

## Memorandum

**Date:** July 8, 2016

**To:** Memo to File

**From:** Melina Thung, SPU Deputy Director, Office of Utility Services

**Subject:** Recommendations from Study Group on Water and Wastewater Rate Structures

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### **Background:**

It is best practice for utilities to periodically review the structure and methodology used in the utility rates charged to customers. In 2014, SPU staff and two customer representatives from SPU's Water System Advisory Committee reviewed the drinking water rates structure and methodology and recommended several changes to the City Budget Office (CBO).

After reviewing these recommendations, CBO asked SPU to do three things:

- More fully address the threshold question of whether there is a compelling case to change the rate structure at this point.
- Analyze bill impacts of rate structure changes, paying attention to affordability for multi-family residents as well as single family residents.
- Engage customers early on in the analysis.

In early 2016, SPU created a Rate Design Study Group ("Study Group"), whose 14 members included City staff and SPU customers (*see Attachment 1 for list of members*). The job of the Rate Design Study Group was to:

- Gain an understanding of SPU's current water and wastewater rate structure and options.
- Offer an opinion on which options, if any, to move forward to a broader customer outreach effort this fall, with rate structure recommended changes to the Council in early 2017.

SPU also hired an independent expert, HDR Consulting, to assess SPU's current water and wastewater rate structures and options for moving forward.

## **Work of the Rate Design Study Group**

The Study Group had five meetings from May through early July. With the support of the rate consultant, the Study Group reviewed and discussed SPU's historical and current rate structures, the rate structures of other utilities, and potential changes to SPU's rate structure.

No water rate option received unanimous support from Study Group members. The strongest support was voiced for two choices:

Retain the status quo. Customers have not expressed concern about the current rate structure. Our rate consultant has confirmed that our rates are in line with generally accepted practices across the region and nation. And while there may be other rate structure options that improve upon one or more policy goals, the arguments to move away from the status quo are not compelling enough at this time.

Eliminate the third tier. The need for such a strong price signal directed at a small subset of customers has greatly diminished given the success of SPU's conservation programs and its current situation of excess supply capacity. And although it was explicitly designed as a penalty rate to discourage "water wasters," there is the possibility that the third tier unfairly burdens households with large families, avid gardeners, efficient irrigators of large lots, or people with undetected leaks. Finally, the third tier may not even increase conservation in the aggregate because the impact of the higher price on a few is offset by the slightly lower second tier price for the many.

The Study Group spent minimal time discussing the wastewater rate structure. The rate consultant's opinion is the status quo is a viable option. The other option for future consideration is adding a fixed charge component that is greater than the current 1 CCF minimum.

*See Attachment 2 for more detail on the Study Group observations.*

## **SPU Decision**

SPU wishes to thank the Study Group for its thoughtful review and discussion. Having customer perspectives and insights early in an analysis is invaluable, especially when the rate structure work so directly affects customers.

Support for the status quo was heard from several Study Group members and the rate consultant reports it conforms to industry standards. Given this, SPU believes there is not a sufficiently compelling reason to move forward with possible rate design changes at this time. This memo will be placed in a file in the Rates Group at SPU, so that it is available the next time SPU looks at its rate structure.

SPU will also do further analysis on the ideas for improvements that can be pursued within the status quo water rate structure. These ideas are described in Attachment 2.

**Attachment 1. Study Group Members**

**Seattle Public Utilities**

Regina Carpenter

Diane Clausen

Bruce Flory

Rich Gustav

Paul Hanna

Joan Kersnar

Craig Omoto

Melina Thung

**Water System Advisory Committee**

Tom Grant

Melissa Levo

Rodney Schauf

**Creeks, Drainage and Wastewater Advisory Committee**

Noel Miller

Gary Olson

**City Budget Office**

Aaron Blumenthal

**Attachment 2. Observations from the Rate Design Study Group**

**Question 1. Is retaining the status quo water rate structure a viable option for the Mayor’s Office to choose?**

Most of the members of the Study Group believe retaining the current rate structure is a viable option for the Mayor’s Office to choose. And several of the Study Group members believe the status quo is the preferred option. Some of the reasons are:

- As the old saying goes, "if it ain't broke, don't fix it." Customers have not expressed concern about the current water rate structure. According to our rate consultant, SPU's water rate structure is in line with generally accepted practices across the region and the nation.
- Some Study Group members said that moving away from the status quo should require a stronger, more compelling argument than what is needed to retain the status quo. While many Study Group members believe there are compelling arguments to change the water rate structure by eliminating the third tier rate, not all Study Group members believe this is compelling enough to move away from the status quo.

