

UTILI-FACTS

Utility Funding and Rate Design:

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

Water and wastewater utilities require money 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 at set rates.

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;
- Money from 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 tied to actual expenses. They are also the source of funds if the rates are not properly designed.

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 system 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.

Money 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 improvements in the form of additional equity. However, this may not be possible due to an already high level of debt by the IOU.

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 (PUCT) 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 PUCT or a city with jurisdiction over an IOU operating within the city's corporate limits. The IOU calculates proposed rates using the following information:

- Determining 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 its invested capital.

- Expenses incurred by the IOU to process the rate application and to attend and be represented at the hearing. Such expenses may include cost of an attorney to represent the IOU; costs associated with preparing the application including those incurred by consultants, accountants, or engineers; travel expenses, and/or costs of any mailing, printing, or copying of the application and additional supporting documents.

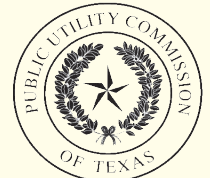
- Adjusting any expenses that have changed or will change after the end of the 12 month period. (The change must be known and measurable.)
- Determining how much water was sent into the distribution system and how much water was actually consumed by customers.
- Allocating the cost of service to the 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:

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

Rate design is an art and not a science. The process is difficult to perform accurately. The challenge for water and wastewater IOUs is to design rates that cover their regular expenses without overcharging customers.

For additional information please contact your IOU or the PUCT.



QUESTIONS:

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