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June 14, 2011

By E-Mail & US Mail

Mayor Nader Baroukh
City of Falls Church
300 Park Ave
Falls Church, VA 22046

**Falls Church's Proposed Water Rate Increase,
MFSG's Rate Study, and a Suggestion for a New Path Forward**

Dear Mayor Baroukh:

The City Attorney's letter of June 1, 2011, invited Fairfax Water to submit comments concerning the City's proposed water rate increase and the Water Rate Study, Final Report, by Municipal & Financial Services Group (MFSG), dated May 27, 2011. The City Council is scheduled to take action on the proposed rate increase on June 27. Fairfax Water appreciates the opportunity to respond.

As set forth below, we think that MFSG's study is flawed and does not support the significant rate increases proposed. More fundamentally, the rate increase puts Falls Church on a trajectory to charge water rates that are more than 60% higher than the rates Fairfax Water charges to its own customers in Fairfax County. The primary reason for that cost disparity is that Fairfax Water has significantly larger economies of scale that enable it to supply water at the lowest unit cost in the region.

Before the City charts a course in the direction of higher water rates, we ask the Council to consider whether a different approach would lead to a significantly better outcome and a more robust and reliable water system for all of the citizens and businesses that we serve.

A. MFSG's Study Is Flawed.

1. MFSG's Original Study Was Flawed.

On May 13, 2010, Falls Church awarded the contract to MFSG to conduct a comprehensive water rate study.

On March 23, 2011, the results of MFSG's study were presented to the Falls Church Public Utilities Committee. MFSG proposed water rate increases of 8% each year for FY 12 through FY 14, and 3% rate increases each for FY 15 and FY 16. The PUC voted to approve the recommended rate increases. According to the City Attorney, however, the underlying rate study was not provided to the PUC before it voted.

On March 28, 2011, MFSG made a PowerPoint presentation to the City Council in which it repeated its recommendations. The City Council then unanimously voted on first reading to adopt the proposed rates. (TO11-07.) According to the City Attorney, MFSG's underlying rate study was not provided to Council members before they voted either. The PowerPoint presentation, however, was posted to the City's website, although it has since been taken down.

MFSG's PowerPoint presentation explained that it used a "utility approach" to calculate the water rate increases. MFSG included a 7.8% "return on equity" in the projected revenue requirements for the water system.

In correspondence with the City Attorney in April, our general counsel explained that including a return on equity in the revenue requirements would violate Judge Ney's permanent injunction that the City not profit from the operation of its water system, even if the City did not actually transfer those profits to the general fund.

To the City's credit, the City Attorney advised on April 25, 2011, that the Council would postpone the vote on second reading, scheduled for that evening, in order to consider this issue and the other issues raised, namely, why rates were being increased when the system had been generating profits in prior years, and why the MFSG study had failed to examine the adequacy of the City's tap fees. The City Attorney, however, declined to produce a copy of MFSG's underlying rate study, contending that it was only a draft and that no one outside of the City Manager's office had seen it.

On June 1, 2011, the City produced MFSG's revised water rate study, a "final report" dated May 27, 2011. MFSG switched from a utility basis approach to a cash needs approach. The City Attorney explained that, under the new approach, "there will be no transfer of water fund profits to the City's general fund, or a return on equity." The City Attorney invited Fairfax Water to submit comments on the new study by June 15, 2011.

2. MFSG's Final Report Is Also Flawed.

Fairfax Water commends the City for directing MFSG not to include a return on equity in the revenue requirements for the water system. But the revised, final report is also seriously flawed. We do not think it supports the significant water rate increases that MFSG proposes.

As a preliminary matter, it does not appear that "Management and Financial Services Group, LLC," was qualified to transact business in Virginia during the time that it did most of its work on your study. MFSG's certificate to transact business in Virginia lapsed on December 31, 2005. Falls Church awarded the contract on May 13, 2010. And it was not until May 11, 2011, that MFSG registered with the State Corporation Commission, although the vendor certified when it submitted the proposal that it was already registered. This appears to violate Code § 2.2-4311.2(D), which requires all contractors to be registered in Virginia throughout the course of their work for a public body. We do not know if the City is aware of this omission. Should you wish to pursue it, however, the City may have recourse under Code § 2.2-4311.2(E).

