

To the Mayor and Members of the City Council**August 9, 2016**

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**SUBJECT: WATER DEPARTMENT FY2017 PROJECTED REVENUE REQUIREMENTS**

Each year the Water Department completes cost of service studies for Retail and Wholesale customer classes for both water and sewer services. Those studies are used to determine the rates that will be recommended to the City Council. The purpose of this Informal Report is to outline the process and topics addressed in the FY2017 rate setting process and to provide the projected change in water and sewer revenue requirements.

Retail Water and Sewer Rate Process

Retail rates paid by Fort Worth residents and businesses are based on the Department's cost of service, which is established as part of the annual budget process using industry standards. Once the cost of service is determined, the preliminary rates and specific topics that might affect the rate structure are presented to the Department's informal Water and Sewer Retail Rate Structure Stakeholder Group for input and feedback. This group is comprised of customers representing the various retail customer classes, which include residential, commercial, industrial, irrigation and super users. The group is charged with ensuring equity among customer classes and providing input into how costs are allocated within rate structures.

Water Department staff met with the Stakeholder Group on June 6, June 13, June 20, and June 27 to present budget drivers and costs, trends in water and wastewater usage over the last decade, and preliminary FY2017 rates for both water and sewer service. Staff requested feedback on specific issues impacting revenue recovery and rate structure. These topics included whether to untie Irrigation volumetric water rates from Residential rates, tiered cost recovery, and continuing the fixed vs. variable cost recovery plan for retail water and sewer service.

Budget Drivers

The cost of the raw water purchased from the Tarrant Regional Water District (TRWD) continues to be the major cost driver in the Water budget. The raw water rate for FY2017 is projected to increase by 7.17%, resulting in a cost increase of \$4,654,975 over FY2016. At a total cost of \$88,508,355, the raw water purchase represents 34% of the FY2017 Water budget and 20% of the total FY2017 Water and Sewer Fund budget. The primary driver of the rate increase from TRWD is the cost of the 150-mile Integrated Pipeline project, which will transport additional water from Cedar Creek and Richland Chambers Reservoirs to Tarrant County by 2020 to improve reliability and support growth. Increases in raw water costs are expected to lessen over for the next several years as this project moves toward completion.

Additional drivers in the FY2017 proposed budget include an increase of \$1.5 million in debt service and \$1.4 million in pay-go cash financing to support the City Council-adopted Capital Improvement Plan and improve coverage ratios through a multi-year plan, as well as an increase of \$1.1 million in transfers to the General Fund for street rental and services received from General Fund departments. These increases are partially offset by a \$2.5 million reduction in the budgeted contribution to reserves made possible by strong financial performance and an anticipated additional contribution to reserves in the current fiscal year to improve liquidity and financial indicators.

Finally, the FY2017 budget includes funding for 13.0 new positions required to meet new regulatory requirements and the demands of an expanding service area for sampling and monitoring of the system; to perform water quality investigations and line locates in the growing system; to manage capital facility needs based on criticality and reliability and provide additional maintenance of new and expanded

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electrical systems at the water reclamation facility; and to improve customer service levels for engineering planning and modeling activities due to an increase in the number of development and operational requests. This additional staffing is offset by the transfer of one position to the General Fund, for a net increase of 12.0 authorized positions.

Irrigation and Residential Volumetric Water Rates

Since the inception of a tiered rate structure for the Irrigation customer class in 2008, its volumetric rates have been tied to the rates of the upper tiers of the Residential customer class. However, different water usage patterns of the two classes create difficulty in maintaining each class at its cost of service. This issue was discussed in depth with the Stakeholder Group. After reviewing several options, the Stakeholder Group recommended untying the Irrigation volumetric rates from the Residential rates, enabling each class to stand alone relative to its cost of service.

