DATE: June 15, 2021

TO: John Kmiec
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FROM: Chris Avery
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Tucson Water

SUBJECT: WHETHER A.R.S. § 9-511.01 OR TUCSON CODE § 27-32 PRECLUDE THE CITY FROM ADOPTING A DIFFERENTIAL RATE FOR CUSTOMERS OUTSIDE OF MUNICIPAL BOUNDARIES.

During the Mayor and Council meeting of June 8, 2021, a member of the Mayor and Council requested the City Attorney’s Office to respond to allegations that the proposed differential rate considered at Item Number 8, Public Hearing: Amending the Tucson City Code (Chapter 27) Relating to the Implementation of a Differential Rate Structure, was illegal under two separate statutes: A.R.S. § 9-511 and Tucson Code § 27-32. This Memorandum is a response to that inquiry.

As a preliminary matter, the Arizona Supreme Court in Jung v. City of Phoenix, 160 Ariz. 38 (1989), expressly held that as “a general rule a municipally owned waterworks system supplying water outside its corporate limits may charge more for that service than it charges the users who reside within the corporate limits.” 160 Ariz. at 40. Because the municipality is providing a public utility service, it must charge a “reasonable rate.” Id. at 41. The Jung Court held that “proof that service of nonresidents involves greater expenses is sufficient to show a city acted reasonably in charging higher rates for nonresidents,” but that a cost of service analysis is provided only as an illustration and not a limitation. Id.

The statutory analysis is simple. Like Jung, A.R.S. § 9-511.01(D) and -511.01(E) require that any proposed water rate be “just and reasonable” and declare that “unjust and unreasonable” rates or charges are illegal. A.R.S. § 9-511.01(A) also establishes the procedures for adopting a new rate or revenue increase. Tucson Code § 27-32 provides that Tucson Water rates “shall, to the extent possible, be consistent with the policy of charging for water in direct proportion to the cost of securing, developing, and delivering the water to the customers of the city water system.”

Under Jung, a differential rate would be legal if the Mayor and Council were to accomplish the following steps: (1) provide appropriate direction to staff about the amount of a differential water rate, so that the rate differential is reasonable, (2) provide direction regarding the purposes for which the differential rate will be used, and the policy considerations underpinning that decision (again, so that the rate being charged is reasonable, and not arbitrary or punitive), and, (3) allow for sufficient time for all of the procedural requirements to be accomplished before the rate is actually assessed to customers, including the furnishing of a “cost of service” or rate study.
On June 8, when the Mayor and Council directed Tucson Water to return to the Mayor and Council with four proposed revenue increases, it also directed that Tucson Water provide an analysis of how any increased revenues could be used for (1) expanding the Low-Income Program, (2) water resources management, and (3) infrastructure reliability. This direction ensures that all of the funds from any differential rate will be used for programs within Tucson Water, and any increased spending to support those programs will increase the total costs that Tucson Water will spend in future years, all of which will be paid by Tucson Water ratepayers. Thus, to the extent that revenues from a differential rate increase stay within Tucson Water and are spent to accomplish the policy goals of the Mayor and Council, Tucson Water’s rates, in the aggregate, are “cost of service” rates.

Nonetheless, in light of this direction by the Mayor and Council on June 8, as summarized in the Legal Action Report, it is the recommendation of this office that any proposed differential rate adopted by the Mayor and Council during the continuation of the Public Hearing be analyzed by a cost of service study before final adoption. First, such a study—as recognized by Jung—could form the basis for a showing that the adopted rates are reasonable. Second, to the extent that the rates are entirely or “to the extent possible” based on proportional costs of service, the rates would be reasonable under Jung and A.R.S. § 9-511.01, and would also be consistent with Tucson Code § 27-32. If some portions of the differential rates were found not to be based on “cost of service,” the extent of that discrepancy would be an important consideration in any subsequent legal analysis of whether the rates are “reasonable.” While the Jung Court expressly held that a city may “glean a [reasonable] profit from outsiders,” a cost of service study showing that even some of the rate is supported by increased costs is an important component of determining whether the “profit” is reasonable. 160 Ariz. at 40-41 (insertion mine). Following the results of such a study, if the Mayor and Council were to obtain a reasonable “profit” from non-resident customers, the Mayor and Council should amend Tucson Code § 27-32 alongside any such rate or revenue increase to reflect that policy decision; to expressly hold that rates for customers within the unincorporated area will be set in proportion to costs, plus a reasonable differential.

CA/dg
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