More importantly, the MFSG report has serious substantive flaws.

First, despite the substantially different methodology, different projected revenue requirements, and foregoing a 7.8% "return on equity," MFSG has recommended the exact same rate increases as it did before, completely undermining the study's credibility. MFSG has failed to explain why it first recommended the utility basis and then switched to the cash basis. Moreover, in the new study, the revenue requirements projected for the period FY 11 to FY 16 are more than \$5 million *less* than under the original recommendation. Yet MFSG is recommending the *same* water rate increases as before. This creates the appearance that MFSG is simply trying to justify the same numbers but without using the "return on equity" that it has disclaimed.

Second, MFSG has failed to explain why the City's previously profitable water rates are suddenly now unprofitable. For years, the City had been transferring millions of dollars in surplus profits from the water fund to the general fund. (Attachments 1-2.) The most recent transfer was in excess of \$2.4 million for FY 09, which the City restored to the water fund in December in accordance with the rulings by Judge Ney. Falls Church budgeted a profit of \$2.4 million for FY 10, although it was enjoined from transferring that amount.

In light of these consistent surpluses, we were expecting Falls Church to lower its water rates in response to Judge Ney's ruling, not to raise them, let alone to raise them so substantially. MFSG has failed to account for this history of surplus profits, and it has failed to explain how a water system that had been so profitable just last year is now operating in the red and needs a rate increase.

Third, MFSG has failed to address the City's tap fees. The City's instructions to bidders directed the water rate consultant to examine the City's tap fees, as well as the commodity

charge. The tap fees consist of availability charges, connection charges, and local facilities charges. The City's availability fees, for instance, have not been raised since 1996. A proper rate study should examine whether these fees are properly covering the costs of new connections. If not, then existing customers are subsidizing new growth in the form of higher commodity charges. MFSG does not report examining any of the City's tap fees to determine if they were properly recovering costs. Indeed, Schedule 18 of the MFSG report shows that, looking only at the ability of the 1996 availability fee to cover future debt service – without regard to other system costs – a deficit results by FY 15.

MFSG's failure to examine and update the City's tap fees represents a serious flaw in the study. Moreover, the City Charter appears to require that tap fees be included in the same ordinance setting the commodity charges. Section 13.09 requires the Council "to adopt for that utility *a schedule* of rates which in its judgment will produce receipts equal to expense." 1995 Va. Acts ch. 655, § 13.09 (emphasis added). So it would seem appropriate, at a minimum, to delay any changes to the schedule of rates until the City has reexamined, updated, and included its tap fees.

B. It is Unfair to Fund Water Reserves By Increasing the Commodity Charge Because the Ratepayers Already Funded Those Reserves.

It appears that a significant driver for the increased revenue requirements in MFSG's revised rate study is the creation of three designated reserve funds that MFSG is recommending for the water fund. According to MFSG's Schedules 7 and 7B, the revenue requirements include more than \$14 million to fund these reserves for the period FY 12 through FY 20.

As a water customer of the City for two office buildings in Merrifield, Fairfax Water must object to funding these reserves through an increase in the water commodity charge. As established in the litigation, the City previously transferred nearly \$58.9 million in surplus revenues or "profits" from the water fund to the general fund from 1981 until 2008. (Attachment 1.) Most of that transfer – \$36.8 million – occurred between 2000 and 2008, following a report by the Falls Church News Press on March 16, 2000, that, "Eureka! City Council Discovers 'Liquid Gold' in Water System." Much of that transferred money included the sizable reserves that had been built up in the water fund. As of June 30, 2001, for instance, the water fund had in excess of \$43 million in available cash and investments. (Attachment 2.) The \$43 million available in 2002 is now about half of that amount, according to the City's FY 2010 financial report. MFSG's rate study shows little knowledge about the history of depleting the reserves by transferring moneys to the general fund.

