Exhibit I
Dear Chair and Members, Citizens’ Water Advisory Committee:

I have reviewed the attached materials prepared by Raftelis Financial Consultants for your July 28, 2021 Citizens’ Water Advisory Committee (CWAC) Finance Subcommittee meeting and am providing the following comments for your consideration.

As you are aware, the attached Raftelis technical memorandum comprises the first phase of determining a basis for a differential rate in the unincorporated County based on a cost-of-service analysis independent of any policy considerations by the Mayor and Council. This phase employs an equity-based investment approach calculating a rate of return on utility investment. The methodology is designed to evaluate rates for private utilities predicated on a return paid to owners of the utility to recover costs from ratepayers and generate profits to owners.

However, there is no basis to apply this private utility profit model to a municipal utility. A municipal utility has no identified owners as it is organized as an enterprise within a municipal corporation bound by Governmental Accounting Standards Board rules. In the case of Tucson Water, all customer ratepayers have contributed equally to investments made and secured against the enterprise, either directly or through developer funded expansions. The only exception that may warrant a differential rate for a municipal utility, aside from differential infrastructure and operational costs, is if one class of customers incurs risk beyond that of another class. This context has been raised in prior CWAC meetings where it was stated that the City of Tucson General Fund acts to “backstop” the enterprise fund in the event of a force majeure default. However, even if this eventually were to occur, an emergency expenditure exceeding the reserve capacity of the Tucson Water Enterprise Fund would result in a loan secured by the enterprise to cover the default amount. That loan, however, would be repaid to the City General Fund or other loaning entity with principal and interest by all Tucson Water ratepayers, regardless of jurisdictional location. As such, the risk to the enterprise is borne by all ratepayers of the enterprise since City residents contributing to the City General Fund though property taxes are no more owners of the system than international visitors contributing to the City General Fund through sales tax payment for goods and services.
Additionally, the equity-based utility investment approach requires inferring a rate of return based on cost of equity values. Since municipal utilities cannot be evaluated on the basis of cost of equity, the phase 1 analysis arbitrarily selects values ranging between 5 and 10 percent based on Arizona Corporation Commission rate cases for private utilities. However, these values include imbedded profit margins and applying these ranges to “outside City customers” assumes outside customers pay dividends to inside customers who somehow hold a greater risk-based ownership stake in the utility.

Furthermore, while “outside customers” is not defined in the memorandum, I understand from clarification provided at the July 28 CWAC Finance Subcommittee meeting that “outside” refers to the unincorporated area customers, defined as “non-owners” and that the other municipalities served by Tucson Water are considered “inside” or “owners” of the Tucson Water Utility. This means that Tucson Water customers within municipalities other than the City of Tucson are somehow also considered owners of the enterprise. While this distinction does not stand up to scrutiny, it should be moot since the entire equity ownership approach does not apply to a municipal utility.

It is recognized that the phase 1 Raftelis analysis was conducted with limited time and so employed a simplified approach which did not provide the level of detail expected of a full cost-of-service study. Missing elements that warrant pursuing in phase 2, some of which were raised at the July 28 meeting, include:

- Providing the calculations showing how inside/outside consumption splits are determined.
- Comparison of inside/outside revenue since outside customers are paying proportionally more based on consumption than inside customers due to the current volumetric tiered rate structure.
- Including payments made for procuring CAP water under Central Arizona Water Conservation District property tax levies, where unincorporated County residents are currently subsidizing City of Tucson CAP water costs (see Table 2 in Historical Perspective Regarding Regional Water and Sewer Rates Established by Pima County and City of Tucson’s Mayor and Council).
- Including PFAS and other contaminant treatment costs relegated to Tucson Water rate payers based on contamination within vs outside City limits.
- Consumption was used as basis of cost split but certain costs, such as director’s office, billing and metering, financial and engineering are fixed costs not tied to consumption. These would more equitably be distributed using a metric such as number of connections.
- Inclusion of the reclaimed system since it is subsidized by potable system rates.
- Comparison of inside/outside pumping and distribution infrastructure requires adjustments recognizing that the majority of City well fields and recharge/recovery facilities are located in the unincorporated area and that distribution infrastructure serving other municipalities transit through the unincorporated area.

In summary, I recommend that you reject phase 1 of the Raftelis cost-of-service analysis, as artificially assigning return on investment based on utility cost of equity bears no relationship to
municipal utility value where cost of capital is limited to cost of debt and where dividends are not paid out to “owners.” Additionally, I hope you will request that phase 2 of the cost-of-service study evaluates costs having a legitimate basis for differential potential, including those itemized in the above bullets in addition to those identified within the Raftelis presentation for phase 2 evaluation such as peaking characteristics, fire service, non-revenue water, distance and elevation.

Finally, it is important that water considerations are applied equitably across the region and that differential rates be based on legitimate cost-of-service in lieu of retaliation for perceived taxation inequities unrelated to water that should be resolved by other means. Doing so will allow us to concentrate on better regional management of our limited water resources that impact all residents across the Santa Cruz basin. To this end, the County Administrator has provided an overview of opportunities regarding water resources management of the lower Santa Cruz basin that are candidates for future City of Tucson partnerships and CWAC discussion.

Sincerely,

Yves Khawam, PhD
Assistant County Administrator for Public Works

Attachment

c: C.H. Huckelberry, County Administrator
Jan Lesher, Chief Deputy County Administrator
Carmine DeBonis, Jr., Deputy County Administrator for Public Works
Jackson Jenkins, Director, Regional Wastewater Reclamation Department
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