Wealth-Based Water Rates—Really?

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ast month in this column we discussed the challenges of ensuring the affordability of water service and the USEPA’s new framework for addressing this challenge. We also promised that this month’s column would discuss a concept that some are vetting: the water industry might solve its affordability concern by overhauling its existing rate architecture and replacing it with one in which the relatively affluent pay more for water and wastewater services, and those less financially fortunate pay less.

While the existing approach to setting water and wastewater rates is not perfect, the out-of-the-box idea of basing the payment for water on one’s wealth is fraught with problems. It is important in this discussion to first understand the basic benefits of the existing and proven rate-setting practice for water and wastewater, referred to as a cost-of-service rate methodology. The details of this approach for drinking water are described in the AWWA manual M1, Principles of Water Rates, Fees, and Charges. The rate principles for drinking water outlined in the manual apply to wastewater as well.

Overall, one of the most important benefits of the cost-of-service rate methodology is that it is generally considered fair and equitable. Over many years and in many courts of law, this methodology has been found defensible because it results in rates (also referred to as user fees) that reflect the differing cost burdens of serving each of the utility’s customer classes. At a basic level, the cost-of-service methodology does this by first determining the cost that needs to be recovered from rates (referred to as revenue requirements); next, by determining the unique cost of serving each customer class; and finally by designing rates that recover the cost of serving each customer class. The wealth-based water-bill concept would most likely tinker with the third step (rate design) and may altogether ignore the important second step of determining the cost of service by customer class.

It is true that on the basis of “vertical equity”—a public finance measurement of fairness—pegging customers’ water bills to their income or wealth could have merit. The test of vertical equity is successfully achieved when those with greater income or wealth pay more than those with less. Carrying this a bit further, one could imagine that wealth-based water bills might also be progressive, another test of fairness in which those who make more money pay a greater percentage of their income than those who make less. While wealth-based water bills are likely to more closely reflect a customer’s ability to pay than traditional rate-making and therefore appear at first glance to be a positive step toward the affordability of water, they suffer from a number of significant deficiencies. For example, wealth-based bills do not reflect the cost of providing water service. Moreover, they would result in payments that are divorced from a customer’s water usage. They thus lose two important benefits of the existing cost-of-service approach.

Effectively, a shift away from the traditional cost-of-service rate-setting approach to wealth-based water bills will result in rates that are less legally defensible unless there is an objectively formed, rational nexus between wealth and a customer’s water usage. Further, the idea of wealth-based water bills brings into question whether the water bill will actually be a tax rather than a user fee. While there is often a great deal of confusion about the differences between taxes and user fees, one core difference is that user fees reflect the cost of providing water service, whereas taxes are unrelated to the cost of the service to a customer.

In a pure wealth-based billing system, the major investments water utilities have made in water meter and billing systems would be rendered worthless. While their investments in metering and billing systems provide multiple benefits to the utility, fairness and equity in assessing user charges are at the top of the list. And why is this? Precisely because the cost of providing water service to each customer is closely and rationally related to that customer’s water usage; as noted, the rational nexus to wealth on the other hand is not clear, if in fact there is one. What is clear is that under a wealth-based concept, meter reading would not be necessary for billing. Further, the customer’s incentive for the wise and careful use of water—our most precious resource—would of course be lost.

All AWWA members can probably agree that the affordability of water service is enormously important. But we think that most water professionals will also agree that wealth-based water bills are not the solution because the numerous benefits of a traditional rate-making methodology, which flow from the relationship between the cost of service and customers’ usage, would be lost in a system that based water bills on wealth instead.

If you have any comments or concerns, please write me at OpenChannel@awwa.org.