

CITY COUNCIL REPORT

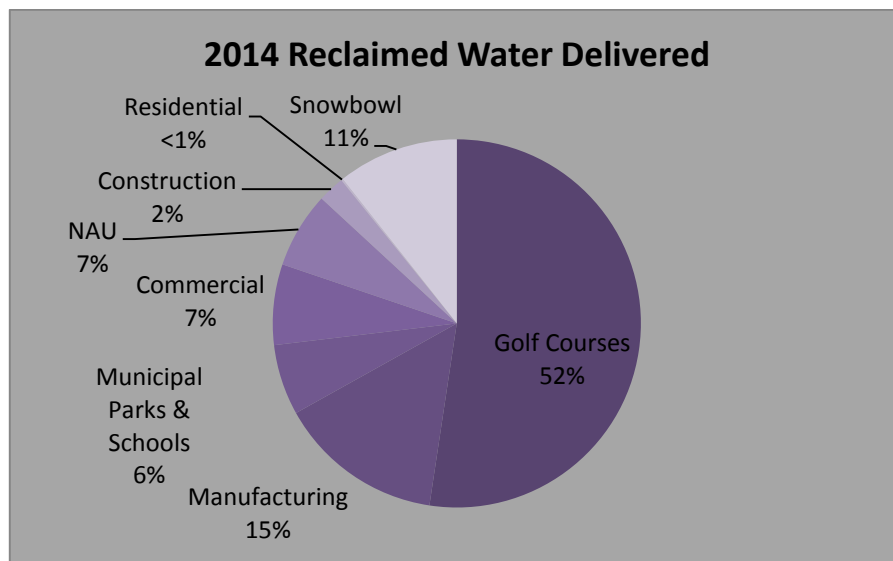
DATE: September 8, 2015
TO: Mayor and Council Members
FROM: Brad Hill, Utilities Director
CC: Josh Copley, Jerene Watson, Barbara Goodrich, Leadership Team
SUBJECT: 2015 Utilities Rate Study Questions

The purpose of this City Council Report is to respond to three (3) questions from Council regarding the 2015 Utilities Rate Study being conducted by Willdan Financial Services.

DISCUSSION:

Question No. 1: The issue of cost v. revenue for reclaimed water?

To answer the first part of the question, please refer to the August 6, 2015 Willdan Financial Report 1 of 2, Table RW-1 on page 52. This table shows the current (FY15) and five-year projected revenues, expenses and fund balance for the reclaimed water utility. The revenue projections were based upon delivering approximately 680 million gallons/year (or ~2,100 acre-feet/year). Using the projected revenue, expense and water deliveries expected over the next 5 years, the upcoming average cost for the operations, maintenance & repair of reclaimed water is estimated to be \$1.62/1000 gallons (or ~\$527/acre-foot). The chart below illustrates the type of customer's or Customer Classes and their relative deliveries in 2014.



To address the second part of the question; why do certain customers appear to be “subsidizing” other customers and why is the per gallon cost allocated to each Customer Class different? Please refer to Table RW-4, page 55. This table illustrates the variability of rates charged between each Customer Class (e.g., Tier 1 Private Residential = \$1.23/1000 gallons compared to NAU (all others) = \$3.17/1000 gallons) and yet, the 5-year average cost of reclaimed is estimated to be \$1.62/1000 gallons. Below is a brief summary of Willdan Financial Service’s explanation (*in italics*) on why this occurs and how Flagstaff’s reclaimed water rates were established:

Setting rates for reclaimed water often follows the same basic rate-making principles and procedures as the setting of water rates. That is, water rates are typically developed based on a cost-of-service approach which allocates the costs to water customers in a manner generally consistent with the proportionate cost to provide water to those customers. At the heart of this methodology are the relative usage characteristics of each type of customer and their relative peaking factors. For example, a peaking factor is developed by relating the maximum demand for a customer class over a period (month, day or hour) to the average demand for that customer class over the same period which then establishes a ratio of peak demand vs. average demand. The resulting ratio, or “peaking factor”, represents the relative peaking requirements between customer classes so that those costs associated with meeting peak demands can be more appropriately allocated to specific customer classes. The importance of this is that those customers that create a higher “peaking factor” create the most expenses to the utility regarding capital infrastructure and operational costs to deliver water during those peak times. This also explains why our “off-peak customers” (e.g., golf courses) have a lower rate while our on-peak customers (NAU) have a higher rate as compared to the 5-year average of \$1.62/1000 gallons.

Additionally, reclaimed water rates also take into account the fact that this water supply is typically a substitute for potable water and that those customers often want or need a pricing incentive. This is why it is common for reclaimed water rates to be established, by policy, at a discount from the potable rates and why many utilities set their reclaimed rates at a percentage of the potable water rate (e.g., 30%-75%). This approach to reclaimed water pricing is common in utility rate-making and referenced in reclaimed water pricing literature from the American Water Works Association (AWWA) and Water Environment Federation (WEF).

In Flagstaff’s case, the existing reclaimed water rate structure (e.g., Table RW-4, page 55) was established many years ago by City Council (>10 years) and is a mixture of both approaches. That is, the initial basis for allocating costs considered the “total demand and peaking factors” per customer type (e.g., commercial, NAU, etc), but the actual cost per gallon was established by policy as a percentage of the potable water rates. Willdan Financial Services proposed reclaimed water rates (i.e., Table RW-4 & RW-6) do not change the existing rate structure, but rather add an additional 3% or 7% evenly across all Customer Classes. As mentioned earlier, this is consistent with industry standards.

Question No. 2: Since Ratepayers Subsidize Reclaimed Water, can you explain how that works with the Potable Water Rates and how that is reflected on the water bill? As noted above, the new proposed reclaimed water rates do not require a subsidy from the water customers, but rather the projected revenues cover the projected

expenses. One caveat is there are two projects that are currently budgeted in FY15/16 in the wastewater utility that will benefit the reclaimed water customers (redesign/configuration of the pump station at Wildcat Hill WRP and the new booster pump station proposed at Bushmaster Park). These projects were already funded within the combined Wastewater/Reclaimed Water fund balance and began in FY15 prior to when the funds were split into separate funds.

In terms of the existing rates adopted by City Council in 2010 there is a subsidy from water to reclaimed water. Our utility billing does not break out the components of the water portion on a customer's water bill. In addition, this is also not done for the wastewater, reclaimed water, environmental fee, trash services, recycle services or stormwater. Each of these charges may consist of many components but are developed and combined as an overall rate for the specific service provided.

Prior to Fiscal Year 2015, the water, wastewater, and reclaimed water operations were reported in a single enterprise fund of the City. Therefore, technically there were no "transfers" between the funds as they were balanced as a combined fund, although reclaimed water revenues did not cover all reclaimed expenses at that time per the rate study. During FY15 and FY16, these operating funds were split into separate enterprise funds for better tracking, management and transparency. This now helps to demonstrate that each fund operates financially independent. Should a subsidy be needed, it will clearly be shown by a revenue transfer between the funds during the budget process.

Question No. 3: What is the consultant's conclusion with regard to the rates for the 11 different classes of reclaimed water? Please refer to the answer for Question 1.

RECOMMENDATION / CONCLUSION:

This report is for information only.