Don’t Panic: How Courts are Looking at Water Rates

CALIFORNIA WATER EFFICIENCY PARTNERSHIP

March 18, 2026

Water Resources Economics

Promoting the Value and Price of Water Service

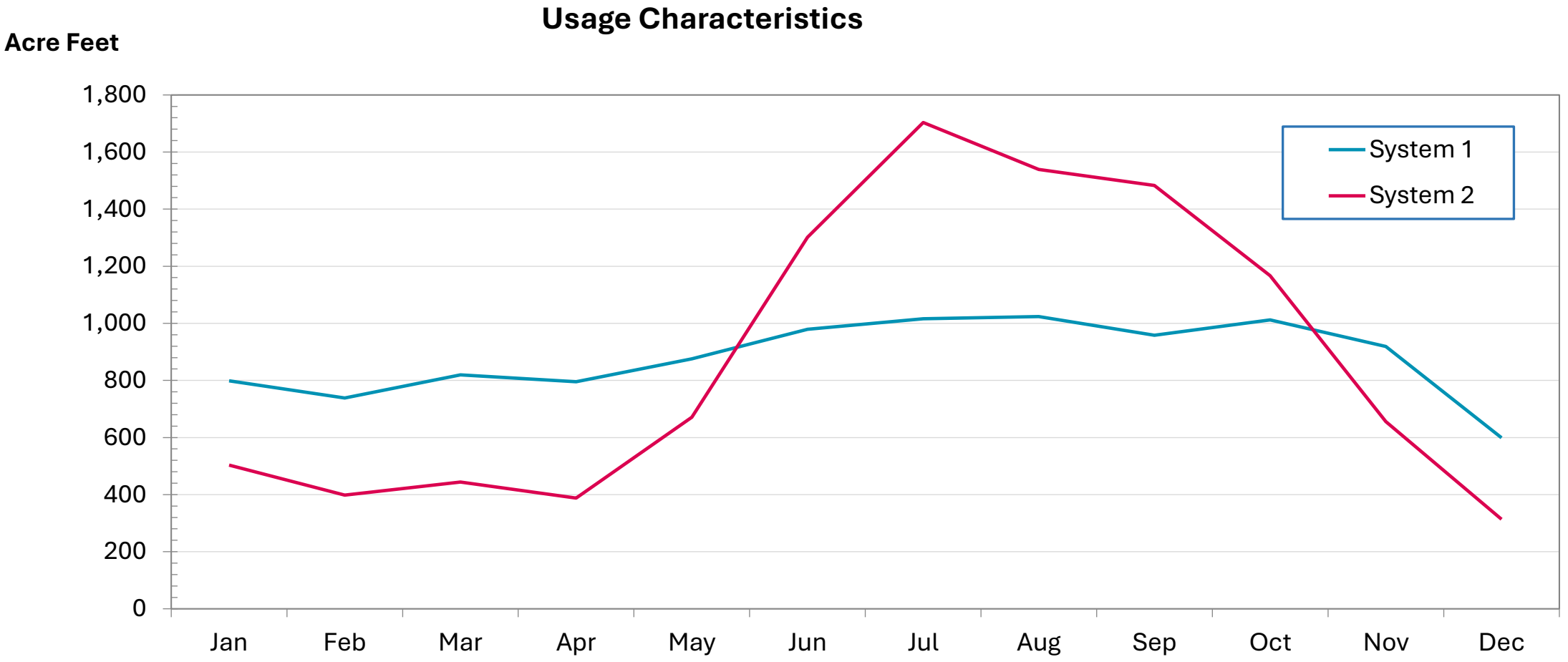
Rate Study Process

Policy Framework	Financial Plan	Cost-of-Service Analysis	Rate Design	Documentation
Identify Key Policy Objectives (Revenue Stability, Customer Affordability, etc.)	Develop Multi-year Cash Flow Projections to Determine Annual Rate Revenue Requirement	Allocate the Rate Revenue Requirement to Customers in Proportion to Use of and Burden on the Water / Wastewater System	Identify Appropriate Rate Structure Changes and Calculate Proposed Rates	Develop a Study Report to Provide Transparency and Defensibility
Which rate structure reflects our value?	**How much revenue do we need?**	**Who should pay for what?**	**What are the impacts of the proposed rate structure?**	**Is there a report that shows the proportionality of the rates?**

