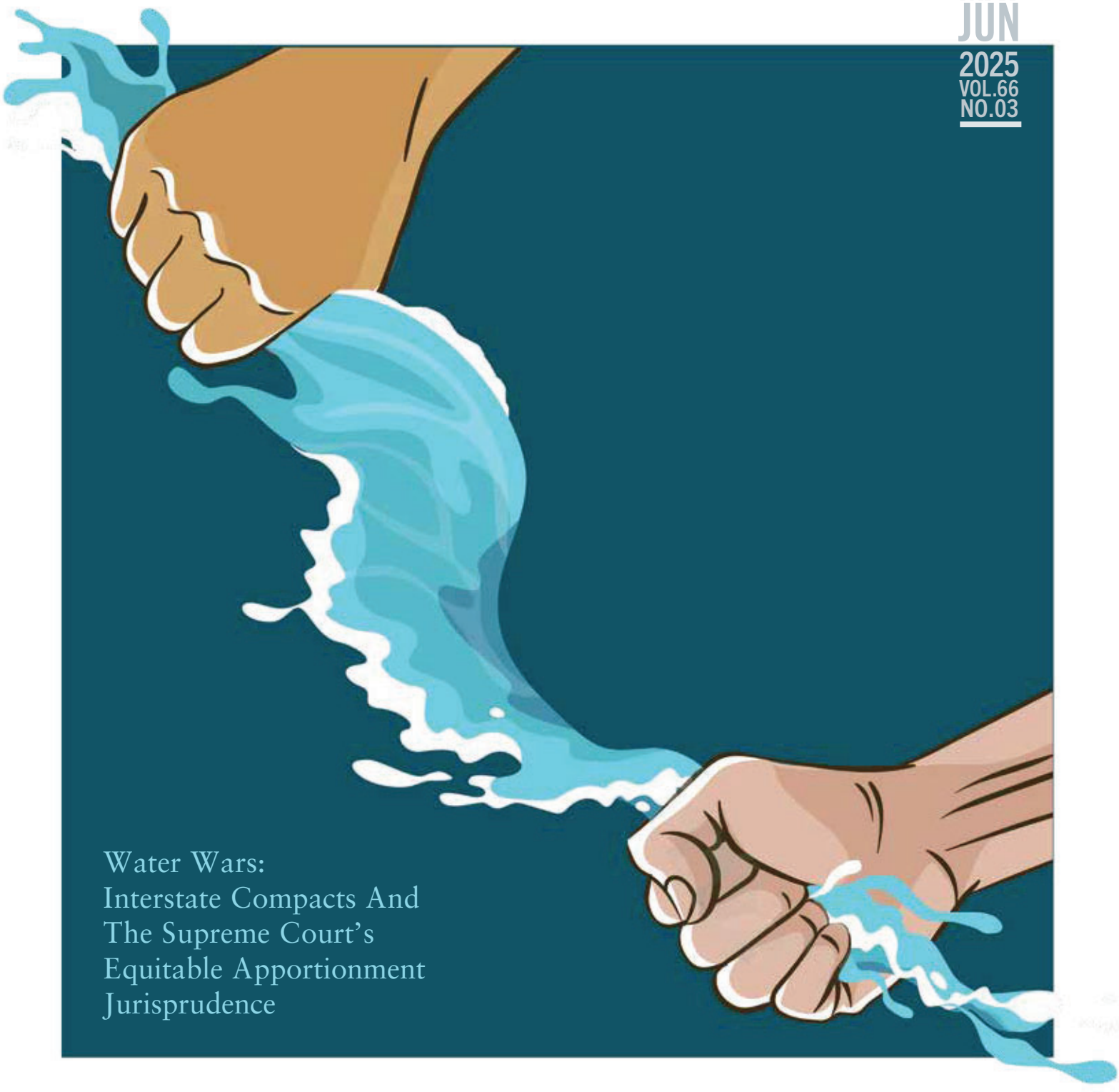
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# Municipal Lawyer

THE JOURNAL OF LOCAL GOVERNMENT LAW

MAY JUN
2025
VOL.66
NO.03



## Water Wars: Interstate Compacts And The Supreme Court's Equitable Apportionment Jurisprudence

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# PRACTICE TIPS

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## Coexisting with Special Districts and Franchised Utilities after Annexation

A developer convinces a city council to annex an unincorporated area so it can build a new housing subdivision. While the process is ongoing, a special district[1] that currently provides utility services in the proposed annexation area advises that it will oppose any effort by the city to extend services into the proposed subdivision. Fearing it will miss an important growth opportunity, the city moves forward with the annexation and enters into an agreement with the developer to extend utilities into the newly annexed area.

