

**MEMORANDUM**

DATE: June 25, 2018  
TO: William Stowe, CEO and General Manager  
FROM: Peggy Freese, CFO *pf*  
SUBJECT: Cost of Service Update

Last year, DMWW engaged Raftelis Financial Consultants to conduct a review of our Cost of Service (COS) study. 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. Raftelis recommended changing from a “historical cost” COS model to a “revenue requirements” COS model. In the past, we compiled the COS using actual financial data from the prior year. We used this information to make rate recommendations that went into effect in the following year. This created a substantial “lag” in the rate-setting process. While we have attempted to mitigate the lag in rate setting by projecting COS results forward using average cost increases, there are many challenges in doing so. The historical cost and revenue requirements models are both AWWA accepted methodologies and both are widely used. However, we feel a switch to the revenue requirements model will be beneficial to DMWW. After Raftelis completed their review of our COS and presented their recommendations, we asked them to develop a new COS model for DMWW utilizing the revenue requirements methodology.

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. DMWW will use this model for our 2019 budget and rate recommendations. Raftelis will assist us through our first use of the model. Finance staff has reviewed the model with Raftelis during development and provided ongoing input. They are making final revisions to the model and are also working on the cash flow tables that we will use to track capital improvement fund balances for our full-service customers. We expect Raftelis will deliver the model and train provide training to finance staff in August.

In addition to the development of a COS model, we have asked Raftelis for recommendations regarding our wholesale rate structure. Specifically, customers who produce some water but peak off DMWW create many challenges. It may be appropriate to implement some type of a peaking rate. In a recent discussion with Raftelis, they shared that they are exploring the idea of a higher base rate for wholesale customers that would be paid regardless of water consumption. This recognizes that we have O&M costs associated with our large investment in capital assets that are fixed regardless of the volume of water produced. Customers for whom capital investments were made should pay their share of the O&M costs even when they are not buying water from DMWW.