Cost-of-Service Overview

- Cost-of-Service is the Standard Methodology Used to Establish Water Rates in the United States
- **Guiding Principle:** Each Customer Should Pay Their Fair Share
- **Goal:** Recover Costs From Customers in Proportion to Their Use of the Water System
  - For example, Certain Costs May be Allocated:
    - Per Account (e.g., billing and customer service costs)
    - Based on Meter Size/Capacity (e.g., capital repair & replacements)
    - Based on Water Use (e.g., electricity costs to move water)

Water System Costs and Peaking Demand



Both water systems have annual demand of approximately 10,500 AF / year.

Which water system requires larger facilities/infrastructure?

What is Cost of Service?

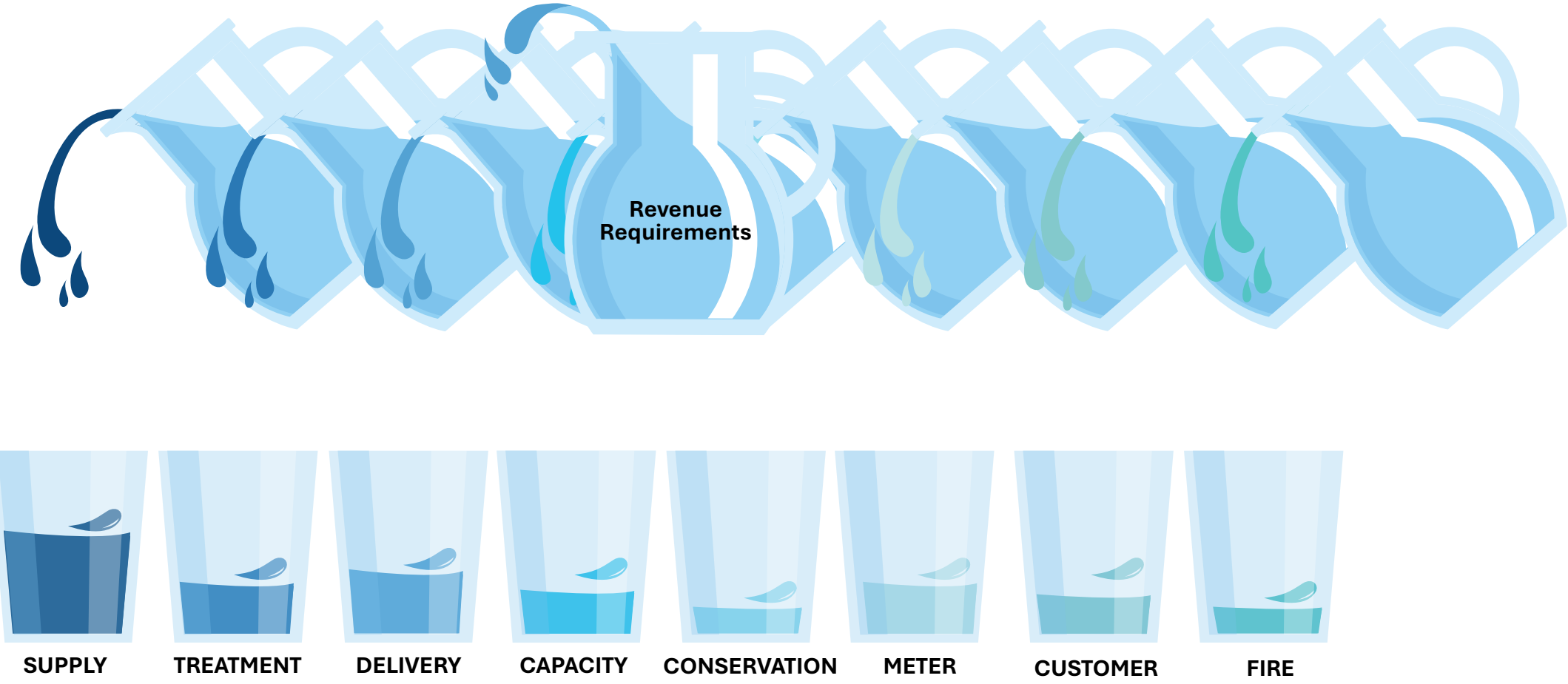
Revenue Requirements
Total Funds Needed to Cover Operating Costs, Debt Obligations and Planned Investments

