

**MEMORANDUM**

DATE: September 3, 2021  
TO: Ted Corrigan, CEO and General Manager  
FROM: Amy Kahler, Chief Financial Officer  
SUBJECT: Proposed 2022 Water Rates

**Background**

In 2017, DMWW engaged Raftelis to evaluate our Cost of Service model that is used annually to assign costs to customer classes. Raftelis is a nationally known financial advisor specializing in public-sector work. The firm has helped author the AWWA’s rate setting manual, “Principles of Water Rates, Fees, and Charges,” more commonly known in the water industry as the “M1 Manual.” DMWW’s approach to rate setting is to identify costs by customer class and set rates such that all customers “pay their own way.” A customer class should not pay any more, or any less, than the cost to serve.

Raftelis updated DMWW’s Cost of Service model to be consistent with widely accepted industry cost principles. Their calculations and methodologies showed DMWW is not recovering the cost to serve some customer classes, including the purchased capacity customer class. Because DMWW recovers 100% of costs from all customers as a whole, where one customer class is under-recovering costs, another customer class is over-recovering. This is called cross-subsidization, and is not permitted per the Wholesale Water Service Master Agreement (“Master Agreement”) and agreements with other entities served by DMWW.

Raftelis’ significant findings fell into two broad categories:

**1. Past Across-the Board Rate Increases**

DMWW has approved across-the-board rate increases in the 6-10% range in recent history. While an across-the-board approach is attractive because it is simpler and easier to communicate to customers, it misaligns the cost of service and revenue, because not all customer costs increase by the same amount. This previous approach to rate-setting has caused a gap between the cost to serve and the current purchased capacity rate.

**2. Rate of Return**

Section 17 of the Master Agreement provides that “The Purchased Capacity Rate shall be less than the With Storage Rate and shall be determined by eliminating any charge for return on invested capital related to DMWW’s (a) treatment plant capacity, (b) transmission mains and (c) source water storage in the DMWW’s cost of service studies.” [emphasis added]

Raftelis highlighted that DMWW's previous cost of service model eliminated rate of return on all capital, not just that capital which has been invested by the purchased capacity customers. Raftelis' model eliminates the return for purchased capacity investments as outlined in the agreement; however, it does not provide a rate of return credit on capital which has been invested by Des Moines customers, consistent with industry cost principles. The reduction in this credit increases net capital costs assigned to purchased capacity customers.

### **Current Wholesale Rate Structure**

DMWW's current wholesale rate structure recovers costs in a per-thousand-gallon volume rate (other than a nominal monthly availability, more representative of a "meter fee"); however, this rate structure fails to recognize that fixed capital costs are incurred regardless of the volume of water purchased. Raftelis recommended that DMWW revise our wholesale rate structure such that purchased capacity customers pay the fixed capital costs assigned to them based on the demands they place on the system, generally defined by maximum day demand units of service. In addition to more appropriately providing revenue to offset fixed capital costs, this approach also addresses intra-class inequity within the Purchased Capacity customer class.

Staff has worked with Raftelis over the last two years to identify options for a revised Purchased Capacity rate. Staff and the Board have previously stated support for moving toward wholesale rates that have an appropriate fixed charge that considers maximum day usage, combined with a volumetric rate; however, the implementation of this change has not been adopted in previous years to allow regionalization discussions to finalize.

### **Proposed 2022 Rates – Conceptual Approach**

Regionalization discussions have progressed but are still underway, and staff recommends that DMWW proceed with establishing 2022 purchased capacity wholesale rates based on the recommendations made by Raftelis to include: 1) a fixed monthly availability per Max Day thousand gallons to recover fixed costs, and 2) a volumetric charge per thousand gallons to recover variable costs. DMWW legal counsel's opinion is that the rate changes contemplated are within the boundaries of the Master Agreement (it should be noted that through its counsel, West Des Moines Water Works has formally shared a contrary view of the Master Agreement language).

The 2022 budget has not yet been finalized, but work will be completed over the next several weeks integrating Raftelis' recommendations into the revenue projections. Proposed 2022 rates and a preliminary look at the 2022 Budget will be presented at the October Finance & Audit Committee meeting.