If the City had not diverted so much water money to the general fund, it would not now need to fund reserves through new rate increases. It would be particularly inappropriate to restore the water fund reserves by raising the commodity charge to Fairfax County ratepayers. Fairfax ratepayers contributed 92% of the prior water moneys that were diverted to the general fund, but they received no benefit from the City's general fund expenditures.

We do not quarrel with the wisdom of having reserves in the water fund. You should. But a rate increase would make Fairfax County ratepayers, including Fairfax Water, pay twice for the same reserves. That is unfair. It is akin to the company's bookkeeper diverting money from the retirement account and then asking the company's shareholders to restore the fund by paying into it again; the bookkeeper, instead, should return the money.

If the City believes MFSG when it recommends increasing reserves, the City should fund those reserves by transferring back the moneys previously diverted to the general fund before FY 2009. Indeed, \$14 million is only a quarter of the total amounts previously diverted.

C. The City Should Consider a Different Approach From Rate Increases.

The increases recommended by MFSG will start Falls Church down a path to charging water rates that are more than 60% higher than Fairfax Water's rates; eventually, the rates will likely be double.

Fairfax Water is able to charge the lowest water rates in the region because it enjoys tremendous economies of scale in its operations, supplying water to more than 1.6 million people in Northern Virginia. Our water rates to our retail as well as to our wholesale customers are based on true cost-of-service methods. Our wholesale water rates do not cross-subsidize the retail rates we charge to Fairfax County residents; our wholesale customers audit our rates and are satisfied that they are fair. Our large customer base has enabled us to efficiently construct and operate two state-of-the-art water treatment plants, one on the Potomac River and the other on the Occoquan Reservoir. These plants not only produce finished water that surpasses all federal and state water quality standards, but they provide redundancy and back-up for the entire system. Since Hurricane Isabel, we have made system improvements that will enable us to continue to deliver water if a region-wide power outage is repeated. Since 1982, we have participated with the two other major water suppliers in the Washington DC Metropolitan Area in the Water Supply Coordination Agreement. That system of cooperation, which involves the management of three upstream reservoirs on the Potomac River, twenty-year demand forecasts every five years, and an inter-jurisdictional agreement to share the costs of future water augmentation, has effectively eliminated the prospect of any water restrictions being imposed on Virginia under the Potomac River Low Flow Allocation Agreement of 1978. Our economies of scale and good stewardship have resulted in triple-A bond ratings from all three rating agencies, enabling us to fund capital expenditures at extremely favorable interest rates. And our approach has been to make growth pay for growth, so that existing customers do not subsidize the cost of new construction to support growth.

We do not mention these things to boast, but to point out the significant opportunity for a win-win relationship with the City of Falls Church. Falls Church's water supply depends on a single source (the Potomac River), a single water supplier (the Washington Aqueduct), and a single transmission main feeding its system. The City decided to forego constructing a new

Mayor Nader Baroukh
June 14, 2011
Page 6

Potomac River crossing needed to improve its system capacity and reliability because the cost was prohibitive. According to Mr. Etris's testimony in 2009, the City's only viable long-term back-up plan is to rely on water service from Fairfax Water. The City's continuing efforts down this path, however, will simply lead to higher costs and reduced system reliability for its customers.

There is a better way. Fairfax Water is open to discussing any number of arrangements that could benefit all of the customers served by the City. The history of water supply in the DC Metropolitan Area since 1957 has been a history of episodic, bold, and successful initiatives that have greatly benefitted the people of Northern Virginia: the Low Flow Allocation Agreement of 1978, the Water Supply Coordination Agreement of 1982, and *Virginia v. Maryland* (establishing Virginia's rights in the Potomac River). There is no reason that, together, we cannot add another such success to the growing list and provide more reliable and less expensive water service to our customers.

CONCLUSION

We ask the City not to raise its water rates, as recommend by MFSG. The MFSG study is flawed. The revised study lacks credibility because it justifies the same numbers as the original study, despite different methodologies, different revenue requirements, and ostensibly foregoing a "return on equity." MFSG did not explain why a water system that has consistently generated millions of dollars in profits is suddenly in need of a significant rate increase. And it did not examine the City's tap fees.

