



Legislation Text

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City of Alexandria, Virginia

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MEMORANDUM

**DATE:** APRIL 3, 2019

**TO:** THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

**FROM:** MARK B. JINKS, CITY MANAGER /s/

**DOCKET TITLE:**

Virginia American Water Company Rate Case (PUE-2018-00175).

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**ISSUE:** Consideration of Virginia American Water Company's proposed rate increase.

**RECOMMENDATION:** That City Council:

- 1) Indicate to the State Corporation Commission (SCC) the City's opposition to Virginia American Water Company's (VAWC) proposed 15.84% overall increase in revenue requirement over a 3-year period and resulting rate increases, including the proposed 10.8% Rate of Return on Common Equity;
- 2) Advocate for a more gradual introduction of consolidated revenue requirements and application of single tariff across all districts to lessen the sharp increase in rates proposed to be borne by customers in the Alexandria District;
- 3) Ask staff to continue to investigate the benefits and trade-offs of selling the City's fire hydrants to VAWC;
- 4) Oppose VAWC's proposal to establish the Water and Wastewater Infrastructure Service Charge (WWISC) as a permanent program until the authorized pilot is complete and undergoes thorough and thoughtful cost and benefit evaluation by the SCC.

**BACKGROUND:** The Virginia American Water Company (VAWC) is a public water utility affected with the public interest to provide the essential service of water treatment and delivery to individuals and businesses. A public water utility is uniquely able to wholly provide the treatment and delivery of water more efficiently and effectively than a collection of smaller water utilities could otherwise provide and is considered a *natural monopoly*. Natural monopolies like a public water utility lack market competition and are subject to economic

regulation. Economic regulation includes the public or governmental intervention to ensure the provision of safe, adequate, and reliable service at revenues and prices are sufficient, but no more than sufficient, to compensate a utility for its costs including an appropriate return on its investment in capital in order to achieve public benefits that may not otherwise be achievable given a lack of competitive markets. Specifically, economic regulation includes governing the allowable revenue utilities received, the rates and prices utilities charge, a utility's budgets and capital investments, programs for water efficiency, and related services. In the Commonwealth of Virginia, the State Corporation Commission has the statutory role to administer economic regulation of public utilities, including public water utilities.

The SCC generally applies a cost of service approach to the economic regulation of public water utilities in Virginia. This cost of service approach typically includes the total of operating expenditures and capital expenditures, including a rate of return, for providing service to each customer class - i.e. residential, business, industrial, etc. Operating expenditures include costs for operations, maintenance, depreciation, taxes, etc. and are recovered on a dollar-for-dollar basis. Capital expenditures reflect investment in capital assets and includes a rate of return reflecting a weighted average cost of capital that generally includes the costs of debt and a rate of return on common equity according to equity investment by shareholders. The cost of debt is typically fixed. The rate of return on common equity is typically a determination by the SCC. This determination includes the SCC's review of what rate of return on common equity is fair and reasonable. When evaluating what rate of return on common equity is fair and reasonable, the SCC must weigh many factors of the public water utility's financial and operational risk exposure, financial markets, etc. In short, in the cost of service approach to economic regulation, a public water utility derives a profit from investment in capital, while all other costs are generally passed through to customers. The result of the cost of service approach forms the public water utility's revenue requirement or allowable revenues.

Once the SCC determines the public water utility's revenue requirement, the allowable revenues are translated into rates to charge customers. These rates form the mechanism for a public water utility to recover the revenue they've been authorized. Public water utilities, like Virginia American Water, may apply a two-part rate schedule to charge customers for each billing period. This two-part rate schedule consists of a fixed, "minimum charge" and a "rate" charge according to the volume of water used. A billing period is typically thirty (30) days long. In certain cases, Virginia a public water utility may be able to levy additional charges as permissible by statute or by other arrangement, and taxes and third-party surcharges may also apply.

To conduct the aforementioned process of economic regulation, and determination of a revenue requirement and rates, a public water company like Virginia American Water files a rate application with the SCC. The SCC creates a docket, and a process akin to the court of law takes place where the public water company and interested parties litigate the merits for or against an increase in a revenue requirement and rates. Subsequently, the SCC provides an order with the determination of their findings.

On November 2, 2018, VAWC submitted an application to the SCC to petition for an increase in allowable revenues and to increase customer rates, along with other policy and programmatic changes (the SCC assigned Case Number PUR-2018-00175).

**DISCUSSION:** VAWC - a regulated subsidiary of American Water Works Company, Inc. or American Water (NYSE: AWK) - is a strong corporate partner of the City of Alexandria and is positively engaged in the Alexandria community. In addition, VAWC also operates water treatment and distribution service in four districts in Virginia, including the Alexandria District, Prince William District, Hopewell District, and Eastern District. VAWC also operates wastewater treatment services in the Dale City area of Prince William County.

