

Water Rates & Tax-Exempt Entities

TEXAS CITY ATTORNEYS
ASSOCIATION CONFERENCE
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HORSESHOE BAY

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“As the water utility industry itself evolves, it is important that rate-setting practices be reviewed and refined to ensure adequate revenue recovery and the equitable distribution of cost responsibilities.”

—American Water Works Association (AWWA)

Legal Framework

Legal Framework

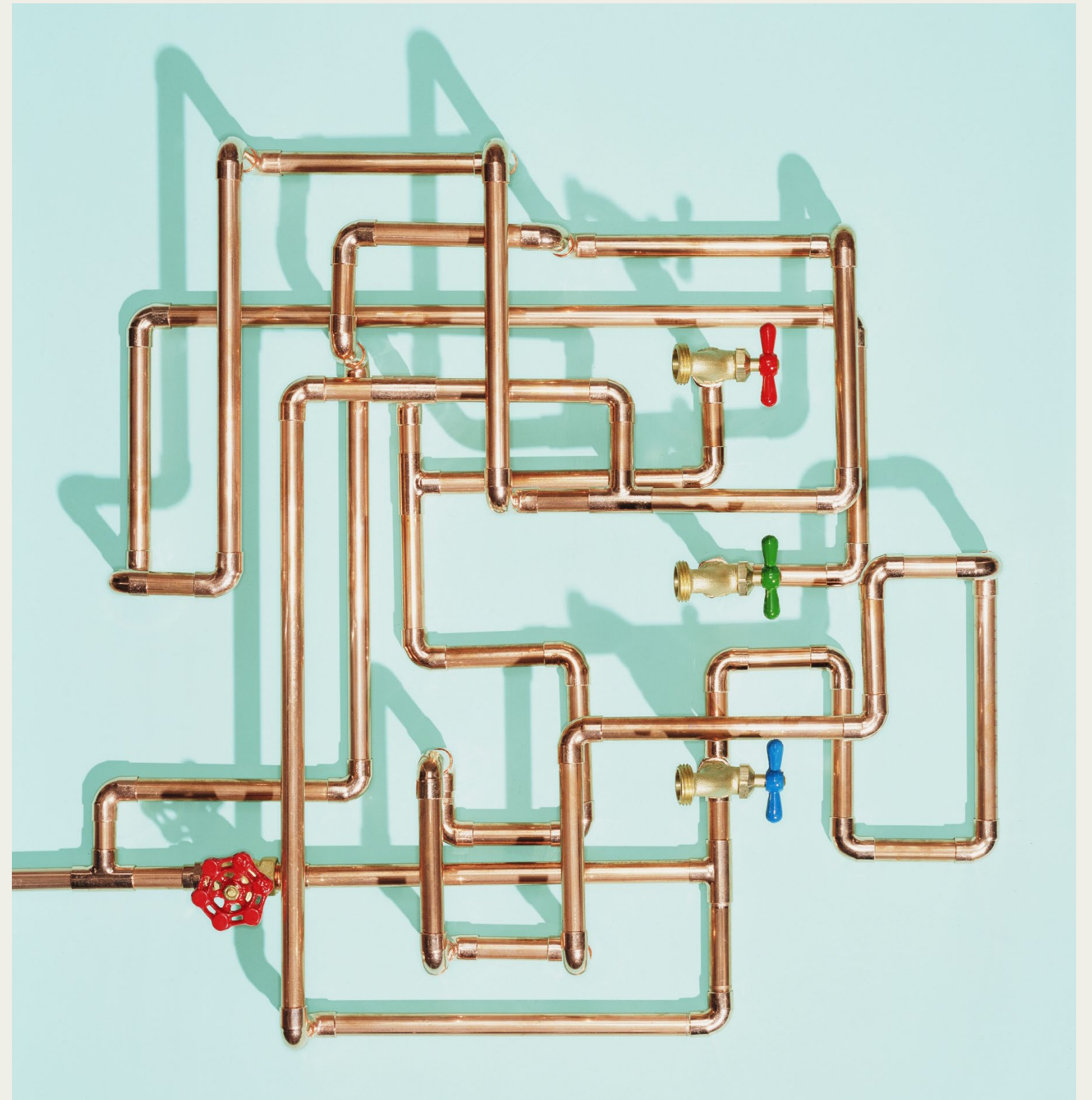
- Texas Local Government Code § 552.001
- Just, reasonable, and non-discriminatory
- Cost-of-service methodology: must reflect actual infrastructural impact

