

Issue Paper 2: Review of the Issue of Multi-Year Rate Adoption and the Tualatin Valley Water District

Introduction

For a variety of reasons, the adoption and implementation of rates across the United States varies from utility to utility. In some cases, this is driven by the governing body's preferences for setting rates over a specific period of time, the need and reason for the rate adjustments, utility policies, or political reasons. While the level of the rate adjustment is usually a significant discussion issue, the number of years adopted (e.g., one year versus multiple year rate adjustments) during a single rate hearing is also an important consideration. In most cases, the governing body has the ability to adjust rates at any time as long as procedural requirements are met (e.g., customer notification, public meeting). In most instances, utilities adopt rates for a short-term period (i.e., 1-5 years) as the ability to accurately predict costs and changes over a longer time period can be difficult. This issue paper is intended to discuss the advantages and disadvantages of adopting rates for a single year versus a multi-year time period.

Overview of the Issue

The water utility industry began as a relatively simple business which did not resemble the complexity of today's modern water system. Today, water utilities operate in a highly regulated environment requiring systems that provide safe drinking water and fire flow, and are often tasked with conserving the limited and precious resource. A small utility serving 5,000 customers may have tens of millions in asset value and dozens of employees.

Water rates have become an increasingly larger portion of household expenses and as a result, they have drawn more attention. Since 1998, water rates have grown at 5% per year on average, or twice the rate of inflation¹. Water rates continue to increase to fund regulatory requirements, capital improvements, and system renewal and replacement needs. Historically perceived as a relatively inexpensive and plentiful resource, customers now have a better understanding of the challenges and costs associated with providing safe drinking water.

While the challenges of providing service to customers and meeting regulatory requirements have increased, the need for stable and consistent revenues have also increased. It is a prudent business practice for utilities to consistently review their rates to confirm their adequacy and equity. At the same time, customers typically prefer small annual adjustments to large one-time adjustments. When taken together, a utility must consider the transition of rate adjustments and how they can best be implemented.

To provide the cost-basis for its rates and any proposed rate adjustments, a water utility will generally conduct a comprehensive water rate study. This study includes the development of a multi-year projected financial plan that determines the appropriate level of rates to adequately

¹ Source: American Water Works Association and Raftelis Financial Consulting, Rate Trends in Survey Years, 2016.

support the utility's operating and capital costs over the planning period. In some cases, a utility will review rates annually and adopt rates for a one-year period. In other cases, a utility may adopt rates for a multi-year period (e.g., 2 to 5 years). Once adopted in a single resolution or ordinance, the rates automatically adjust each year to the adopted rates for a particular year.

TVWD's Current Approach

In 2012, Tualatin Valley Water District (TVWD or the "District") completed a comprehensive rate study that included a 30-year revenue requirements forecast and rate projection. District staff maintain and update the forecast model to develop rate projections based on projected operating costs and the District's capital improvement plan. For purposes of budgeting and rate setting, TVWD adopts a biennial (2-year) budget, while adopting rates on an annual basis.

Review of Best Management Practices

Industry groups such as the American Water Works Association (AWWA), Water Environment Federation (WEF), and the Government Finance Officers Association (GFOA), don't specifically address or have a best practice for rate adoption. However, there are principles and best management practices that address the issue of setting rates for a specific time period.

While AWWA does not have a best management practice that speaks specifically to rate adoption, the M1 Manual² does reference eleven objectives for developing cost based rates which were paraphrased from the book "Principles of Public Utility Rates".³ Three of the objectives speak specifically to consistency in rates and the need to plan for the future. These are:

1. Effectiveness in yielding total revenue requirements (full cost recovery)
2. Revenue stability and predictability
3. Stability and predictability of the rates themselves from unexpected or adverse changes

Taken together the above principles call for rates that cover the utility's costs, provide stable and predictable revenue, and finally, from a customer's perspective, are stable and predictable in terms of changes from year to year. To meet these objectives, rates must be planned and adopted to avoid under-funding the utility in the short-term and preventing larger future rate increases. This can be accomplished through annual rate adjustments or through multi-year adjustments. How the proposed rate adjustments are implemented can have a direct impact upon the customer's perception of the stability and predictability of the rates and their water bill.

There are six GFOA Best Practices/Advisories which stress the importance of multi-year financial planning. These Best Practices are:

1. Recommended Budget Practices from the National Advisory Council on State and Local Budgeting, Approved January 1998
2. Establishment of Strategic Plans, Approved March 2005
3. Multi-Year Capital Planning, Approved February 2006

² Source: American Water Works Association, Principles of Water Rates, Fees and Charges, Sixth Edition, 2012.

³ Source: Principles of Public Utility Rates, Bonbright, Daniels and Kamerschen.

4. Long-Term Financial Planning, Approved February 2008
5. The Public Finance Officer's Role in Supporting Fiscal Sustainability, Approved February 2012
6. Financial Forecasting in the Budget Preparation Process, Approved February 2014

GFOA's Best Practices place an emphasis on multi-year planning to effectively and formally plan for the utility's future. The two main principles at issue in the above Best Practices are the need for both a long-range financial plan and strategic plan. Despite what these two plans might be named, most utilities routinely conduct comprehensive financial planning or rate studies which have all the hallmarks of a long-range financial plan. Utilities are also often required to conduct master plans which could be described as strategic plans. The most important part of developing a long-range plan is the implementation, or adoption of annual or multi-year rate adjustments.