**Question 2. Should SPU consider eliminating the third tier water rate?**

The Study Group spent much time discussing the pros and cons of the third tier, and many in the Study Group believe there are strong reasons for eliminating the third tier rate. The table below summarizes the main points for and against retaining the third tier.

**Table 2. Arguments for and against retaining the third tier rate**

Arguments for retaining the third tier rate	Arguments for eliminating the third tier rate
<p><b>1. <u>The third tier penalizes single family residential households who use significant amounts of water</u></b>                      The third tier is seen as a "rate cliff" that customers want to avoid, and so provides a strong incentive to conserve water in the summer, especially for households with many people and/or large lawns/gardens. It is likely that in most cases, consumption in the third tier represents discretionary use of water to maintain irrigated landscapes as opposed to essential uses (i.e. bathing, toilets, cleaning, cooking, etc.).</p> <p><b>2. <u>The third tier is an important drought tool</u></b>                      During regular water years, the potential negative consequences of the third tier can be mitigated by setting the rate level closer to the second tier rate. During severe droughts, the third tier could be increased in</p>	<p><b>1. <u>The third tier has negative unintended consequences</u></b>                      The third tier is a penalty rate, designed to discourage wasting water. Some of the water consumption in the third tier may be households with large families, or avid gardeners, or people with undetected leaks. These customer use large amounts of water but may or may not be wasteful.</p> <p><b>2. <u>Eliminating the third tier may have little effect on conservation</u></b>                      Eliminating the third tier, if combined with increasing the second tier rate, increases the conservation incentive for more customers. SPU staff estimate the net effect may be a wash – that is, having a third tier rate may generate no more conservation savings than not having a third tier rate (and having a higher second tier rate).</p>

<p>order to send a higher price signal to residential customers for discretionary water usage.</p> <p><b>3. <u>The third tier may promote social equity</u></b> While some low income households are impacted by the third tier, 75% of the customers with consumption in the third tier in 2014 were in census tracts with higher-than-average income.</p>	<p><b>3. <u>The third tier reduces revenue stability</u></b> The impact of weather-induced swings in summer consumption on revenue is amplified.</p> <p><b>4. <u>The third tier rate decreases economic efficiency</u></b> Not every customer faces the same marginal rate and the third tier rate sends a price signal to a subset of customers that is much higher than SPU’s estimate of the marginal social cost of water. For example, a residential customer who gets into the third tier due to irrigating a large lawn pays a marginal rate almost twice as high as a general service customer irrigating the same size lawn with the same amount of water.</p>
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***Question 3. Should SPU use its social equity toolkit if and when it moves forward with rate structure options?***

The Study Group unanimously believes that SPU needs to consider social equity if it moves forward with rate structure options. To support social equity considerations, SPU has a toolkit that decision-makers should use when developing options.

***Question 4. Are there improvements that can be pursued within the status quo water rate structure option?***

The Study Group believes there are improvements that can be pursued, even if the status quo rate structure is retained. Suggestions to consider in the next water rate study are:

- Improve financial stability. Increase the meter charge to be more in line with the meter charges of other utilities. This will improve revenue stability.
- Modify third tier rate. Third tier rates are levied on residential summer water consumption when monthly summer water consumption exceeds for a residential household exceeds 18 ccf. This threshold could change, and be set higher at (for example) 20 ccf or 25 ccf. These levels are in line with other local water utilities. Another consideration is to continue to hold the third tier rate constant or even look at lowering the rate.
- Review leak policy. Currently, water leaks that occur in the summer are subject to the higher summer rates, including the third tier rate. The Study Group recommends reviewing this policy.
- Review rate parity issues and options. SPU is in a balancing act between setting equivalent residential and commercial rate components, and assigning costs to the two retail rate classes in alignment with the cost allocation model. Rate parity and cost allocation issues and options can be reviewed in the next rate study, as necessary.

- Create a new example customer (multifamily resident). This will highlight rate impacts on multifamily residents during the rate setting process and will increase awareness during rate making decisions.