

# COST-RECOVERY POLICIES FOR PUBLIC UTILITIES

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**Abstract.** This paper describes (1) the importance of developing written cost-recovery policies for publicly held water and sewer utilities, (2) recommends steps for developing such policies, and (3) gives examples of policy issues to consider when developing a cost-recovery policy document.

## WHY WRITTEN POLICIES ARE IMPORTANT

Policies guide water resource decisions. Whether policies are maintained in written or unwritten form, local policies impact decisions on budgeting, rate-setting, environmental protection, facility sitings, levels-of-service, and many other issues. Policies are generally developed and communicated through the political process by elected or appointed decision-makers. If properly developed, policies will create a framework in which allocation of scarce water resources can be fair and reasonable and long-term goals can be achieved.

Written policy documents are the best mechanism for communicating decision-makers' policies for several reasons:

1. Written policy documents provide consistent guidelines that result in equitable, non-arbitrary, and non-discriminatory treatment of citizens, customers, developers, and other water resource beneficiaries.

2. Having policies in writing eliminates guesswork for utility and governmental staff by allowing them to make decisions that are consistent with the intentions of decision-makers and the public.

3. The creation of a policy document requires open discussion of issues among decision-makers and the public. This process gives decision-makers a better understanding of technical issues and local priorities, which helps them clarify their own philosophical positions. Also, public consensus on some issues, such as water conservation, can be enhanced by the exercise.

4. A policy document provides a reference source for voters and customers to understand the decision-makers' existing positions and act accordingly to either support or promote change of these positions.

5. Policy documents help decision-makers identify needs for new or revised policies and bring these needs to the attention of the public, and vice versa.

6. Policy documents provide a means of distributing information about the utility to third parties, such as federal or state agencies, bond-rating agencies, insurance companies, or underwriters.

## GUIDELINES FOR DEVELOPING COST-RECOVERY POLICIES

The following steps are recommended for developing cost-recovery policies for publicly-held water and sewer utilities in Georgia.

1. Review existing cost-recovery policies, written and unwritten. Are policies being applied fairly at this time? Are all developers and customers treated uniformly? For example, if some customer groups are charged differently from others, what is the rationale? Is that rationale still as applicable today as it was when first enacted?

- Begin to develop a list of "how things are traditionally done." Group the ideas into categories such as rates, impact fees and other connection charges, billing, developer charges, service extensions. This list can be considered the first draft of a written policy document.

2. Examine and develop a consensus for the utility's cost-recovery goals and objectives. Interview staff, elected decision-makers, and citizens' groups to identify appropriate goals and objectives. For example, has one citizens' group been requesting the extension of sewer service into their neighborhood for a long time? What is preventing the utility from meeting this objective? If the cost of the extension is preventing the extension, both the fairness of the refusal and cost-recovery alternatives should be examined. There may be a feasible way to extend service and equitably recover the costs.

3. Evaluate how well existing policies are meeting these goals. For example, if the elected decision-makers have set a goal for the water and sewer utilities to be self-sustaining, and one utility is being subsidized by *ad*

valorem tax revenues or rates from the other utility, then a policy change is in order.

4. In testing the adequacy of existing policies, solicit help from staff in each department and the public so that a wide spectrum of issues is covered. If your community has a citizens' advisory council, ask for their input in the beginning. This may prevent conflicts and promote cooperation later.

5. Distribute a list of current policies, goals, and any discrepancies between the policies and goals to the decision-makers. They may find such issues very educational and even surprising. They may also realize that they have not yet clarified their own intentions on many issues and may ask for further information from staff.

6. Develop an organized, clearly written draft document including the staff's and decision-makers' comments and distribute it to the customers through a news-letter, bill insert, or the local newspaper. Make it clear that the document is a *draft* and that public response is welcomed and encouraged. If you feel that any items will be particularly controversial to certain groups or individuals, get them involved up-front. Explain the need for the policy or action, and ask them to work out a solution to the problem.

7. Hold a special public hearing or publicize that the cost-recovery policy document will be considered and discussed at a regular public meeting. Listen to those who express interest and incorporate their ideas.

8. When each party's input can be incorporated, or compromises can be reached, revise the policy document for adoption by the elected decision-makers. From this point, staff will be allowed to take appropriate action with a clearer understanding of the needs and desires of the decision-makers and the customers.

9. Because all financial planning occurs in a dynamic environment, cost-recovery policies will warrant revision from time to time. Although this document will be formally adopted and viewed as an official guideline, it should be regarded as changeable and adaptable (rather than fixed and permanent) positions of the utility. The customers, decision-makers, or staff of the utility may request revision of these policies annually prior to adoption of budgets and new rates.