On November 2, 2018, VAWC submitted an application to the SCC to petition for an increase in allowable revenues and to increase customer rates, along with other policy and programmatic changes (the SCC assigned Case Number PUR-2018-00175). VAWC last filed a rate application to the SCC in 2016 with subsequent approval in 2017.

### **Overview**

VAWC attributes increasing capital investment in their infrastructure as the primary reason for petitioning the SCC for an increase in allowable revenue and to increase customer rates. Moreover, per statutory authority, VAWC continues an elective process of consolidating their revenue requirement and accelerating a 3-year phased-in approach to applying a single tariff across each district for each customer class. Finally, VAWC reflects slight reductions in operations and maintenance costs, and implications of the federal Tax Cuts and Jobs Act of 2017, to marginally reduce the overall revenue requirement proposal below what may have otherwise been proposed.

### **Capital Improvement**

VAWC attributes increasing capital investment, about \$98 million, in infrastructure across all service districts as the primary reason for petitioning the SCC for an increase in allowable revenue and to increase customer rates. Attachment 1 provides an overview of capital investments directly or indirectly in the Alexandria District. These capital investments have taken place either through VAWC's Alexandria District capital plan or through the WWISC. The WWISC is discussed in further detail below.

### **Revenue Requirement & Rate of Return on Common Equity**

VAWC seeks a 15.84% increase in allowable revenues based on a 10.8% proposed Rate of Return on Common Equity (ROE). In total, VAWC requests an approximately \$5.98 million increase in allowable revenues from water service through a 3-year phased consolidation of revenue requirement and transition to a single tariff across all districts for each customer class.

Table 1 provides the authorized ROE for American Water's largest regulated subsidiary water companies which ranges from 9.1% to 10.0%. The most recent rate case among American Water's subsidiaries - in West Virginia - resulted in a 9.75% ROE. In VAWC's most recent rate case, the SCC authorized a 9.25% ROE. In City staff's judgement a 10.8% rate of return as proposed by VAWC is too high.

*Table 1: Rate base, Authorized ROE, Authorized Equity Ratio, and Rate Case Effective Date for American Water's Largest subsidiary water utilities.*

American Water Regulated Subsidiary	Authorized Rate Base (\$000s)	Authorized ROE (%)	Authorized Equity (%)	Effective Date of Rate Case
California	\$ 498,135	9.20%	55.39%	1/1/2018
Illinois	\$ 883,386	9.79%	49.80%	1/1/2017
Indiana	\$ 841,915	9.75%	41.55%	1/29/2015
Kentucky	\$ 405,704	9.70%	47.36%	8/28/2016
Missouri	\$ 1,249,293	10.00%	52.80%	5/28/2018
New Jersey	\$ 2,950,471	9.60%	54.00%	10/29/2018
New York	\$ 275,463	9.10%	46.00%	6/1/2017
Pennsylvania	\$ 3,162,597	10.00%	53.75%	1/1/2018
West Virginia	\$ 652,900	9.75%	48.40%	2/25/2019

Should the SCC accept VAWC's proposal as is, the effect is an increase in allowable revenues from Alexandria District water customers of \$7.8 million or a 48% increase over currently-allowable revenues at the end of the 3-year period. Allowable revenues for residential, commercial, and industrial customer classes in the Alexandria District will increase by 60%, 42%, and 6%, respectively. However, should the SCC determine VAWC should be approved for a lower ROE, the total revenue requirement will subsequently decrease. The total magnitude of any decrease in relationship to a change in the approved ROE is complex and outside the scope of staff's ability to immediately address.

Of particular note may be the observed discrepancy between VAWC's total proposed increase in allowable revenues (\$5.98 million) and the increase apportioned to Alexandria District customers (\$7.8 million). Through the 3-year phased consolidation of VAWC's revenue requirement and transition to a single tariff across all districts for each customer class, customers in the Alexandria District will experience an increase in rates while customers in the Prince William, Hopewell, and Eastern Districts will experience a decrease in rates. The net decrease in allowable revenues from these other districts is about \$1.79 million.

### **Rates**

In a memo dated January 14, 2019 (Attachment 2), VAWC provides example billing calculations for Alexandria residential customers who hypothetically might use 2,500 gallons or 4,500 gallons, respectively. A summary of these monthly billing calculations are found in Table 2 below. For example, in the first year the proposed new rates would be implemented, an Alexandria residential customer who uses 2,500 or 4,500 would see their total monthly billing increase by 8% or 32% in the first year, respectively, as compared to their current monthly billing. In the second year of the proposed new rates, the same Alexandria residential customer would see their monthly billing increase from the first year by 3.8% or 12.4%, respectively. Finally, the same Alexandria residential customer would see their monthly billing increase between the second and third year by 3.6% or 11%, respectively. According to VAWC, an average Alexandria residential customer uses about 4,300 gallons per month. **This represents a 65% increase over a three-year period.**

