October 19, 2021

Subject: Public Hearing: Amending Tucson Code to implement a differential rate structure for Tucson Water customers located in unincorporated Pima County and adoption of proposed changes to the Tucson City Code Sections 27-32 and 27-33 relating to charges for water service; Adoption of Ordinance. (Outside City)

Issue – Public hearing concerning the proposed implementation of a differential rate structure for Tucson Water customers located in unincorporated Pima County.

City Manager’s Recommendation – Following the close of today’s public hearing the Mayor and Council are respectfully requested to consider adoption of the attached ordinance (Attachment A), which will cause the attached differential rate schedule (Attachment B) for Tucson Water customers located in unincorporated Pima County to take effect on or after December 1, 2021.

Background – On June 22, 2021, Mayor and Council unanimously adopted Ordinance 11846 directing staff to establish a differential water rate for customers in unincorporated Pima County, to take effect on December 1, 2021.

By adopting Ordinance 11846, Mayor and Council found that implementing this rate structure would result in reasonable differential rates and would advance policy considerations that are critical to the City, including:

- The rate structure supports and rewards annexation and incorporation, providing economic benefit and increased state shared revenues for the City and the region;
- The rate structure recognizes that the City, as owner of Tucson Water, bears financial risks and liabilities that are not shared by the unincorporated County, including the City’s financial backstopping of the utility;
- The rate structure promotes environmental sustainability and water conservation, particularly in areas outside the City limits where the City has limited powers to promote those interests.

Mayor and Council further found that implementation of a differential water rate structure is permissible under Arizona law and commonplace among Arizona municipalities that own and operate water utilities.

Mayor and Council moved to direct staff to complete a broad cost-of-service (COS) analysis to demonstrate that a rational relationship exists between the adopted differential rate structure and the services provided to customers residing in unincorporated Pima County. Staff have engaged with the utility’s financial consultants to produce the differential rate COS study as directed. Results of the COS study have been provided to Mayor and Council and made available for public review, and the COS study is included here as Attachments C and D (Phase 1 Preliminary Outside Differential Rate Analysis; Phase 2 Outside Differential Rate Analysis).

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At the Regular Meeting of Mayor and Council on August 10, 2021, the Mayor and Council adopted a Notice of Intention to implement the previously adopted differential water rate structure. Implementation of the adopted differential rate structure was scheduled for public hearing today. At the conclusion of today’s public hearing, the Mayor and Council will have completed the necessary steps to adopt the proposed Attachment A Ordinance, which will entirely supplant Ordinance 11846.

**Present Considerations** – Tucson Water engaged Galardi Rothstein Group and Raftelis (GRG/Raftelis) to perform a COS analysis to assess various options for calculating rate differentials to be applied to outside-City customers. The results of the COS analysis are supplemental to the policy basis already used to approve the differential rate. In making this decision to assess a higher rate, Mayor and Council made a policy decision that outside-City customers would be considered “non-owners” of the Tucson Water system from a rate-setting perspective and should be assessed rates consistent with that status.

The Phase 1 analysis performed by GRG/Raftelis used readily available data to develop revenue requirements for the Tucson Water system. Revenue requirements were allocated between inside-City customers and outside-City customers based solely on annual water use. The outside-City customer revenue requirements were compared to the revenue generated by outside-City customers under Tucson Water’s existing rates. The difference between the calculated revenue requirements and revenue at existing rates serves as an approximation of a cost-based rate differential. The results of the Phase 1 analysis indicated outside-City rate differentials ranging between 6.1% and 25.7%, depending on the cost of equity applied to outside-City customers for determining a return on investment for inside-City customers.

Upon completion of the Phase 1 analysis, Tucson Water tasked GRG/Raftelis with performing a Phase 2 analysis. Phase 2 involved exploring potential differences in the costs to serve outside-City customers in more detail, and to narrow the range of returns on investment that could be used to calculate a differential rate. The Phase 2 analysis determined that cost-based rate differentials range between 9% and 26% depending on the differential in the rate of return between inside-City and outside-City customers. The choice of an appropriate rate-of-return differential between inside-City and outside-City customers is a policy decision. However, even if no rate-of-return differential is applied, the Phase 2 analysis determined that a cost-based differential of approximately 5% exists between inside-City and outside-City customers. This 5% differential is driven by the higher peak demands of the outside-City customers as well as the greater relative cost of constructing, operating, and maintaining the distribution system that serves the outside-City customers.