## EXAMPLE POLICIES

Several of the goals, objectives, and policies recently adopted by the Mount Pleasant Waterworks and Sewer Commission in South Carolina illustrate the types of issues Georgia utilities may wish to examine.<sup>1</sup>

### Cost-Recovery Goal

A goal may be defined as the overall long-term end toward which policies are ultimately directed.<sup>2</sup> Thus, the

cost-recovery goal is a summary statement of what the utility would like to achieve with its cost-recovery program. For example:

*Goal 1. The cost-recovery goal of the utility is to fully and equitably recover all costs of operating, maintaining, and expanding the water and sewer utilities from the customers of the service area while maintaining a high degree of financial stability.*

This goal encompasses the utility's intent underlying its cost-recovery decisions. All costs must be fully recovered for the utility to continue providing quality water and sewer services to its customers and meeting federal and state regulations. It is also important that rates are equitable so that no one customer class is subsidizing another and so that existing customers are not subsidizing growth unless a decision has been made to do so to meet a stated social objective (such as to create jobs). Financial stability is important to ensure reasonable rates and a strong ability to borrow money when necessary.

### Cost-Recovery Objectives

Measurable cost-recovery objectives help indicate the extent to which the utility's policies are effective in meeting the cost-recovery goal.<sup>2</sup> Three examples are provided.

*Objective 1. Improve Credit Rating—The utility will achieve an uninsured credit rating of "A" or better by both Moody's and Standard & Poor's for the combined water and sewer systems or for each utility separately.*

This objective will require that the example utility improve the system's current ratings, which will result in savings on planned future debt.

*Objective 2. Minimum Fund Balances—The utility will meet or exceed minimum Fund balance requirements including all mandatory requirements specified in existing bond ordinances and two additional requirements hereby established by the utility:*

*•Beginning in FY 1993, the General Utility Fund will maintain a minimum balance of not less than a 45-day working cash reserve as recommended by the American Water Works Association (AWWA). (This sum will equal 45/365 times the total annual operating budget, including debt service and capital outlays).*

*•By the end of FY 1994, the sum of the balances in the Extension and Expansion Fund (E&E Fund) and the Renewal and Replacement Fund (R&R Fund) will be not less than 10 percent of the following year's planned capital expenditures. (This requirement will equal the current year's CIP projects plus the current year's budgeted routine capital outlays times 10 percent).*

*In the event cash reserves are drawn below these levels, the utility will automatically make it a priority to build them back up to the level of the stated objective within six months.*

Unrestricted cash-on-hand gives the utility flexibility in funding unbudgeted but necessary items, paying for capital cost overruns, implementing small capital projects without bonding, and providing cash for emergency situations, such as repairs after natural disasters. But, it is at times prudent to decrease the amount of cash-on-hand in order to defease debt, avoid or delay bond issues by cash-funding capital projects, or prevent or lessen the need for rate increases. The balance between saving and spending cash reserves is a managerial policy decision; this objective defines the level of cash-on-hand below which the utility does not intend to draw its unrestricted cash reserves and it creates a reasonable target level of reserve balances to maintain over time.

**Objective 3. Equitable Charging Practices—Equity between customer classes and between existing and future customers will be maintained at current levels or enhanced where practicable by employing principles that promote equity in the calculation of rates, fees, and charges.**

- Typical monthly bills will be kept within a range of plus or minus 15 percent of other communities in the county. (Monthly bills will fall in a range of between 85 percent of the lowest to 115 percent of the highest in the survey based on 7,000 gallons of usage per month).

- Impact fees and other connection charges will be calculated and adopted to ensure that "growth pays for growth" to the maximum extent practicable.

Like the AWWA,<sup>3</sup> the example utility believes the public can be served best by self-sustained enterprises adequately financed with rates based on sound engineering and economic principles. In general, these engineering and economic principles call for a public utility pricing system to be (1) adequate to generate revenues sufficient to meet all revenue requirements, or costs, of the utility without returning a profit, and (2) reasonably fair to each customer class served.

The example utility operates as a business enterprise independent of other revenue sources. In other words, the water and sewer utilities are managed as an enterprise fund, and prices are calculated to approximate those that would prevail in a competitive market. Furthermore, the utility endeavors to minimize subsidies between customer classes and between existing and future customers because subsidies provide a benefit to some by shifting the cost to others with no underlying economic justification. All of these issues may be reflected in a cost-recovery policy document.

### Cost-Recovery Policies

Cost-recovery policies guide the way in which the utility conducts its programs and activities to achieve the identified goal.<sup>2</sup> Eight examples are provided:

*Policy 1. The authority to set rates, fees, and charges rests with the elected decision-makers of the utility.*

This authority is granted according to the Charter of the utility.

*Policy 2. The utility will not provide free services and will not waive adopted rates, fees, or charges to any customer or group of customers because to do so is arbitrary and discriminatory. Special payment schedules may be requested in writing on the grounds of hardship. Approval of such requests is discretionary.<sup>4</sup>*

The authority to grant special payment schedules for adopted rates, fees, and charges rests with the elected decision-makers of the utility and may be delegated to the manager. Such special payments schedules are granted sparingly and only once. The local water and sewer use ordinance allows the utility to place a lien on the title of the property for unpaid bills.

*Policy 3. The basic principles the utility will use in calculating rates, fees, and charges are as follows:*

- All costs incurred will be considered investments of the resources of the utility. These resources include the capital costs of developing facilities and capacity for providing services; the operational costs of providing services from these facilities; and the administrative costs of programs and activities related to the facilities and services provided.