*Table 2: Example VAWC Billing Calculations for Alexandria Residential Customer*

Gallons Used per Monthly Billing	Currently Monthly Billing	Year 1 Proposed 2019	Year 2 Proposed 2020	Year 3 Proposed 2021
2500	\$ 15.98	\$17.26 (8%)	\$17.91 (3.8%)	\$18.56 (3.6%)
4500	\$ 19.91	\$26.29 (32%)	\$29.55 (12.4%)	\$32.79 (11%)

As previously discussed, VAWC uses as a two-part rate tariff consisting of a minimum charge and a volumetric rate charge. In this rate application, VAWC proposes no changes to the minimum charge for Alexandria's residential or commercial customers. Therefore, all of the changes VAWC proposes in the rate application reflect changes to the volumetric rate charges. Accordingly, the current volumetric rate and proposed volumetric rates for each of the proposed rate years for residential and commercial customers for every 100 gallons of water use above 2,000 gallons per billing period is shown in Table 3 below. In addition, since this rate application reflects three years of proposed changes in rates, the cumulative percentage change over the 3-year period over the current year, and the year-over-year percentage change are also shown below the proposed volumetric rate value. The cumulative percent change over the 3-year period for residential and commercial customers is about 262% and 64%, respectively.

*Table 3: Changes in Proposed Volumetric Rates, including Cumulative and Year-over-Year % Changes*

	Current Rate (\$ / 100 gallons)*	Year 1 Proposed 2019	Year 2 Proposed 2020	Year 3 Proposed 2021
Residential	\$ 0.1964	\$0.4515 (129.9%/129.9%)	\$0.5819 (196.2%/28.9%)	\$0.7118 (262.4%/22.4%)
Commercial	\$ 0.1964	\$0.2674 (36.1%/36.1%)	\$0.2949 (50.1%/10.3%)	\$0.3223 (64.1%/9.4%)

As previously noted, VAWC estimates an average Alexandria residential customer uses about 4,300 gallons per month. Based on data in the rate application, an average Alexandria commercial customer uses about 72,300 gallons per month. As such, after the Year 3 proposed rates take effect, the estimated increase in an average residential or commercial customer's annual billing will be about \$156 and \$1,067 per year over what they current pay, respectively.

Under SCC rules, the proposed rates for the first-year increase will take effect May 1, 2019. Each May 1 thereafter, until 2021, rates will increase until they reach the Year 3 level. Should the SCC later determine a lower rate increase, or no rate increase is appropriate, customers will be refunded accordingly, with interest as appropriate.

### **City of Alexandria Government Rates**

After review of VAWC's application, there is no evidence of any changes to rates for water use by the City of Alexandria's government operations including for City facilities, parks, pools, etc. Government organizations, like the City of Alexandria, are charged under different rate tariffs than conventional commercial customers.

### **Fire Hydrants**

Included in VAWC's application is a proposal to acquire the City's fire hydrants. Currently, the City owns and

maintains fire hydrants in the right-of-way while VAWC provides the necessary water service. The City is the sole jurisdiction served by VAWC whose fire hydrants are not owned and maintained by VAWC. The City and VAWC have engaged in preliminary discussions regarding sale of the City's fire hydrants to VAWC. As such, VAWC has conducted an initial appraisal and valuation process for the fire hydrants which is reflected in the rate application and VAWC's rate base. Should the City wish to sell the fire hydrants to VAWC, the City requires specific processes - including independent appraisal and valuation, public hearing, and City Council consideration - which may or may not be consistent with the timeline of VAWC's rate application. City staff have engaged outside legal counsel to assist in this matter and are working to identify a third-party appraisal and valuation expert. Moreover, City staff will be meeting with SCC staff to discuss the regulatory process of sale and transfer of property to a water utility. Part of this sale discussion will need to focus on whether the sale is in the best interest of residents and businesses in Alexandria. While a sale would result in one-time revenue gain and some General Fund annual savings to the City, it would come at the cost of higher water rates for Alexandria customers.

### **Water and Wastewater Infrastructure Service Charge (WWISC)**

VAWC takes the opportunity of this rate case application to propose programmatic changes to the WWISC. The WWISC is an additional billing charge which VAWC imposes to accelerate the funding of non-revenue infrastructure replacement. The WWISC was originally proposed in a 2014 rulemaking before the SCC, and adopted as a 3-year pilot program for the Alexandria District as a part of VAWC's most recent rate case which concluded in 2017. At the direction of City Council, City staff intervened in the aforementioned rulemaking and rate cases in opposition of the adoption of the WWISC on the basis of SCC's statutory authority to approve imposition of such a charge. Ultimately, the SCC approved the WWISC in VAWC's most recent rate case final order. The City appealed the decision to the Virginia Supreme Court who ultimately adjudicated on the side of the SCC.

