

UTILI-FACTS

Utility Funding and Rate Design:

A Guide for Customers of Private or Investor-Owned Water or Wastewater Utilities

Water and sewer utilities require funds to provide services to their customers. Capital improvements are funded through various sources, including surcharges from customers in certain situations. Daily operations are funded by charging customers a set rate.

Funding Sources for Capital Improvements

Improvements to utility facilities and operations are funded by one or more of the following:

- **Cash flow** from operations;
- **Loans** from banks or other lending agencies;
- **Investment** by the owner; and/or
- **Surcharges** from customers.

Cash flow from operations is the most difficult to use for funding improvements. First, cash flow depends on the accuracy of the utility's rate formulas. Second, depreciation and return are the only components of the rates that are not cash-funded. If the rates are set too low, depreciation and return may be paying for other operational expenses.

Loans from banks or other lending agencies are not easy for utilities to obtain. The period the utility has to pay back the loan is typically shorter than the period over which the utility is allowed to recover the cost of the capital improvements through rates. Also, since there is uncertainty about the accuracy of a utility's rates, banks require that the utility demonstrate the ability to repay the loan.

Funding from the owner of a private or investor-owned utility (IOU) depends on the owner's own financial standing. It may be desirable for the owner of an IOU to contribute additional funds for capital improvements in the form of additional equity. However, this may not be possible.

Surcharges from customers may be the only choice left to the IOU if all other sources of funding are not available. Surcharges are subject to approval by the Public Utility Commission of Texas (PUC) or a city with jurisdiction over an IOU operating within the city's corporate limits.

Rate Design

Rates are proposed by the IOU and subject to approval by the PUC or a city with jurisdiction over an IOU operating within the city's corporate limits. The IOU calculates the proposed rates using the

following information:

- **Determination of its actual cost of service** for a recent 12 month period (usually the IOU's most recent fiscal year).

The cost of service includes:

- **Allowable expenses**, such as operations and maintenance expenses, depreciation expense, and taxes.
- **Return (interest) on invested capital.**
- **Adjustment of expenses** that have changed or will change after the end of the 12 month period.

(The change must be known and measurable.)

Rates Are Determined By

- How much water was sent into the distribution system and how much water was actually consumed by customers, and
- Allocation of the cost of service to the minimum monthly charge on your bill and to the amount you pay for the gallons used each month.

The expenses that make up the cost of service can be described in three different ways:

- **FIXED:** Expenses that occur every month whether or not you use any water or sewer service; for example, office rent, telephone, money owed on the well or pump;
- **VARIABLE:** Expenses that vary depending on the amount of water or sewer services you use; for example, chemicals to treat the water and electricity to operate the well; and
- **COMBINED:** Expenses that have an element of both; for example, an operator's pay

Rate case expenses incurred by the IOU to process the rate application and to attend and be represented at hearings for the rate

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QUESTIONS:

Call: 512-936-7405

Email: water@puc.texas.gov

Write:

Public Utility Commission
Water Utility Regulation
Division
1701 N. Congress Ave.
P.O. Box 13326,
Austin, TX 78711-3326

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change application. Such expenses may also include travel expenses, and/or costs of any mailing, printing, or copying of the application and additional supporting documents. Typically, reasonable and necessary rate case expenses are surcharged over a reasonable period of time.

The challenge for water and sewer IOUs is to design rates that cover their regular expenses without undercharging or overcharging customers.

For additional information please contact your IOU or the PUC.