


City of Alexandria, Virginia

MEMORANDUM

DATE: APRIL 2, 2008

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: JAMES K. HARTMANN, CITY MANAGER 

SUBJECT: PROPOSED VIRGINIA-AMERICAN WATER COMPANY RATE INCREASE

ISSUE: Virginia-American Water Company proposed rate increase.

RECOMMENDATION: That City Council authorize City staff to provide formal comments to the State Corporation Commission in regard to the proposed 24.9 percent increase in the Virginia-American Water Company's Alexandria District rates.

DISCUSSION: On February 8, 2008, the Virginia-American Water Company (Water Company), a privately-owned for-profit entity, filed with the State Corporation Commission (SCC) an application for a 24.9 percent increase (16.8 percent increase if passed on purchased water revenues are included) for the Alexandria District (Case No. PUE-2008-0009), which encompasses the City of Alexandria. Under SCC rules, this rate increase will become effective on July 8, 2008, but would be subject to a refund with interest if the SCC later determines a lower rate was appropriate. In March 2004, an 8.15 percent water company requested increase went into effect but was later refunded when the SCC determined that a 3.5 percent increase was more appropriate. The proposed 24.9 percent increase is driven largely by proposed new capital investments in the Water Company's Alexandria infrastructure, as well as the Water Company's request for an increase in the rate of return on common equity. The investments in infrastructure are consistent with City Council's articulated desire for the Water Company to increase capital investments in the infrastructure that delivers water to City customers.

City staff and the City consultant have reviewed the rate case documents and recommend that the City of Alexandria submit formal comments to the SCC in objection to the proposed size of the general increase of 24.9 percent in water rates. Staff has found that the rate case documentation contains sufficient information to support a rate increase, but not as large as requested. The following are items that staff noted in the rate case documentation:

- The Water Company's last submitted rate increase documentation was for the test year ended on September 26, 2003. Since then, the Water Company has invested approximately \$10 million in improvements to the facility that supports Alexandria customers.

- Staff compared the annual revenues and expenses from the prior rate case (test year ended September 2003) to this rate case (test year ended September 2007). Staff noted in the four-year period total operating revenues on an annual basis increased 3.9 percent, operations and maintenance expense increased 13.0 percent, depreciation and amortization expense increased 27.2 percent, and interest expense decreased 2.7 percent. This resulted in a 97.2 percent decrease in Income Available for common equity as calculated by the Water Company.
- The Water Company's Percentage Rate of Return on Common Equity for the September 2007 test year in their rate case documentation was 0.11 percent. The Water Company is requesting enough revenue to increase its rate of return on common equity to 11.5 percent. The last rate increase (2004) was designed by the SCC to provide the Water Company with a 10.1 percent rate of return on common equity.

City staff is not convinced of the merits of all the arguments and facts associated with the rate increase request for the following reasons:

- Increase in Rate of Return on Common Equity: As stated above the Water Company is requesting an 11.5 percent rate-of-return on common equity. This rate-of-return is based on the work of an independent consultant hired by the Water Company who developed a rate-of-return calculation for the Virginia-American Water Company as a whole and not for the Alexandria District independently. The consultant determined that the Water Company should receive a higher rate-of-return because the Water Company has a higher business risk when compared to a selected group of other water companies. Key factors contributing to the high business risk include water quality concerns, small size, higher financial risk (bond rating) and high concentration of revenues from industrial customers in the Hopewell District. The Water Company purchases the water sold in the Alexandria District from the Fairfax County Water Authority. Staff believes that circumstance should mitigate the water quality concerns, and that Alexandria residents should not have to pay more because of American Water Works' (the Water Company's parent company) bond rating or industrial customers in Hopewell. Alexandria customers' solid and consistent revenue stream, coupled with no risk of water production, reduces revenue generation and cost risk substantially and should reduce the proposed rate of return of 11.5 percent to no higher than the 10.1 percent the SCC approved in 2004. Given the fact that capitalization percentage rates have dropped since 2004, a rate less than 10.1% may be warranted.
- Decrease in Customers: The SCC develops approved water rates from historical data accumulated for test years. According to the rate case documentation, the number of customer meter billings decreased from test year 2003 to test year 2006 by 505 (6 residential customers and 499 commercial customers). The Water Company sold 65 million gallons less water in test year 2007 than it did in test year 2003. This does not seem possible with the City's growth in population and increase in commercial tax base. In addition, from test year 2001 to 2003, the Water Company lost 438 residential customers and sold 197 million gallons less water. The Water Company attributed the large reduction in water sales in 2003 to the weather. Calendar year 2003 was a rainy year but 2007 was dry. This year's rate case has fewer gallons of water sold in 2007 than

the 1999, 2000, and 2003 rate case filings. Staff believes that there is some sort of an anomaly in the 2003 and 2007 water usage numbers and cautions its use in determining the City's water rates.

- **Large Rate Increase:** The 24.9 percent rate increase requested by the Water Company would generate \$1.6 million a year in additional income for common equity. The Water Company's investment in common equity increased by \$2.4 million between 2003 and 2004, and the investment in the rate base increased by \$2.2 million in the same period of time. With this large rate increase, the Water Company would recoup its investment in less than two years, which is less than is customary for capital investments of this type.

In prior years, the SCC staff has concurred with many of the issues identified by City staff. In addition the SCC has raised additional items, which have resulted in the SCC approving rate increases substantially lower than requested by the Water Company. As mentioned earlier, in 2003 the Water Company requested a rate increase of 8.15 percent, the SCC approved a rate of 3.5 percent. In 2000, the Water Company requested a rate increase of 5.21 percent and was approved for a rate increase of 2.97 percent. The Water Company has invested heavily in its infrastructure located in the City and thus has justified a rate increase, but not a 24.9 percent rate increase.

It should be noted that the parent company of Virginia American Water is planning to spin off its U.S. based operations with a stock offering. As a result, the higher the returns to the Water Company are, the higher the stock offering price could be.

FISCAL IMPACT: None to the City, but if the rate increase is approved, Alexandria customers will experience a 16.8 percent overall water rate increase.

STAFF:

Mark Jinks, Deputy City Manager

Laura B. Triggs, Director of Finance