Convert Revenue Requirements Into Unit Costs

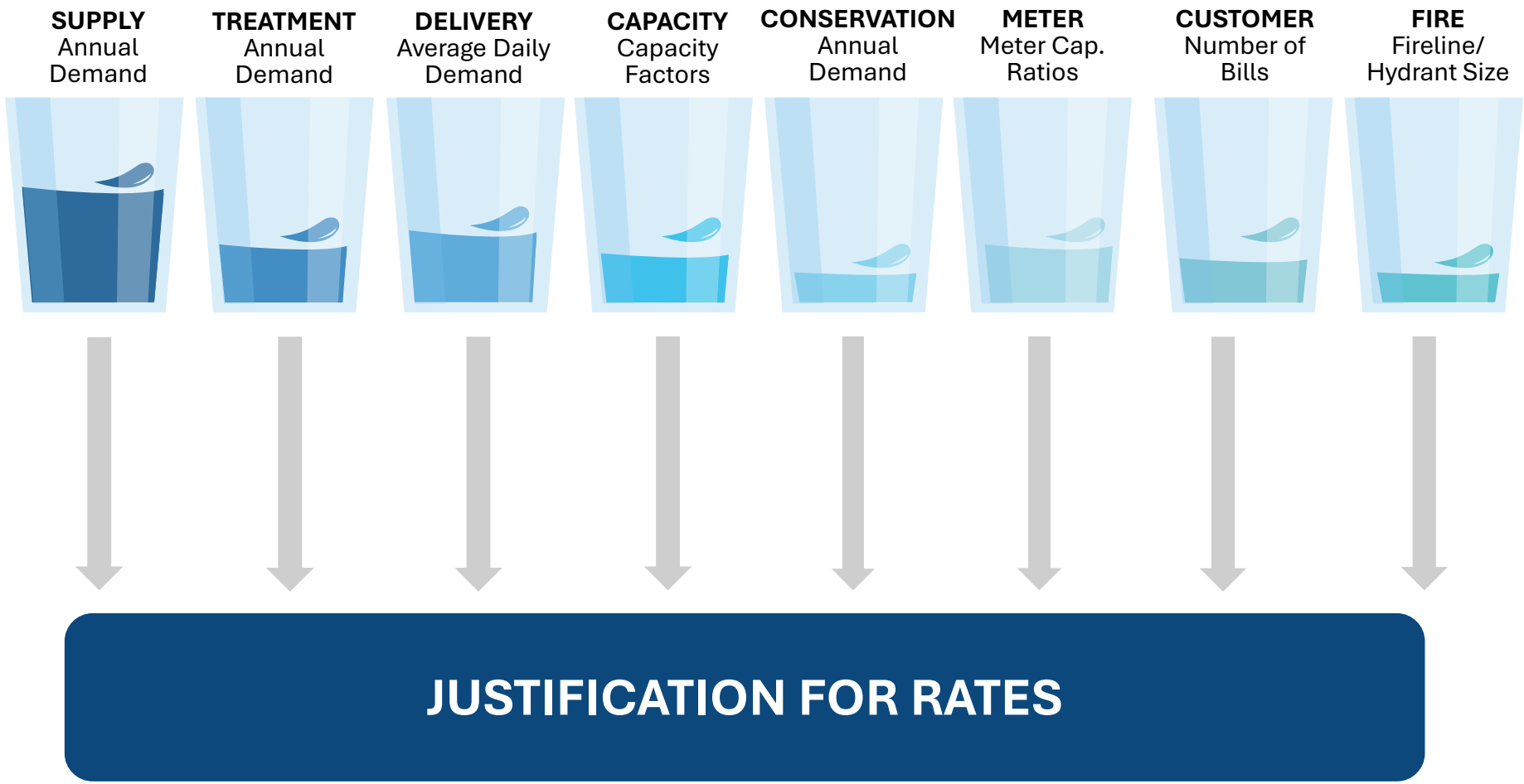
Costs are Allocated to Customer Classes Based on Their Use of the System and Usage Characteristics

