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Managing Tomorrow's Resources Today

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June 30, 2015

Ms. Jeanine Townsend
Clerk to the Board
State Water Resources Control Board
1001 I Street
24the Floor
Sacramento, CA 95814

Subject: **Comments Regarding Conservation Water Pricing**

Dear Ms. Townsend:

HF&H Consultants, LLC is a consulting firm that specializes in conducting rate studies for agencies that provide water, wastewater, and solid waste services in California. I have managed the firm's water and wastewater consulting services since I co-founded the firm in 1989. I have extensive experience advising our clients on setting their rates in compliance with Proposition 218. I offer the following comments as an independent rates consultant and not on behalf of any of my clients.

My comments address four areas in which legislation is needed to improve implementation of California Constitution Article XIII D, enacted by Proposition 218 in 1996 (and to which I will refer below as Proposition 218). My comments are intended to answer the three questions in the Board's Notice of Public Workshop, which are concerned with actions the Board could take to help agencies improve the effectiveness of rate structures and pricing mechanisms.

SAN JUAN CAPISTRANO DECISION

If this appellate court decision is not de-published, it will lead to a problematic style of setting tiered rates that will strip agencies of the discretion they need to set reasonable, conservation-oriented rates. Moreover, trying to set tiered rates so that each tier is proportional to the cost of service that could be associated with each tier assumes that this is possible. For the analyst, this raises fundamental questions related to the cost of water supplies:

- If I have only one source of supply, does this mean I cannot have tiered rates and instead must settle for a one-tier, uniform rate?
- If I have multiple sources of supply, does this mean I have to have exactly as many tiers as I have sources of supply?
- Do each of my tiers have to be sized according to how much water is available from each source of supply or can I size them based on customer demand patterns that reflect efficiency and inefficiency?
- Do I have to change the rate for each tier every time the cost of the source of supply changes?
- Do I have to change the size of each tier as the availability of my water supplies varies?

In addition, the analyst may also want to distribute other operating and capital costs based on the associated function, such as meeting average day, peak day, and peak hour demands. The analyst is then faced with aligning these functional cost allocations with the allocation of supplies:

- How do I correlate multiple sources of supply that do not correspond to functional allocations related to peaking with the functional allocation categories?
- What if I am able to correlate each of my sources of supply with the functional allocations of my other costs and end up with tiered rates that yield fees and charges that are disproportionate across a range of consumption from lowest to highest?
- What if the rates that are supposedly equal to the cost of service for each tier are out of step with crucial rate-making objectives that must be achieved to encourage efficiency and discourage waste?

The industry practice before *San Juan Capistrano* allowed the analyst to set rates for each tier that resulted in proportional fees and charges that met reasonable rate-making objectives without trying to analyze the cost of providing service in each tier. The analysis prescribed in *San Juan Capistrano* is intractable and artificial because each tier may not have its own cost of service. The cost of service spans the range of tiers and should only be tested for proportionality based on the resulting fees and charges.

The test for proportionality does not have an absolute standard. Proposition 218 does not contain any guidance for determining whether a fee or charge is or is not proportional. Proportionality is a mathematical property that should be judged based

on the mathematics. Proposition 218 places the burden of proof on the agency setting the rates to show its math. Absent a quantitative demonstration of how the fees and charges are derived, the proportionality of the fees and charges cannot be judged properly. However, when the math is shown, rate payers are given the opportunity to decide whether proportionality has been achieved through Proposition 218's majority protest process. In other words, Proposition 218 allows the rate payer to assess whether the fees and charges are proportional regardless of whether each tier is related to the cost of service, if, first, it were a legal requirement that each tier needs to equal the cost of service and, if, second, it were possible to make the necessary calculations.

San Juan Capistrano is a bad decision and must be de-published. Legislation is greatly needed that provides clarity over the discretion that agencies have to set tiered rates that meet reasonable rate-making objectives. This discretion should reflect the common industry practice that allowed setting the size and rate for each tier so that the resulting fees and charges reflect the appropriate conservation price signal for the customer class as a whole.

RATE ADJUSTMENTS DURING WATER SUPPLY EMERGENCIES

Proposition 218 requires a notification process when new water rates are created or when existing rates are increased. During times of normal supply conditions, projections can be made based on multi-year trends in customer demand that will not be too far off after five years, at which time fresh rate projections are warranted. During droughts, projections are more uncertain given how difficult it is to estimate customer conservation.

The impact of conservation reduces rate revenue and certain variable expenses. By and large, however, rate revenue decreases more than variable expenses. In order to offset the lost revenue rates need to increase to protect the agency's reserves from covering the deficit. Such rate increases do not necessarily increase a customer's bill. A customer who conserves may pay no more when charged higher, revenue-neutral rates.

Regardless of customer bill impacts, the agency has to go through the Proposition 218 notification process just to make a revenue-neutral rate increase. Agencies are reluctant to go through Proposition 218 noticing for a revenue-neutral rate increase because of the potential for a subsequent rate reduction after the drought. Under such circumstances, it would be beneficial for agencies to be able to adjust rates in inverse proportion to demand reductions without the need for a full Proposition 218 notice each time.

Legislation that would allow agencies to index their rates to increases and decreases in demand would greatly ease rate making during droughts. Adjustments could go in either direction, both increasing and decreasing rates for the duration of the drought. For implementation, the severity of the drought would need to be defined that is appropriate to the portfolio of available water supplies.

HARDSHIP ASSISTANCE

Proposition 218 has been interpreted to prohibit providing hardship assistance using rate revenue. The use of non-rate revenue is used by agencies to provide hardship assistance; however, many agencies have taken the position that they are prohibited from providing any assistance whatsoever. This is a bad interpretation of Proposition 218. Proposition 218 simply does not say that rates cannot be subsidized. What Proposition 218 says is fees and charges must be proportional without any further specifics.

Proportionality takes many forms, one of which can certainly reflect affordability. Fees and charges that reflect income levels were a common industry practice prior to Proposition 218 and continue to be in place with utilities regulated by the California Public Utilities Commission. Affordability is also a common policy in setting rates outside the United States.

Legislation is needed to provide agencies with the option to provide hardship assistance from rate revenue provided the agency's notice to rate payers fully discloses the intention to do so, indicating the impact on the subsidizing rate payers. Rate payers could then decide whether to allow or protest this policy. This approach is contained in Section 1-4.B.3. of your Board's *Revenue Program Guidelines* for setting sewer service charges.

Absent such reform, tiered water rates will be denominated by how much low-income customers can afford without a subsidy. This constraint results in a weaker price signal in structuring the tiers.

VOLUMETRIC RESIDENTIAL SEWER RATES

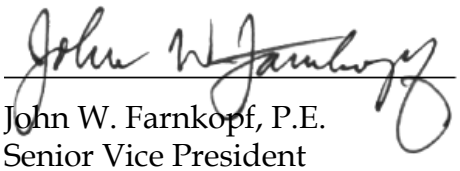
On October 8, 2012 I testified before the Board as a consultant to the Natural Resources Defense Council concerning the benefits of volumetric residential sewer rates. I testified as to the additional water conservation signal that is achieved by converting

flat residential sewer rates to volumetric sewer rates. The Board should take steps that would encourage agencies that to charge volumetric residential rates.

I conclude by expressing my thanks to the Board for providing this opportunity to provide my comments.

Very truly yours,

HF&H CONSULTANTS, LLC



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