- Utility services are goods and their full costs will be recovered. Monthly rates will be reviewed annually by utility staff and updated as often as necessary to fully recover costs and meet the requirements of the adopted cost-recovery policies of the utility.

- As a responsible natural monopoly, the utility will price its services to recover costs without generating a profit over time.

- The entire pricing system will be as equitable as practicable so that optimal economic use of the utility's resources will occur.

*Policy 4. In-house or independent cost-recovery reviews of monthly rates will be prepared annually. A comprehensive independent cost-recovery study of rates, fees, and charges will be conducted at least every 5 years or more frequently if deemed necessary by the utility. (Under the terms and conditions of EPA grants, sewer rates must be evaluated every 2 years for adequacy and equity).*

The annual updates may be done by utility staff or an outside consultant. At a minimum, rates, fees, and charges will undergo a comprehensive review every 5 years by a qualified, independent consultant to maintain a sufficient and equitable cost-recovery system. Cost-recovery studies should be conducted more frequently if major changes occur in (1) costs, (2) regulations, (3) technologies, or (4) the demographics of the customer base.

*Policy 5. Monthly water and sewer volumetric rates will be set to recover all costs and funding requirements of the*

utility that are not to be recovered from the other rates, fees, and charges of the utility, including minimum Fund balance requirements.

In the interest of discouraging excessive or wasteful water use and encouraging conservation of water resources, the utility's water and sewer rate schedules include flow-based charges. Thus, the customers who use more water and generate more wastewater pay higher total charges than those who conserve water. Volumetric rates for water and sewer are calculated and levied per 1,000 gallons of metered water per account, rounded to the nearest 100 gallons.

*Policy 6. A water conservation rate of 100 percent of the volumetric rate will be levied to all water customer classes for monthly metered water usage in excess of 9,200 gallons times the number of residential equivalent units (REUs) assigned to the account.*

To help protect the long-term availability of water supply, water conservation may be one of the most important issues facing many utilities in the future. Water conservation rates encourage efficient water use and penalize customers who waste water.

The quantity of metered water used to calculate excessive usage for customers with irrigation meters is the sum of the readings for the irrigation and household meters unless separate water impact fees were paid for the two meters. In this case, each meter's usage is treated separately to determine excessive usage.

Revenues from the water conservation rate are primarily used to help offset any decrease in revenue from the volumetric rate that results as customers use less water in response to the conservation rate.

*Policy 7. To the nearest extent practicable, the utility will require that growth pays for growth.*

The purpose of capital-recovery charges is to recover the full costs of providing capital facilities to new customers, to make system improvements, and to meet the demands of increasing regulatory action. To help prevent existing customers from subsidizing the cost of capital facilities required for growth and development in the service area, the example utility levies impact fees designed to make growth pay for growth.

Impact fees are charges assessed against new development to recover part of the capital costs of the water and sewer utility infrastructure needed to serve the new customers. As part of the capital-recovery charges, the impact fees allow the utility to recover the capital costs of developing the new service directly from the customers who benefit from the service, rather than from all customers of the systems through monthly rates.

Under the Georgia Development Impact Fee Act, impact fees must be properly developed to recover the

costs of growth as fairly as possible from the beneficiaries of the facilities developed by the utility.

*Policy 8. Impact fees will be designed to recover identified major capital costs associated with providing water and sewer service facilities, including but not limited to water treatment plants, storage facilities, pumps, and distribution mains; sewer collection, transmission, storage, and treatment facilities; and other capital equipment with expected lives of 10 years or more.*

- The utility's water and sewer impact fees will have a rational nexus (a reasonable link) between the fee levied and the benefit received by the future customer.

- Impact fees will recover both the costs of existing excess capacity in capital facilities and new facilities planned specifically for growth.

- The impact fee cost basis will be the original costs (without deducting depreciation) and planned costs discounted over 10 years at the EPA's stated discount rate. (Currently 8.25 percent).

- A "double payment credit" will be deducted from the impact fee to prevent future customers from paying for debt financed capacity in both their impact fee and their monthly rates.

- Impact fees will be updated at least every 5 years in order to maintain equity to both existing and future customers to the maximum extent practicable.<sup>5</sup>

## REFERENCES

- <sup>1</sup>FY 1993 Cost-Recovery Policies. Mount Pleasant Water works and Sewer Commission. Mount Pleasant, South Carolina. Adopted July 1, 1992.
- <sup>2</sup>Definitions extracted from Florida Administrative Code, Rule 9J-5, as related to the 1985 Growth Management Act.
- <sup>3</sup>American Water Works Association. Manual No. M1. *Water Rates. Manual of Water Supply Practices.* 1983.
- <sup>4</sup>American Water Works Association. Manual No. M26. *Water Rates and Related Charges. Manual of Water Supply Practices.* 1986.
- <sup>5</sup>American Water Works Association. Manual No. M29. *Water Utility Capital Financing.* 1988.