16 Tex. Admin. Code § 24.41, cost - of - service

Only those expenses that are reasonable and necessary to provide service to the ratepayers may be included in allowable expenses. Components of allowable expenses may include (but are not limited to):

- Operations and maintenance expense incurred in furnishing normal utility service and in maintaining utility plant used by and useful to the utility in providing such service.
- Depreciation expense based on original cost and computed on a straight-line basis over the useful life of the asset as approved by the commission.
- Federal income taxes on a normalized basis.
- Funds expended in support of membership in professional or trade associations, provided such associations contribute toward the professionalism of their membership.
- Advertising, contributions and donations
- Credit card and electronic payment processing fees.
- **Assessments and taxes other than income taxes.**

**How do we get rate
classes that lead to
everyone paying
their fair share?**



Before the PUC

Challenges to Tax - Exempt Rate Class before PUC

- Tax-exempt rates challenged before the PUC in the following dockets:
 - PUC Dkt. No. 54713
 - PUC Dkt. No. 54966
 - PUC Dkt. No. 57445
 - PUC Dkt. No. 57765
- These cases involve MUDs (not municipalities) creating new rate class for tax-exempt entities. Rise in private developers working with local housing authority to create public housing. Because the project was through the local public housing authority and on land leased from government entity, the properties were tax-exempt and did not contribute to the MUDs through payment of taxes.
- MUDs argued they were allowed to consider tax revenue contributions in their utility rates.
- Also argued that the new rate class was established to ensure parity with district customers and to recoup the actual cost of providing services to petitioner that was lost due to the conversion to tax exempt status.
- Rate studies conducted to review and address concern over increasing concern about private entities developing public multi-family housing.

Before the Courts

CONFERENCE NAME

Arguments before the Court

If a municipally owned water utility has a rate class for tax-exempt entities as part of its rate structure that charges a higher rate than other commercial customers, that rate is a tax in disguise. Thus, such a rate class is an impermissible tax in violation of the Texas Tax Code and the Constitution .

Arguments before the Court

- In Texas, a proper utility rate determination is based upon consideration of three factors: (1) the utility's reasonable operating expenses; (2) the rate base and; (3) a reasonable rate of return *Suburban Util. Corp. v. Pub. Util. Comm'n*, 652 S.W.2d 358, 362 (Tex. 1983).
- A rationally based assessment that takes into account needed overhead and capital expenditures is inherently not a tax. *See Bexar Cnty. v. City of San Antonio*, 352 S.W.2d 905, 907 (Tex. App.—San Antonio 1961, writ dismissed) (holding that cities may fix rates to recoup the costs of operating and maintaining a utility system).
- To determine whether a fee charged by a governmental entity is a tax by another name, Texas courts have applied the “primary -purpose” test. *See e.g. Gatesco Q.M. Ltd. v. City of Houston*, 503 S.W.3d 607 (Tex. App.—Houston [14th Dist.] 2016, no pet.). Under that test, a “fee imposing statute” is a tax if “the primary purpose of the fee is the raising of revenue.” *Id.* at 616. The analysis under the primary purpose test is one of intent—“whether the fee is intended to raise revenue in excess of that reasonably needed for regulation.” *Id.*

What the Legislature has to say

HB 685

- The last few years, various groups have tried to change the law to prevent municipalities from creating a rate class for tax-exempt entities, specifically, a tax-exempt rate that is higher than the commercial or industrial rate for customers that pay ad valorem taxes.
 - 86th, 87th, 88th, and finally passed in the 89th Legislative Session
 - Specifically applies to municipalities
- Not a prohibition on a different rate class for tax-exempt entities, but can't be higher rate for tax-exempt entities
- Still need to factor in cost-of-service considerations in setting the rate structure

HB 685

SECTION 1. Subchapter 2, Chapter 552, Local Government Code, is amended by adding Section 552.916 to read as follows:

Sec. 552.916. PROHIBITION ON RATE DISCRIMINATION. A municipality may not establish a rate for water or sewer utility service applicable only to entities that qualify for a sales tax or ad valorem tax exemption that is higher than a rate established for entities that receive comparable utility service.