Cost of Service
Fundamental Benchmark Used to Establish Utility Rates in the United States

Distribute to Cost Components



Distribute to Customer Classes



Rate Making Legal Environment

Cost of Service Requirements

- **Proposition 218** (Article XIIIC and XIIID of California Constitution)
- **Proposition 26**
- **California Government Code 54999**

Pass-Through Provision

- **AB 3030** (Section 53756 to the Government Code)

Water Conservation

- **Article X of California Constitution**
- **CA Water Code Chapter 3.4:** Allocation-based Conservation Water Pricing (AB 2882)
- **SB X7-7:** 20% Reduction by 2020
- **SWRCB Regulations:** Each Agency to Self Certify Adequate Supplies for 3 Years (Assuming Drought 2012-2015) and Set Conservation Standards Equal to Projected Supply Shortage
- **Executive Order B-37-2016:** Establishes Urban Water Use Target Indoor Water Budget + Outdoor Water Budget = Total Water Budget

Proposition 218 (Article XIIIC and XIIID of California Constitution)

- Applies to Property-related Fees for Service Including Retail Water / Wastewater Rates
- Rate Implications:
  - Rates must be proportional to and may not exceed the cost of providing service
  - One customer class (residential, commercial, etc.) may not subsidize another customer class
  - Retail agencies typically conduct a “cost-of-service analysis” at least once every 5 years to ensure a sufficient nexus between rates and costs
- Procedural Requirements

Proposition 218

Due to a Series of Court Rulings on Water Rates

Water and Wastewater is a Property-Related Service

Rates Need to be Proportional to the Level of Service

This is the nexus requirement.

Administrative Record is Required to Document the Rationality and Calculation of the Rates

We need to show the math behind our work.

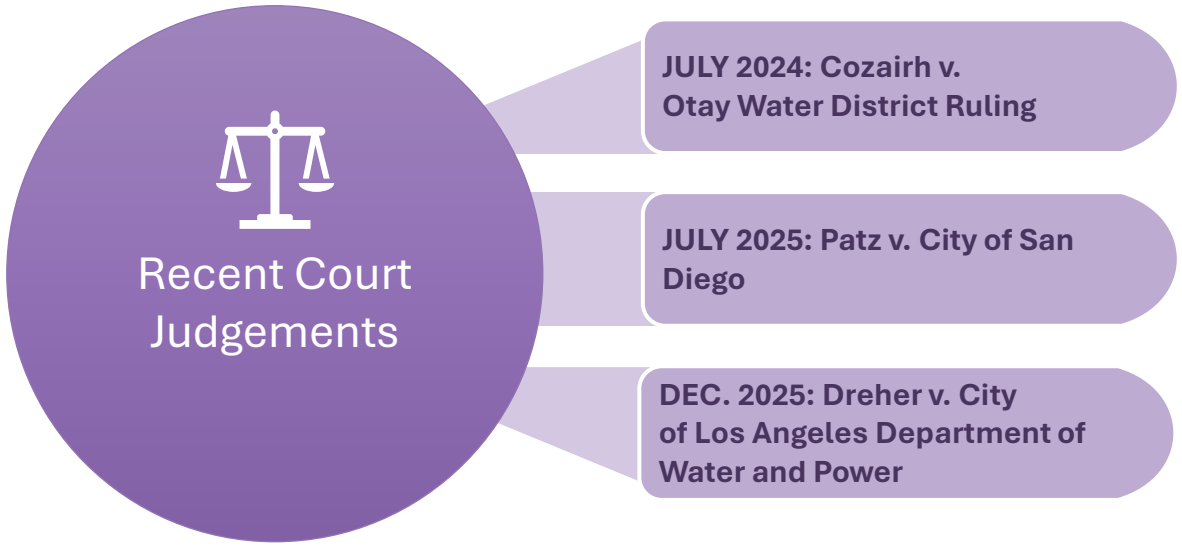
"Demonstrate the Cost Basis" per the San Juan Capistrano decision.