Moreover, MFSG's recommendation to fund \$14 million in reserves overlooks that the City's water customers have already funded that amount and more in reserves that were systematically diverted from the water fund to the general fund. So, if the City accepts MFSG's recommendation to increase reserves by that amount, it should do so by paying back that money from the general fund, not by increasing water rates.

More fundamentally, however, now is the time for the City Council to chart a better course that will result in efficiencies for both the City's inside and outside customers, as well as greater system reliability. We invite you to discuss a new relationship that could result in mutual benefits for all of our customers.

Very truly yours,



Philip W. Allin
Chairman

Mayor Nader Baroukh

June 14, 2011

Page 7

cc: Members, Falls Church City Council
Wyatt Shields, City Manager
Members, Board of Supervisors of Fairfax County
Anthony H. Griffin, Fairfax County Executive
Members, Fairfax Water

Attachment 1

History of Falls Church Return/Fee Transferred to General Fund

1981	400,000	1995	1,389,888
1982	440,000	1996	1,543,931
1983	448,631	1997	1,590,312
1984	428,298	1998	1,622,118
1985	1,004,054	1999	1,992,444
1986	1,150,410	2000	3,029,637
1987	1,003,401	2001	4,576,191
1988	927,579	2002	4,878,754
1989	1,283,145	2003	4,625,874
1990	1,290,869	2004	4,625,874
1991	1,391,560 ¹	2005	4,625,874
1992	1,511,614	2006	4,625,874
1993	1,277,828	2007	2,905,121
1994	1,362,636	2008	2,926,174
	Total	\$ 58,878,091	

^[1] City claims the amount for 1991 was higher -- \$2,070,468 (see City Deposition page 287).



Attachment 2

City of Falls Church Water Fund: Summary of Financial Information FY 1995 – FY 2008

<u>Fiscal Year</u>	<u>Operating Revenues</u>	<u>ROE or Mngmt Fee Transferred to General Fund</u>	<u>Transfers as % of Operating Revenues</u>	<u>Interest Income</u>	<u>End of Year Cash Plus Investment</u>	<u>Water Rate</u>
1995	\$ 9,714,263	\$ 1,389,888	14%	\$ 1,501,172	\$ 28,340,252	\$ 1.59
1996	\$ 10,028,549	\$ 1,543,931	15%	\$ 1,710,220	\$ 32,421,236	\$ 1.59
1997	\$ 9,593,782	\$ 1,590,312	17%	\$ 1,799,372	\$ 32,717,241	\$ 1.59
1998	\$ 10,794,944	\$ 1,622,118	15%	\$ 1,947,629	\$ 35,456,708	\$ 1.59
1999	\$ 11,133,052	\$ 1,992,444	18%	\$ 1,877,041	\$ 37,905,668	\$ 1.59
2000	\$ 11,787,769	\$ 3,029,637	26%	\$ 2,107,227	\$ 41,980,285	\$ 1.64
2001	\$ 10,977,933	\$ 4,576,191	42%	\$ 2,317,682	\$ 43,083,598	\$ 1.64
2002	\$ 11,297,328	\$ 4,878,754	43%	\$ 1,011,479	\$ 40,201,867	\$ 1.64
2003	\$ 12,583,244	\$ 4,625,874	37%	\$ 486,165	\$ 22,702,791	\$ 1.97
2004	\$ 12,528,123	\$ 4,625,874	37%	\$ 226,032	\$ 19,523,044	\$ 2.36
2005	\$ 14,554,007	\$ 4,625,874	32%	\$ 394,219	\$ 20,242,611	\$ 3.03
2006	\$ 18,326,495	\$ 4,625,874	25%	\$ 584,249	\$ 13,226,210	\$ 3.03
2007	\$ 19,385,666	\$ 2,905,121	15%	\$ 838,788	\$ 22,679,406	\$ 3.03
2008	\$ 19,705,069	\$ 2,926,174	15%	\$ 868,636	\$ 20,643,207	\$ 3.03

