public service, with its consequent duties and burdens, but they may act in a private capacity as distinguished from their public capacity . . . .").

43. *Davisworth*, 224 S.W.2d at 652.

44. Handy v. City of Rutland, 598 A.2d 114 (Vt. 1991) (citing EUGENE MCQUILLIN, THE LAW OF MUNICIPAL CORPORATIONS § 35.37i, at 632–33 (3d ed. rev. 1986)); *see also* Hicks v. City of Monroe Utils. Comm'n, 112 So. 2d 635 (La. 1959). *See generally* Farley Neighborhood Ass'n v. Town of Speedway, 765 N.E.2d 1226 (Ind. 2002) (noting that even in jurisdictions where extraterritorial utility rates are judicially reviewable, challengers bear a substantial burden in proving that the rates charged are not reasonably related to a legitimate legislative purpose).

45. *See* City of Texarkana v. Wiggins, 246 S.W.2d 622 (Tex. 1952).

46. Inland Real Estate Corp. v. Village of Palatine, 437 N.E.2d 883 (Ill. App. Ct. 1982).

47. City of Phoenix v. Kasun, 97 P.2d 210, 215–16 (Ariz. 1939) (McAlister, J. dissenting).

48. 126 Cal. Rptr. 371 (Cal. Ct. App. 1975).

appellate court held that a contract rate for nonresident sewer service set at four times the rate charged inside the city limits violated nonresidents' "primary right [to not be charged] an unreasonable rate for such service and . . . the city, as a public utility, [had] the corresponding duty not to charge [nonresidents] an unreasonable rate for such service."[49]

To be sure, even in jurisdictions that have allowed such claims, the standard of review is highly deferential to municipalities.[50] Nonresident challengers have the burden of proving arbitrary, unreasonable, or discriminatory rates.[51] And, charging nonresidents higher rates than residents will be upheld if there is any rational basis for the differential—even if it is not the stated purpose. Further, differences in rates (both between residents and nonresidents and among nonresidents) need not be based solely on differences in costs. For example, municipalities may justify differences in rates because providing water and sewer services often increases the value of the properties served; however, municipalities are only able to capitalize (through the ad valorem tax system) on the increased value of properties that lie within their territorial boundaries. Nonetheless, in jurisdictions that allow judicial review, municipalities may run into trouble if the "discrimination rests solely on the nonresident status of the user."[52] In other words, if the only conceivable basis for charging nonresidents a higher rate than residents is the existence of a municipal boundary or simply that it is "prevailing practice" to do so, courts may be receptive to an equal protection claim by nonresident customers.[53]

Potential Limitations on Extraterritorial Ratemaking

Although the North Carolina courts subscribe to the principle that the reasonableness and arbitrariness of rates charged to (and even among) nonresidents are not generally reviewable, they may make exceptions in cases requiring interpretation of specific statutory provisions or involving allegations of contract law violations.

Legislative Limitations

The terms of contracts in which municipalities set utility rates are only enforceable if they comply with state law, and courts have consistently held that judicial review is appropriate where state law sets standards for the review.[54] For example, in *City of Phoenix v. Kasun*, the Arizona Supreme Court held that it was without jurisdiction to determine the reasonableness or unreasonableness of extraterritorial utility charges because there was no explicit statutory provision to enforce.[55] Subsequent to that decision, the Arizona legislature enacted legislation specifically governing the provision of water service to nonresidents. The statute provided, in relevant part, that "[a] city or town acquiring the facilities of a public service corporation rendering utility service without the boundaries of such city or town, or which

49. *Id.* at 59; *see* Perrysburg v. Koenig, WL 803592 (Ohio App. 6 Dist. Dec. 8, 1995) (concluding that a municipally owned public utility may not impose whatever conditions it chooses when selling its services to nonresidents and that the terms of the contract governing the sale may not be unlawful); *cf.* Schroeder v. City of Grayville, 520 N.E.2d 1032 (Ill. App. Ct. 1988) (holding that once a city has begun serving extraterritorial customers, it may not discriminate among such customers unreasonably); Bair v. Mayor and City Council of Westminster, 221 A.2d 643 (Md. 1966) (concluding that if a city has undertaken to supply water to an area outside its borders, it must do so impartially to all those within a reasonable distance of its lines).