This is a common scenario. Cities and towns often find themselves at odds with special districts and private utilities when they annex new territory. Litigation sometimes ensues. What follows are some questions to consider when evaluating whether to annex into an area served by a special district or a franchised private utility:[2]

**1. What is the effect of an annexation?**
Although the process and result vary from state to state, generally speaking, when an area of land is annexed into an adjoining city or town, the new area becomes, ipso facto, a part of that municipality. Residents of the annexed area become entitled to the benefits and services provided by the municipality, such as police, fire, and utilities. Ordinances and regulations such as zoning and building codes become applicable as well.[3] Franchisees and other entities operating under a grant of right to serve the city or town may also acquire additional service territory through the annexation process.[4]

**2. Does annexation automatically grant a municipality the right to extend its utilities into the newly annexed territory?**
No. Although a municipality may enjoy the right to provide utility services within its corporate boundaries, that power may not automatically extend into newly annexed territory that at the time of annexation is served by a special district, franchisee operating under a state or county grant of right, or other entity operating under statutory authority.[5]

**3. Are there specific statutory prohibitions that preclude expansion of municipal utilities into newly annexed territory?**
Yes. There are federal and state statutes which limit, and in some instances prohibit the expansion of a municipal utility system into annexed territory if that area is at the time of annexation served by a special district or other protected service provider. The most widely known example of these statutes is probably 7 U.S.C § 1926(b), which provides protection to rural water districts who serve water customers in unincorporated areas of counties, often near the boundaries of cities and towns. Section 1926(b) includes an "anti-curtailment" provision, which protects rural water providers that have taken out a federal loan from displacement or competition by municipal water utility providers. According to 1926(b) "The service provided or made available through any such [indebted] association shall not be curtailed or limited by inclusion of the area served by such association within the boundaries of any municipal corporation…."[6] Federal courts have awarded significant damages to rural water providers upon a finding that a municipal utility has elected to encroach into these protected areas.[7]

**4. What about "core" services such as Police and Fire?**
Some states restrict municipal annexation of areas covered by special districts that perform public safety functions such as fire and ambulance services, especially if

those entities have the authority to levy a tax to fund operations. For example, in Oklahoma, a state statute provides for creating and operating independent county "fire protection districts" funded by a property tax assessed by the entity.[8] A recent amendment to this statute requires a vote of "fifty-one percent (51%) of those paying the current assessment" and assumption of a proportionate share of any outstanding district debt before the area can be "withdrawn" from the fire protection district and annexed by the city or town.

**5. May a city or town extend its utilities into the service area of an existing utility franchisee?**
Not if the franchisee is operating under a valid agreement with the state or county at the time of annexation. Generally speaking, a franchisee may continue operating within the newly annexed area but cannot extend or expand its service area without the consent of the city or town.[11]

**6. If a city or town wants to purchase a special district what factors should guide such a decision?**
The process for acquiring a special district or private utility provider is often governed by statute. It may require approval of the state agency such as a utility regulatory commission or a state water resources board.

**a. Inventory and appraisal.** The first step will likely be an inventory and appraisal of the utility assets. Typically, these evaluations are done by engineering firms that specialize in a particular utility or work exclusively for rural utilities. Be prepared for sticker shock. The appraisal value will likely set the baseline for any price negotiation. When haggling over the purchase price, it is important to remember that it is the "right to serve" over the long term that the city or town is purchasing. The quality of the physical assets that will be acquired should be of secondary concern.

**b. Debt.** Statutes governing acquisition of special districts usually require that the purchasing entity assume any outstanding debt. If the city or town is purchasing an electric utility or solid waste provider, this should not be a problem. However, if the purchase involves a rural water district, eligibility is limited if the debt is a USDA Rural Utilities Service (RUS) loan. Because this program is designed to support development in rural areas and communities, population thresholds and geographical boundaries may preclude a larger urban community from assuming debt owed by a rural water provider. If the city cannot qualify for assumption, it must find a way to pay off the district's debt. If the municipal purchaser is a small town that would itself be eligible for USDA-RUS loans, USDA has permitted these entities to assume outstanding water district debt.[12]

**c. Grant Restrictions.** It is possible that the municipality will be acquiring assets purchased with restricted grant funds. If this is the case, the grant recipient or municipality may need to repay all or a portion of the grant funds to the awarding agency before acquisition can be completed.[13]

**d. Future growth plans.** Removing barriers to future annexation and growth is important. Purchasing a special district that presently limits the ability of the city or town to grow in a particular area can pay off significantly over the longer term.