One entity that specifically addresses multi-year rate adoption as being a financial practice is the Standard and Poor's Rating Services (S&P). In January 2016, S&P released an update detailing its new methodology for assigning credit ratings for waterworks, sanitary sewer and drainage utility systems. The methodology contains several factors categorized as either Enterprise Risk or Financial Risk. The factors that make up the enterprise and financial risks have various weightings to determine a utility's bond rating. The component that references rate adjustments is called Rate Setting Practices, which is a sub-factor within the larger Operational Risk Management Factor. This assessment has four levels: Strong, Good, Standard, and Vulnerable. For this sub-factor, S&P considers a utility to be "strong" if:

*"When rate increases have been needed, the decision-making body has been supportive and timely, even to the extent that multiyear, preapproved rate increases are common, if not standard. Finance decisions are prudent, in our view, rather than simply politically expedient and that could possibly be to the detriment of the utilities near-term financial health. Periodic rate studies (internal or external) are common."*⁴

Though not a best practice, this criteria being included as part of the utility rating process does show that S&P believes adopting several years of rates helps defuse some level of political influence on the level of rates ultimately adopted.

In much the same vein, Moody's ratings agency also notes in its review of a utility's financial health that multi-year rate adjustments are beneficial from a ratings perspective. Moody's states the following:

*"We tend to give higher scores to utilities that set rate structures under which increases are automatic, and do not require annual approval for implementation."*⁵

In the case of Moody's review, multi-year rate adjustments are preferred and utilities can receive a higher rating, which could result in a lower overall cost of borrowing.

⁴ Source: Standard and Poor's Ratings Services McGraw Hill Financial *U.S. Public Finance Waterworks, Sanitary Sewer and Drainage Utility Systems: Rating Methodology and Assumptions* January 19, 2016, P. 21 Table 14.

⁵ Moody's Ratings Agency, "Rating Methodology: US Municipal Utility Revenue Debt" December 15, 2014, P. 16.

As discussed above, while there are no specific industry guidelines on the approach to adopting utility rates for a specified time period, there are best practices in the financial community that can help maintain a financially healthy utility. The bond rating criteria provided by S&P and Moody’s clearly indicates a potential financial benefit of adopting multi-year rate adjustments.

Review of Local Utility Rate Setting Approaches

Provided in Table 1 is a summary of recent examples of the adoption of utility rates for several local utilities and the number of year(s) the rates were adopted for.

Table 1 Number of Years Adopted by Local Utilities	
Agency	# of Years Adopted
Astoria Public Works Department	1
Clackamas Co. Water Environment Svcs (Sewer Rates)	1
Eugene Water & Electric Board (Water Rates)	1
City of Gresham	3
Clean Water Services	1
Medford Water Commission	1
Portland Water Bureau	1
Salem Public Works	2

In many cases, the utility developed a rate study or long-term financial forecast that projected rates over a long-term period. However, as Table 1 shows, the rate implementation period varies from utility to utility.

There certainly are advantages and disadvantages to establishing rates in a single year or multi-year time period. Both can provide sufficient revenue, transparency, and predictability depending on how the rate adjustments are adopted and noticed to the utility’s customers. However, the costs associated with conducting a comprehensive rate study each year are typically significant, and the adoption of a set of multi-year rates can provide greater surety to the District’s customers and the outside financial community.

Provided in Table 2 is a summary of the advantages and disadvantages of single year rate adjustments and multi-year rate adjustments.

Table 2
Summary of Annual and Multi-Year Rate Adjustments

Annual Rate Adjustments	Multi-Year Rate Adjustments
<p>Advantages –</p> <ul style="list-style-type: none"> • Rates reflect most recent expenses and cost projections. • Provides greater flexibility to adjust rates as needed to reflect changing conditions. • Allows customers to provide public input on the proposed rate adjustments annually. <p>Disadvantages –</p> <ul style="list-style-type: none"> • Cost of annual rate projections (rate study). • Need to establish a public process and rate adoption process on an annual basis. • Potentially introduces more politics to the rate setting process. 	<p>Advantages –</p> <ul style="list-style-type: none"> • Transparency of future rate adjustments. • Provides customers with a clear indication of future rate impacts so they can plan accordingly. • Viewed favorably by rating agencies. • Can directly link to and reflect biennial budget process (e.g., adopt 2-year budget/2-year rates). <p>Disadvantages –</p> <ul style="list-style-type: none"> • Need to establish an accurate rate forecast, or maintain adequate reserves to handle any large variations in revenue/expenses. • Economic conditions may change after rate adjustments are adopted. • Public perception if rate changes are necessary after rate adoption.

As can be seen, there are trade-offs between a single-year and multi-year rate adjustment. The major trade-offs appear to be related to the following:

- Annual cost to ratepayers of conducting a comprehensive rate study and public hearing process
- Stability and predictability of the rates from both the utility and customer perspectives
- Positive perception by the outside financial community (rating agencies) of multi-year rate adjustments

Summary

Utilities expend a significant level of time and effort to conduct a rate study and establish rates. As this issue paper points out, utilities may adopt rates for a single-year or multi-year rate setting period. In doing so, there are certain advantages and disadvantages. TVWD maintains a long-range financial plan, but adopts a biennial budget and rates on an annual basis. A key question for TVWD is whether it should revise its current approach of adopting rates on an annual basis and consider adopting rates for a multi-year period (e.g., a two-year period to match its budget, or a longer period based on the results of the District’s financial forecast model). Regardless of the District’s approach to this matter, a key element of either approach is the public outreach and education of customers to provide transparency and customer understanding of the expected rate adjustments.