Tiered Cost Recovery

In previous years, the volumetric water rates for Residential tiers 1 and 2 have been set below the cost of service, while the rates for tiers 3 and 4 have been set above the cost of service to meet revenue requirements for residential users. Because Residential tiers 1 and 2 account for 85% of all residential water use, this rate structure relies heavily upon revenues received from the two upper tiers to recover costs. The Stakeholder Group discussed this issue at length and recommended leaving tier 1 below the cost of service to maintain a "lifeline" rate for domestic uses such as bathing and cooking, and setting tier 2 at the cost of service to lessen reliance upon tier 3 and 4 revenues. Due to an anticipated increase in volumes, setting tier 2 at the cost of service results in a small decrease in the tier 2 rate from the current rate.

Because the Irrigation and Residential volumetric rates were recommended to be untied, the Stakeholder Group also recommended that the second tier of the Irrigation class be set at cost of service, similar to the Residential class. This action results in a small decrease in the tier 2 rate from the current rate and maintains the other Irrigation tier rates unchanged from the current rates. In addition, increases in volumes for Commercial and Industrial customers enable a small decrease from current volumetric rates for these customer classes.

Fixed vs. Variable Revenue Stability Plan

The FY2017 budget continues the multi-year implementation of increased cost recovery from fixed service charges for both water and sewer service to improve revenue stability. This reduces the Utility's dependence on more volatile, volume sales-based revenues. Begun in FY2014, the revenue derived from fixed charges for Water service are increasing from a ratio of 17% fixed and 83% variable to a 30%/70% ratio using a phased approach. Likewise, the fixed revenues for Sewer service are increasing from a ratio of 12% fixed and 88% variable to a 20-25% fixed component. The FY2017 recommended rates reflect the fourth year of the Water plan and the third year of the Sewer plan and continue small increases in the monthly service fees for both Water and Sewer. Moving to a higher percentage of fixed revenue collection is a utility industry trend that lessens dependence on weather conditions and improves stability in revenue collection and cash flow. This issue was reviewed with the customer Stakeholder Group, which continued to support the plan.

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Wholesale Water and Sewer Rate Process

Wholesale rates paid by the Department’s 30 water customer cities and 23 sewer customer cities are based on cost of service studies performed on a three-year rotation using consultant services, alternating water and sewer, with Department staff completing the study the alternate years. The process and methodology are established within the Uniform Wholesale Contracts for water and sewer services. Studies are based on test year expenditure data, adjusting for known and measurable changes. Volumes used to calculate the rate change are based on prior year actual use. Results of the cost of service studies and preliminary rates are presented to the Wholesale Advisory Committee, comprised of representatives of each of the customer cities. Staff met with the Cost of Service Subcommittee of the Wholesale Advisory Committee on May 19 and June 30, and met with the full Wholesale Advisory Committee on June 10 to present the preliminary FY2017 wholesale water and sewer rates. Final rates were provided to the Wholesale Advisory Committee on July 14.

FY2017 Recommendations and System Adjustments

Based on the cost of service studies and the input received from the Stakeholder Group for retail rates and Wholesale Advisory Committee for wholesale rates, staff recommends the following changes and system-wide FY2017 recommended adjustments:

Retail Irrigation and Residential Volumetric Water Rates – Staff recommends untying the Irrigation volumetric water rates from the Residential rates, enabling each class to stand alone relative to its class cost of service, as recommended by the Stakeholder Group.

Tiered Cost Recovery – Staff recommends setting the second tier of the water rates for Residential and Irrigation classes at their cost of service, per the recommendations of the Stakeholder Group.

Fixed vs. Variable Revenue Stability – Staff recommends moving forward with year four and year three of the Water and Sewer fixed revenue recovery plans, respectively, to continue improvement in revenue stability.

These recommendations result in the following adjustments in system wide revenue requirements for Retail and Wholesale Water and Sewer service:

- Retail Water: +1.38%
- Retail Sewer: +1.10%

- Wholesale Water: + 1.27%
- Wholesale Sewer: - 1.59%

Additional detailed information about the recommended FY2017 rates may be provided in August, as desired. Should you have any questions about the retail or wholesale rate processes, please contact John Carman, Water Director, at 817-392-8246.

**David Cooke
City Manager**