**7. Can the special district or franchisee be charged a fee or tax if it continues to serve the annexed area?**
It depends. These entities already have the right to serve the annexed area. The question is whether assessing a fee or imposing a sales tax on their activities is possible. Most states have statutes that address this issue and there is no consensus on how to resolve it. For example, in Oklahoma, if a municipality annexes an area served by a rural electric cooperative, it cannot require the cooperative to pay a franchise fee as a condition of continuing service. However, it can require the cooperative to pay a "gross profits tax" of two percent (2%) on all sales within the annexed area.[14] The utility can also be required to collect city or town sales tax from customers served in the annexed area.[15]

**8. Is there a downside to allowing existing utilities and service providers to continue serving in newly annexed areas?**
Yes, if the result is a significant disparity in the quality or level of services made available to residents of the newly annexed area. The classic example of how this can become a problem is the annexation of an area served by

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**Practice Tips** *cont'd from page 33*

a rural water district or corporation. Section 1926(b) was created to ensure that rural communities and regions can access drinking water. This statute does not require that these water systems maintain pressure and volume sufficient to support fire suppression. Without sufficient "fire flows," a municipality cannot fulfill its duty to provide fire protection in the annexed territory. The solutions can be costly: The municipality must develop a redundant water system in the area and maintain it exclusively for fire protection or purchase additional equipment that will permit it to "truck" water to a fire. Litigation with the water district or with area residents is also a possibility.

States have enacted statutes that address this issue in specific contexts. For example, the Oklahoma statute protecting fire protection district territory from annexation referenced above includes language requiring the county commissioners to examine the service levels currently available under the fire protection district and as proposed by the municipality. If the area in question would be benefitted and the annexation does not harm the remainder of the fire protection district, the county may permit the area to be withdrawn from the fire protection district.[16]

**9. Can a municipality acquire ownership and the right to serve through the exercise of eminent domain?**

Check your state statutes. The general rule is that, absent specific statutory authority, a municipality may not condemn a privately owned public utility's facilities and utilize them for the same purpose. Using eminent domain to acquire utility assets and a right to serve should be a matter of last resort. Litigation costs and a significant jury award for the taking can turn an annexation into an expensive undertaking.

## CONCLUSION.

Unless you are annexing territory served by a failing utility or the county is anxious to turn over control of a public safety district, expect to encounter resistance from existing area utility and service providers. **ML**

## NOTES

1. A "special district" is an independent political subdivision formed pursuant to state statute for the purpose of performing one or more governmental or proprietary functions. Such entities may also be known as "special purpose districts," "authorities," "municipal utility districts (MUD)," or "special taxing districts." Enabling statutes define the range of services that these districts can provide, and typically include public utilities (water, wastewater), public safety (fire, ambulance) and public health (hospital, cemetery) functions. Special districts are governed and operate independently of general purpose governments such as municipalities or counties. The governing board is usually elected by the constituents served. These entities may be funded by taxes, membership fees, user charges, or any combination thereof. Some enabling statutes also grant the district authority to issue debt and exercise eminent domain. A 2022 United States Census survey of local governments found that more than 40,000 special districts presently exist in this country. *See, Individual State Descriptions: 2022 Census of Governments*, United States Census Bureau; *Invisible Government, Special Purpose Districts in Texas,* Texas Senate Research Center, 2014; *Special District fact Sheet*, California Senate Governance and Finance Committee, 2016; *A History of Special Districts*, National Special District Association https://www.nationalspecialdistricts.org/a-history-of-special-districts.
2. A franchise is a right or privilege conferred by the state to a grantee, usually for the provision of some public purpose. Blair v. Chicago, 201 U.S. 400 (1906). The nature, duration and scope of a public utility franchise is a matter of state law. See generally 12 McQuillin Mun. Corp. § 34.2 (3d ed.).
3. 2A McQuillin Mun. Corp. § 7:52 (3d ed.).
4. 2A McQuillin Mun. Corp. § 7:57 (3d ed.).
5. 2A McQuillin Mun. Corp. § 7:55 (3d ed.).
6. 7 U.S.C § 1926(b).
7. Caroline Guerra Wolf, Fire: *When an Old Rule Creates a Hot Mess*, 52 Tulsa L. Rev. 343 (2017).
8. 19 O.S. §§ 901.1, et seq.
9. 19 O.S. 901.23a.
10. *E.g.*, SC Code § 58-27-670; see also, 2A McQuillin Mun. Corp. § 7:57 (3d ed.) (citing several cases).
11. *Id.*
12. *See*, *USDA Rural Utilities Service Borrowers Guide 2011.* https://www.rd.usda.gov/files/RCAP%20USDA%20RUS%20Borrowers%20Guide.pdf, .
13. *See, e.g.*, 2 C.F.R. §§ 200.200.310 – 200.316.
14. *See, e.g.* 68 O.S. §§ 1803 and 2603.
15. *See*, *e.g.* 68 O.S. § 2701.
16. 19 O.S. § 901.23a.
17. *See* 2 Local Government Law § 21:27 (2024); *see also* State ex rel. Missouri Cities Water Co. v. Hodge, 878 S.W.2d 819, 821 (Mo. 1994); City of Pryor Creek v. Public Service Co. of Oklahoma, 1975 OK 81, 536 P.2d 343.