50. *See, e.g.*, Hansen v. City of San Buenaventura, 729 P.2d 186, 190 (Cal. 1987) (noting that judicial review of rates charged by municipalities to nonresidents not as strict as review of privately owned utility rates by public utility commissions and holding that 70-percent surcharge on nonresidents for water service justified because residents had additional obligations); Delony v. Rucker, 302 S.W.2d 287 (Ark. 1957) (noting that the fact that "rates charged by a municipality owned public utility must be reasonable and free from arbitrary discrimination [does not mean] that the exaction of an increased charge for services supplied beyond the city limits is prima facie invalid").

51. *See Delony*, 302 S.W.2d 287.

52. *Hansen*, 729 P.2d at 190.

53. *See* Platt v. Town of Torrey, 949 P.2d 325, 332 (Utah 1997) ("[A] showing by nonresident plaintiffs, when contesting a rate schedule, that rate discrimination rests solely on the nonresident status of the user, without some other legitimate justification, will invalidate the schedule."). Although North Carolina courts have declined jurisdiction, they may change course in the future if presented with a case in which there is no rational basis for the distinction between residents and nonresidents. Municipalities should be prepared to justify rate differentials instead of setting rates based only on "'prevailing practice.' " *See* Jeff Hughes, *The Painful Art of Setting Water and Sewer Rates*, POPULAR GOVERNMENT, Spring/Summer 2005, at 12 (noting the response of North Carolina local governments to a recent survey question asking why they charge their current rates).

54. *See, e.g.*, Handy v. City of Rutland, 598 A.2d 114 (Vt. 1991) (holding that reasonableness of city's extraterritorial utility rates was appropriate for judicial review because Vermont law sets standards for such rates).

55. *Kasun*, 97 P.2d 210 (Ariz. 1939).

renders utility service without its boundaries, shall not discontinue such service, once established, as long as such city or town owns or controls" the utility."[56] In 1989, in *Jung v. City of Phoenix*, certain nonresident water customers sued the city, challenging a 1985 city ordinance that raised water rates for nonresident customers to double those charged to resident customers. (Before enactment of the ordinance, the city had charged residents and nonresidents the same rates.) Instead of denying jurisdiction, as in *Kasun*, the Arizona Supreme Court held that the "obligation of a city to continue utility service as required . . . necessarily implies that the charges for such services will be at reasonable rates."[57] The court distinguished its decision from *Kasun*, noting that in that case the service was based solely on a contract, whereas in *Jung* the plaintiffs had a legal right, derived from the new statute, regardless of the contract. In the latter situation, according to the court, "courts may determine whether the terms on which [a nonresident] obtains this service are reasonable or not."[58]

It can be argued that subsequent to the *Atlantic Construction* decision the North Carolina General Assembly also established a judicially reviewable standard with respect to the ability of municipalities to discriminate *among* nonresidents. At the time that *Atlantic Construction* was decided, G.S. 160-256 governed utility ratemaking. It provided that "for service supplied outside the corporate limits of the city, the governing body, board or body . . . may fix a *different rate* from that charged" inside the corporate limits.[59] In 1971 the legislature adopted a new ratemaking statute, G.S. 160A-314, which states that "[s]chedules of rents, rates, fees, charges, and penalties may vary according to classes of service, and *different schedules* may be adopted for services provided outside the corporate limits of the city."[60] In prescribing the adoption of extraterritorial rate "schedules" in G.S. 160A-314, it is possible that the legislature was limiting the ability of municipalities to negotiate different rates for similarly situated nonresident customers. The statutory language also may be directing municipalities to publish the rates charged to the various classes of nonresident customers to provide ex ante guidance for those seeking to contract with municipalities for utility services. Although no North Carolina cases bear directly on this point, if courts interpret the language in G.S. 160A-314 as conferring a legal right on nonresidents to be charged at the same rate as other, similarly situated nonresidents, judges may be open to reviewing claims of discrimination among nonresidents.[61] (It is important to note that under this interpretation the limitation does not speak to the reasonableness of the amount charged extraterritorially but only to the comparability of rates charged similarly situated nonresidents.)

A second legislative limitation stems from the principle that "a municipality has no legal right either in its governmental or proprietary capacity to sell water to consumers residing outside its corporate limits without legislative authority . . . ."[62] Consequently, the General Assembly has the power to prohibit a municipality from selling utility services to customers outside its territorial limits at higher rates than those charged within its borders.[63] And, in fact, the General Assembly has required one city—Asheville—to establish a uniform set of rates that applies to both city residents and nonresidents who reside in Buncombe County.[64] There is no indication, however, that this is the start of a statewide trend.