In summary, the Phase 1 and Phase 2 COS analyses performed by GRG/Raftelis demonstrate that a reasonable relationship exists between the adopted differential rate structure and the services provided to customers residing in unincorporated Pima County.
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Summary of Adopted Differential Rate Structure – The differential rate structure adopted by Mayor and Council on June 22, and which remains completely intact in the attached Ordinance for consideration with this matter, is presented in Attachment A. Table 1 below compares inside- and outside-City water rates for the single-family residential (SFR) customer class, which is Tucson Water’s largest class with approximately 90% of customer accounts across the entire service area. This class represents 95% of the customer base among customers located in unincorporated Pima County.

The SFR rate structure consists of three basic components: a fixed monthly service charge based upon meter size; a volumetric usage charge based on a four-tiered, inclining-block structure (measured in hundreds of cubic feet, or Ccf); and miscellaneous fees. The SFR volumetric rate blocks established in FY 2016 are as follows, and would not be affected by the adopted differential rate structure:

- Tier 1 = 0-7 Ccf
- Tier 2 = 8-15 Ccf
- Tier 3 = 16-30 Ccf
- Tier 4 = >30 Ccf

For Tucson Water customers in unincorporated Pima County, the adopted differential rate structure would result in a 10% increase for the monthly base rate, the first volumetric tier (0–7 Ccf), the Central Arizona Project (CAP) fee, and the conservation Fee; escalating percentage increases would apply to the inclining block rate structure.

Table 1. Inside/Outside-City SFR Rate Comparison

| Single Family Residential | Current Rate FY 21 & FY 22 | 10% Differential Rate on Base plus Escalating Tiers (T1-10%, T2-20%, T3-30%, T4-40%) |
|---------------------------|---------------------------|-----------------------------------------------|
| Monthly Base Rate (5/8") | $16.33                    | 10%                                           | $17.96                                      |
| 1-7 Ccf                   | $2.07                     | 10%                                           | $2.28                                       |
| 8-15 Ccf                  | $3.82                     | 20%                                           | $4.58                                       |
| 16-30 Ccf                 | $8.39                     | 30%                                           | $10.91                                      |
| Over 30 Ccf               | $12.93                    | 40%                                           | $18.10                                      |
| CAP Fee                   | $0.70                     | 10%                                           | $0.77                                       |
| Conservation Fee          | $0.10                     | 10%                                           | $0.11                                       |

Highlights of Bill Effects – The projected effect of the adopted differential rate structure upon a sample of SFR customers is shown in Table 2 below. The differential rate structure would shift a
greater proportion of the rate increase toward the higher volumetric rate blocks, potentially increasing the conservation incentive for customers using more than the in-City average of 7 Ccf per month.

Table 2. Sample Residential Bill Impact

| Water Bill          | # Ccfs | Current  | 10% Differential Rate on Base plus Escalating Tiers (T1-10%, T2-20%, T3-30%, T4-40%) | Percentage Increase |
|---------------------|--------|----------|-------------------------------------------------------------------------------------|---------------------|
| Low Usage           | 4      | $27.81   | $30.59                                                                              | 10.0%               |
| Inside-City Average | 7      | $36.42   | $40.06                                                                              | 10.0%               |
| Outside-City Average| 10     | $50.28   | $56.45                                                                              | 12.3%               |
| High Usage          | 45     | $417.18  | $545.31                                                                              | 30.7%               |

Financial Considerations – New annual revenues from the implementation of the adopted differential water rate structure are estimated to be about $9.9M. As directed by Mayor and Council at the June 22 public hearing, all additional revenues generated by differential rates will be retained entirely within the utility and will be used for the following three purposes:

- Infrastructure maintenance and upgrades to enhance water delivery from the City limits to outside the City limits;
- Climate Resiliency and Water Sustainability for recharge, retention and reclamation projects (primarily outside the City limits) and enhancing the tree canopy throughout the entire Tucson water system; and
- Financial resiliency in the form of expansion of the low-income program and a one-time pay down of eligible delinquent accounts that have been negatively impacted by COVID-19.

Stakeholder Outreach and Response – Tucson Water conducted extensive community outreach and education about the differential rate proposal prior to the June 22, 2021, public hearing that resulted in the adoption of the attached rate schedule. Today’s public hearing was advertised on the City’s website on September 17, 2021, and in the major local newspaper on September 26, 2021, in conformance with the requirements of State law.

