

MEMORANDUM

DATE: March 13, 2018

TO: William Stowe, CEO and General Manager

FROM: Peggy Freese, CFO

SUBJECT: Cost of Service Review Update

In 2017, DMWW engaged Raftelis Financial Consultants to conduct a review of our Cost of Service (COS) study. Des Moines Water Works follows the industry standard COS methodology as outlined in the AWWA M-1 Manual; however, we have developed our own unique set of processes and procedures over time to support the model and complete the COS study annually. After many years of using our “self-constructed” process, we sought the expertise of professional experts to evaluate our Cost of Service and make recommendations.

To begin their review, Raftelis came onsite and met with Finance staff for a discussion on a variety of cost of service topics including:

- our COS model
- how we use COS information
- our budgeting process
- our rate setting process

Raftelis also met with Ted Corrigan and Dan Klopfer to review DMWW’s capital budgeting process, including our Long-Range Plan and our 5-Year CIP. Additionally, Raftelis met with representatives of our five largest wholesale customers to hear their input regarding our COS.

Raftelis has recommended changing from a “historical cost” COS model to a “revenue requirements” COS model. Currently, we compile the COS using actual financial data from the prior year. We use this information to make rate recommendations that will go into effect in the following year. This creates a substantial “lag” in the rate-setting process. For example, in 2017 we compiled a COS using the actual financial results from 2016. Based on this information, the Board approved rate increases in October 2017 that will go into effect April 1, 2018. The historical cost and revenue requirements models are both AWWA accepted methodologies. Both are widely used. While we have attempted to mitigate the lag in rate setting by projecting COS

results forward using average cost increases, finance staff believes switching to a revenue requirements model will be beneficial to DMWW.

In the revenue requirements model, the budget for the upcoming year will be used for the COS calculations, thus rate increases will be aligned with actual budgeted expenses. As we transition, it will be an iterative process with a first draft COS based on historical costs and preliminary budget estimates. As we proceed through the budget process, we will update the model with O&M and capital budget numbers. This budget-based, or revenue requirements, COS will be the basis of our rate recommendations to the Board. Raftelis is developing a revised COS model for DMWW. As far as COS methodologies, the new model will be substantially similar to our current model. However, Raftelis believes there are some opportunities for simplification of our current process.

The model Raftelis is developing will include a component for multi-year financial planning and rate projection. This will allow us to combine O&M expense projections with our 5-Year CIP information and evaluate the impact to COS and rates in future years.

Raftelis is currently developing the COS and multi-year financial planning model. Throughout their development phase, finance staff will have opportunities to review the model and provide ongoing input. Once they develop the model, they will train finance staff on how to use it.

In addition to the development of a COS model, we have asked Raftelis for recommendations regarding our wholesale rate structure. Specifically, customers who peak off of us create a number of challenges and some type of a peaking rate may be appropriate.

Raftelis' original proposal was \$149,880. After they completed their review of our COS and presented their recommendations, we concluded that we wanted Raftelis to develop a new COS model utilizing the revenue requirements methodology. Additional fees to develop the model, train DMWW staff, and provide support through our first use of the model are \$49,950 bringing their total fees to \$199,830. Our budget for the project was \$200,000. Raftelis is currently working on development of the model. DMWW will use this model for our 2019 budget and rate recommendations. Raftelis will assist us through our first use of the model.