Contract Law Limitations

In addition to the potential legislative constraints, there may be some judicial movement toward limiting a municipality's ability to charge nonresident customers. On at least one occasion, the North Carolina Supreme Court signaled that some of a municipality's dealings with its nonresident customers could come under judicial review. In *Hall v. City of Morganton*,[65] the court affirmed a temporary restraining order preventing the city from threatening to cut off the water supply to a dwelling located outside its borders if the owner did not switch from a private supplier to the city's power system. Acknowledging its decision in *Fulgham*, the court noted that "[m]ore is involved in this case than the right to require the City to serve a customer outside the City limits" and concluded that it had the power

56. Jung v. City of Phoenix, 770 P.2d 342 (Ariz. 1989) (quoting statutory provision).

57. *Id.* at 344.

58. *Id.* (emphasis omitted).

59. G.S. 160-256 (emphasis added).

60. G.S. 160A-314(a) (emphasis added). G.S. 153A-277, likewise, authorizes counties to charge different rate schedules for services provided extraterritorially.

61. *See* Flex-O-Glass, Inc. v. City of Dixon, 718 N.E.2d 730, 735 (Ill. App. Ct. 1999) (holding that "where a municipality has undertaken to provide service to similarly situated nonresident customers, it cannot discriminate unreasonably in its rates and service to these customers").

62. Candler v. City of Asheville, 247 N.C. 398, 411 101 S.E.2d 470, 479 (1958).

63. *Id.*

64. *See* S.L. 2005-139 (Sullivan Act).

65. 268 N.C. 599, 151 S.E.2d 201 (1966).

to restrain the city's "threatened wrongful acts."[66] Given the procedural posture of this case. and the court's limited opinion, it is very difficult to discern whether the court was attempting to carve out a narrow exception—prohibiting municipalities from altering existing contracts with nonresident customers by attempting to bundle utility services—or whether the court was hinting that it may be receptive to a broader swath of claims.

One possible interpretation of the court's opinion in *Hall* is that it saw the municipality's proposed actions as a violation of basic contract principles regarding fair dealing. Thus, even if the rates themselves are not judicially reviewable, both the formation and the terms of a sale of municipally owned public utility services to nonresidents is subject to review to ensure its compliance with the same statutory and common law rules that govern contracts generally.[67] The doctrine of *unconscionability*[68] and other contract law limitations suggest potentially important restrictions on municipalities' extraterritorial ratemaking abilities.

Conclusion

Water, sewer, and other utilities provide major revenues for many local governments across North Carolina. Cities and counties have considerable discretion in setting rates 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. When setting rates for extraterritorial customers, however, local governments are not constrained by the same constitutional or common law utility principles as they are when dealing with their resident customers. In fact, the rates North Carolina's municipal- and county-owned utilities charge extraterritorial customers are not subject to judicial review. It is very likely, however, that the General Assembly has proscribed discriminating among similarly situated nonresident customers.

66. *Id.* at 601, 151 S.E.2d at 202. *Contra* City of Moultrie v. Burgess, 90 S.E.2d 1 (Ga. 1955) (holding that city could fix one rate for nonresidents who purchase water only and another, lower rate for nonresidents who purchase both water and electricity from the city).

67. *See* Perrysburg v. Koenig, App. No. WD-95-011, 1995 WL 803592 (Ohio Ct. App. Dec. 8, 1995) (concluding that a municipally owned public utility may not impose whatever conditions it chooses upon the sale of its services to nonresidents**,** and that the terms of the contract governing the sale may not be unlawful).

68. Admittedly, those claiming that the terms of a contract are unconscionable, and therefore unenforceable, face a high bar. In North Carolina, both procedural and substantive unconscionability must be present to sustain such a claim, although courts tend to view the requirement as " 'more of a sliding scale than a true dichotomy.' " JOHN N. HUTSON JR. & SCOTT A. MISKIMON, NORTH CAROLINA CONTRACT LAW §§ 9–11 (2001) (citation omitted). *Procedural unconscionability* "refers to unfair practices that occur in the making of the contract" and can include inequality of bargaining power. *Id.* at §§ 9–13. *Substantive unconscionability* "involves harsh, oppressive or one-sided contract terms," including excess prices. *Id.*

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