An open and public process was conducted for review and discussion of the differential rate COS study produced by Tucson Water’s financial consultants. The Finance Subcommittee of the Citizens’ Water Advisory Committee (CWAC) met on July 28 and again on September 16, 2021, to consider OCT19-21-325
the COS study. The full CWAC reviewed and discussed the topic at its regular meetings on September 1 and October 6, 2021. Pima County remained actively engaged throughout this process, with County representatives attending CWAC meetings and the County providing input via memoranda to CWAC (Attachment E).

CWAC has prepared a statement to Mayor and Council regarding its engagement in this process. The document is attached as Attachment G.

**Legal Considerations** – Analysis by Tucson Water’s financial consultants demonstrates that a reasonable relationship exists between the adopted differential rate structure and the services provided to customers residing in unincorporated Pima County. Differential water rates are allowed by Arizona law, provided that the rates are based upon a reasonable relationship to the services provided. The practice is commonplace among Arizona towns and cities that operate water utilities serving customers outside of their jurisdiction.

Additional legal considerations were fully addressed by Mayor and Council during the June 22 public hearing that resulted in the adoption of the attached rate schedule. Notably, in *Jung v. City of Phoenix*, 160 Ariz. 38 (1989), the Arizona Supreme Court expressly held that as “a general rule a municipally owned waterworks system supplying water outside its corporate limits may charge more for that service than it charges the users who reside within the corporate limits.” 160 Ariz. at 40. Because the municipality is providing a public utility service, it must charge a “reasonable rate.” *Id.* at 41. The *Jung* Court held that “proof that service of nonresidents involves greater expenses is sufficient to show a city acted reasonably in charging higher rates for nonresidents.” *Id.* One notable difference between the present day and June 22 is the Mayor and Council’s direction to proceed with a COS study; the COS study shows that service of nonresidents involves greater expenses than service of Tucson residents.

On September 22, 2021, Pima County Administrator Chuck Huckleberry addressed a memo to the County Board of Supervisors (Attachment F) stating disagreement with the conclusions of Tucson Water’s differential rate COS study. Mr. Huckleberry contends that the study is based upon invalid criteria and therefore does not provide a legitimate basis for a differential fee to be applied to unincorporated County residents. The County Administrator advises the Board that a July 28, 2021, County Attorney analysis found "standing and capacity” for the County to pursue legal action against the City if a differential water rate is implemented. It is worth noting that the County Attorney’s analysis was made before the completion of Phase 2 of Tucson Water’s COS study.

The Governing Body has conformed to the requirements of State law in adopting the Notice of Intention to increase rates, filing supporting materials with the City Clerk for public review, posting notice of proposed rates on the City’s website, and scheduling and advertising today’s public hearing. Adoption of the Attachment A ordinance will replace the June 22 Ordinance with the attached

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MAYOR AND COUNCIL COMMUNICATION

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ordinance. This ordinance is supported by a COS analysis, and any assorted policy considerations to be added to its legislative history, including, but not limited to, the policy considerations established in the draft ordinance attached to this Communication as Attachment A. The draft ordinance also amends Tucson Code Section 27-32, to provide that rates for customers within the unincorporated area, outside lands placed into trust for Native American tribes, will be set in proportion to costs, plus a reasonable differential.

Consistency with Plan Tucson – The proposed differential rate schedules are consistent with the voter approved goals outlined in Plan Tucson related to the Social Environment policies associated with Governance & Participation (G1-12); the Natural Environment policies associated with Energy & Climate Readiness (including EC8-9), Green Infrastructure (including GI1-6), and Water Resources (including WR1-11); and the Built Environment policies associated with Public Infrastructure, Facilities, & Cost of Development (including PI1-2 & 5-6).

Rate Change Implementation – If so directed by the Mayor and Council following tonight’s public hearing, the differential rate structure will become effective on or after December 1, 2021.

Respectfully submitted,

Timothy M. Thomure, PE, ENV SP
Assistant City Manager

TT/kl
John Kmiec, Interim Director, Tucson Water

Attachments:
- Attachment A: Ordinance
- Attachment B: Adopted schedule of differential rates
- Attachment C: Raftelis Phase 1 Preliminary Outside Differential Rate Analysis
- Attachment D: Raftelis Phase 2 Outside Differential Rate Analysis
- Attachment E: Pima County correspondence with CWAC
- Attachment F: Pima County response to differential rate COS study
- Attachment G: Final CWAC Response on Review of Differential Water Rates Cost of Service Analysis

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