In this rate case, VAWC is not proposing any specific WWISC investments nor establishing a specific rate. Future WWISC investments and rates will be proposed in a separate application to the SCC. Instead, as outlined in the WWISC's terms and conditions, the WWISC is being reset to \$0.00 upon completion of its investment period (typically one year) and the infrastructure investments have been transferred to rate base. The infrastructure investments already funded through the WWISC now manifest themselves in the rate base for which VAWC calculates aforementioned allowable revenue requirement.

Of particular note in this rate case, VAWC proposes programmatic changes to the WWISC. VAWC proposes matriculating its WWISC from a pilot to a permanent program two years ahead of the originally-proposed time for consideration of permanence by the SCC. Moreover, VAWC proposes expanding its coverage beyond the Alexandria District to all districts. The net effect is uncertain. On one hand, expanding the WWISC's coverage to other districts will likely have similar effects to the cons funding levels consolidation and application of single tariff, albeit with other districts likely supplementing the WWISC investment costs of the Alexandria District. On the other hand, re proposed to be evaluated on an annual basis, and City Staff understand forthcoming investments will likely be determined in a subsequent SCC case proceeding. As such, the net financial impact is unable to be determined. However, City staff cautions the matriculation of the WWISC from pilot to permanent status without the SCC's prudent evaluation of the program's costs and benefits before the program's pilot period is complete.

**NEXT STEPS:** City staff has reviewed VAWC's rate application and recommend the City Council oppose VAWC's proposed 15.84% overall increase in revenue requirement and resulting rate increase, including the proposed 10.8% Rate of Return on Common Equity. An increase is warranted, but not at a revenue increase of 15.84%. Moreover, City staff recommends that City Council advocate for a more gradual introduction of

consolidated revenue requirements and application of single tariff across all districts to lessen the sharp increase in rates born by customers in the Alexandria District. In addition, City staff recommend City Council support the further investigation of the benefits and trade-offs of selling the City's fire hydrants to VAWC should such action be in the community's best interests. [Please note, any potential future sale of the City's fire hydrants to VAWC is subject to established statutory and legal requirements, including City Council consideration.] Finally, City staff recommends City Council support the opposition to VAWC's proposal to establish the WWISC as a permanent program until the authorized pilot is complete and undergoes thorough and thoughtful cost and benefit evaluation by the SCC.

The SCC has issued a Notice of Order and Hearing on January 1, 2019. Notice of Participation is due April 9, 2019 and will be filed by City staff before the deadline. Hearings are scheduled for August 27 and 28, 2019. It is recommended City Council support the City's intervention in the rate case as a Respondent. As a Respondent, the City is able to represent the best interests of the Alexandria community through by reviewing discovery, filing testimony, cross-examining VAWC and other participating witnesses, responding to briefs, orders, rulings, etc. Due to the specialized nature of the issues presented in this water rate case, City staff have engaged outside legal counsel and consultant support expertise, as appropriate. As of current, the City of Hopewell has filed a Notice of Participation in the case. Where there is alignment of priorities with other jurisdictions - ex. City of Hopewell, Prince William County, and Prince George County - City staff will seek opportunities to partner as has been done in the past.

In addition to the City's participation as a Respondent on behalf Alexandria community's interests, members of the Alexandria are encouraged to submit comments to the SCC reflecting their desired outcome of PUR-2018-00175 at the following URL: <http://www.scc.virginia.gov/case/PublicComments.aspx>. The Alexandria community may submit comments until August 13, 2019.

**FISCAL IMPACT:** Fiscal impacts to the City of Alexandria are as follows: 1) there is no anticipated changes to rates for water use by the City of Alexandria's government operations; and 2) any fiscal impacts from the consideration of sale of fire hydrants to VAWC are yet to be determined, and 3) should the City proceed to intervene in the rate case, contracting for outside legal counsel and consultant support expertise, as appropriate, is yet to be determined; however, based on previous experiences, on average we estimate these direct costs to be about \$50,000 to \$75,000. Fiscal impacts to members of the Alexandria community will result from the rate case's outcome. If the SCC approves VAWC's proposed 15.84% increase in allowable revenues according to a 10.8% proposed Rate of Return on Common Equity (ROE), after the proposed 3-year phased transition to a single tariff across all districts, the estimated increase in an average residential or commercial customer's annual billing will be about \$156 and \$1,067 per year.

#### **ATTACHMENTS:**

- Attachment 1 - List of VAWC's Capital Improvement Projects (2017 - 2020)
- Attachment 2 - VAWC Letter to City Manager Dated 1/24/2019
- Attachment 3 - VAWC Mailer to Customers of 4/1/2019
- Attachment 4 - PowerPoint Presentation

#### **STAFF:**

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