By Carl Brown, President, GettingGreatRates.com

Cost-to-serve Rates? Really?

The meeting convened. The city's rate analyst insisted, "Your water and sewer rates are fair. They are 'cost-to-serve' rates." I just know it hacked him off that he had to say it.

I was not convinced.

I'm the rate analyst for a group of disgruntled homeowners served by the city. Neither the city nor its analyst would show me the data and assumptions the rates were built upon. If I can't view their data and assumptions and check their math, how can I prove or disprove the "cost-to-serve" claim, much less the "fair" claim?

Warning, I'm going a little wonky now.

The analyst's rate study report stated that he classified costs at the rate class level, but not at the customer level. That is bad. Then it gets worse. The report also revealed that, in order to even out cash flow, the city had him design rates that would recover 95 percent of its costs from a minimum charge and five percent from unit charges.

Fixed costs are related to the fact that someone is a customer – think billing, general administration.

Variable costs are related to the volume of service received – think electric, treatment chemicals.

Unfair! Unfair! Unfair! And by his own admission, certainly not cost-to-serve at the customer level. Rate fairness happens at the customer level – customers pay bills, rate classes don't.

Maybe the city's analyst and I can work it out. I hope so.

You may think, "I don't need to know about this 'cost-to-serve' rates stuff." But you do. Either you should be calculating cost-to-serve rates. Or, you need to occasionally hire a rate analyst to do it. If you have an analyst do it, you need to make sure those rates are fair to customers, not just rate classes. Consider this:

- If your utility's rates are high enough to fully fund the utility's operations, pay for repair, replacement and capital improvements, and build responsible reserves, you have cost-to-serve rates on a utility-wide basis. Martha Stuart would say, "That's a good thing." But it's not enough.
- If your utility is self-supporting and it does it by recovering the right amount of money from each rate class (groups of 'similar' customers), you have cost-to-serve rates at the rate class level. But they probably still are not fair to customers.
- If your utility is self-supporting and does it by recovering costs proportionately from each customer, now you have cost-to-serve rates where it counts – at the customer level. You are on your way to adequate and fair rates.

Back to the city's rates, recovering 95 percent of its costs with a minimum charge will definitely even out cash flow. That's good for the city, but bad for low-volume customers.

Water and sewer utilities do not accrue costs that way. Even water and sewer utilities operating in bad circumstances have variable costs – commodity-related costs – that take up 50 percent or more of the total costs. That means 50 percent or more of the

Note to those who do rate studies:
When you classify costs, don't stop at the rate class level. Classify to the customer level and calculate rates accordingly. Sure, if the town or district wants tailored rates, tailor the rates. But do it from the level of the customer. That way, everyone can see who the winners and losers will be when the rates stray from the cost-of-service structure.

Do the Math . . .

If the average monthly cost per customer is $30.00, at a generous split of 50 percent for fixed costs and 50 percent for variable costs, the minimum charge would be $15.00 and unit charges would total $15.00.

For the "little old lady, widowed, retired, living alone on Social Security," who uses one-fifth as much water as the average customer, her bill would be $15.00 minimum and $3.00 in unit charges, for a total of $18.00.

Switch the cost structure to 95 percent fixed and these are the new splits:

- Average customer – $28.50 minimum charge and $1.50 in unit charges for a total, again, of $30.00.
- "Little old lady..." – $28.50 minimum and $0.30 in unit charges for a total of $28.80.
- Call costs 95 percent fixed and the "little old lady..." is subsidizing high-volume customers by 10-bucks per month. – Is that fair?

revenue should come from unit charges, not five percent. To price fairly, the rate structure should follow the cost structure. I'll explain.

In every water-based utility, there are high-volume customers and low-volume customers, "bigs" and "smalls." When you arbitrarily call 95 percent of costs fixed and recover them with minimum charges, you force a lot of smalls to subsidize the few bigs'. Those rates might be cost-to-serve at the class level, but not at the customer level where fairness counts.

So, let's imagine you are the most cold-hearted utility manager or board president alive. Fairness means nothing to you. Still, you should not want those 95-percent fixed rates. Why?

"Slow-pay" and no-pay" customers are concentrated on the low-volume side of use. When you boost their minimum charge to subsidize high-volume customers, you create more slow-pays and no-pays. That creates an attack for even the coldest heart because now you must chase after more smalls, at big expense, to get small money. That's bad business.

Who are these "slow-pay, no-pay smalls?" Sure, some have no conscience about stealing from others. That's not right. Get after them!

But some are the "little old lady, widowed, retired, living alone on Social Security?" Your bad rates kicked her into the slow-pay, no-pay group. She is already cutting her pills in half. Now you are hassling her for fees she can't pay and really shouldn't have to pay.

When the local paper runs stories about how the mean old utility manager or president is beating up on little old ladies, game over! You are down the road!

Take it from this rate analyst; cost-to-serve rates at the customer level will get you well on your way to rate structure fairness. Adopt rates that are both adequate and charge people fairly, and a different kind of analyst might ask you this, "And how did that make you feel?"

I hope you could smile and tell them, "Good, real good."

Carl Brown is President of GettingGreatRates.com, which specializes in water, sewer and other utility rate analysis. The firm also serves as the RATES Program rate analyst for the Colorado, Kansas, New Mexico, North Dakota, Virginia and Wyoming rural water associations. Contact: (573) 619-3411; carl1@gettinggreatrates.com