SECTION 2. This Act takes effect September 1, 2025.

Compare MOUs with Other Water Service Providers

Sec. 49.2122. ESTABLISHMENT OF CUSTOMER CLASSES. (a) Notwithstanding any other law, a district may establish different charges, fees, rentals, or deposits among classes of customers that are based on any factor the district considers appropriate, including:

- (1) the similarity of the type of customer to other customers in the class, including:
 - (A) residential;
 - (B) commercial;
 - (C) industrial;
 - (D) apartment;
 - (E) rental housing;
 - (F) irrigation;
 - (G) homeowner associations;
 - (H) builder;
 - (I) out-of-district;
 - (J) nonprofit organization; and
 - (K) any other type of customer as determined by the district;
- (2) the type of services provided to the customer class;
- (3) the cost of facilities, operations, and administrative services to provide service to a particular class of customer, including additional costs to the district for security, recreational facilities, or fire protection paid from other revenues; and
- (4) the total revenues, including ad valorem tax revenues and connection fees, received by the district from a class of customers relative to the cost of service to the class of customers.

Be careful when looking at old examples or non -MOU examples of rate structures/schedules for guidance

So what to do?

Best Practices

- Regularly conduct a cost-of-service study—rates shouldn't live forever
- In setting rates, consider classification based on:
 - Meter size
 - Peak demand
 - Usage pattern
- Use Texas-savvy consultants
- Document assumptions
- Scenario testing: inflation, drought, new development

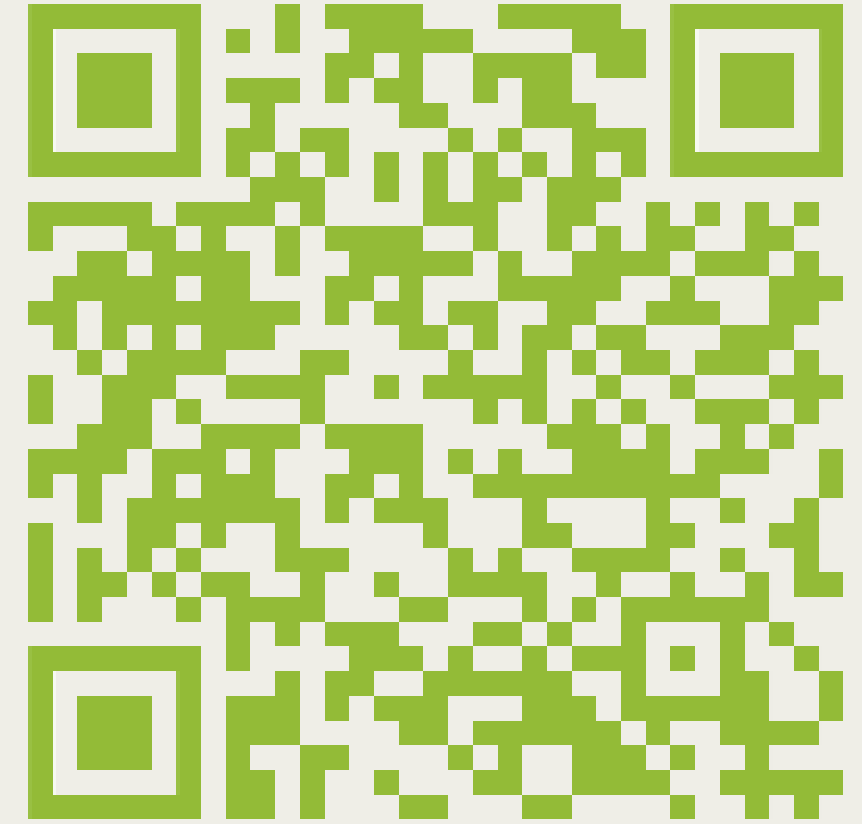
Best Practices

- Plan for public and legal scrutiny
- Paying for infrastructure using revenue bonds instead of solely recovering through rates
- Consider validating bonds (and matters related thereto like the rate schedule) through process set out in Chapter 1205 of the Texas Government Code

Remember

...if you don't revisit your rates, someone else like a judge—might do it for you.

Thank you!



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