Implications

Business Model of Operating the Utility Should be Reflected in the Rate Structure

We Cannot Have Rates that Subsidize Other Customers

Recent Proposition 218 Litigation



- **Implications:**
  - **Higher Burden of Proof** to Show that Rates are Proportional to Costs
  - **Rates Primarily Designed** to Promote Water Efficiency/Conservation, *Even When Compliant with Industry Standards,* May Not Meet Prop 218 Requirements
  - **Tiered Rates** Require a Higher Level of Justification and Are Vulnerable to Legal Challenges
  - **Higher Degree of Uncertainty** Regarding Which Rate Structures Will Pass Legal Muster

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Why do courts seem contradictory?

- We have different rulings on tiered water rates
  - Coziahr and Patz ruled against the traditional tiered water rates
  - Dreher ruled in favor of the water budget tiered water rates
- Why?
  - Most individuals want to blame the judges
  - However, if we take the time to read the rate study, we see another reason

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Atkins – 2013 Otay Report

AWWA provides some basic guidelines for these types of structures. First the consumption-related cost is divided into the base, maximum-day, and maximum-hour cost of service. Then, as shown in Table 2-3 the threshold between blocks (tiers) 1 and 2 is set at the transition between average indoor use and average outdoor use. The objective of this to have block 1 consumption approximate indoor usage and to charge a higher amount for outdoor usage in block 2 to promote conservation. Block 1 pricing is normally set just below the average cost of water and block 2 is set just above the average cost of water. Block 3, which is considered to be in excess of both average interior and exterior water usage, is set at a higher price differential. This is based on the fact that above average use of water is using a larger portion of the water system and therefore should be required to pay for the cost of maintaining this extra capacity to serve their needs. All water systems must be designed for peak or excess use, not average use.

To set the rates in each block, the District uses a standard pricing structure. AWWA suggests that block 2 should be set at a level 30 percent higher than block 1 to reflect the cost incurred for increased capacity costs and supply purchases. Block 3 is then set at a price differential of 2 times the rate of block 1 because the capacity requirement is twice that of block 2 (e.g. single family block 1 breakpoint is 10 HCF and block 3 begins at 23 HCF).

HDR – 2017 Otay Report

HDR spent considerable time reviewing individual customer data and information to estimate and determine reasonable peaking factors by customer class of service. This information is used to equitably allocate the capacity related costs within this study.

- However, the report does not show this analysis
  - It is not enough to state that you did it, you need to show your work

Water Resources Economics

B&V – 2013 San Diego Report

Table 21 Volumetric Cost Recovery over Tiers

Description	Percentage of Cost Recovery in				
	Tier 1	Tier 2	Tier 3	Tier 4	Total
Base Demand Costs	40%	50%	10%	0%	100%
Maximum Day Costs	15%	45%	30%	10%	100%
Maximum Hour Costs			30%	70%	100%

- Why is base demand not spread to all tiers equally?
- Rationale of Max Day?
- Rationale of Hour Cost?

Water Resources Economics

Summary of Otay and San Diego reports

- Otay Water District (2013/2017) — study lacked detailed justification; relied on vague “industry standards.”
- San Diego (2013/2015) — rate logic was inconsistent; irrigation rates lower than residential outdoor use, costs arbitrarily assigned to tiers
- **Lesson: Courts expect clear, parcel-specific data, showing calculations, not generalities or industry standards.**

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LADWP Rate Study Summary

- PA Water Rate Study is 418 pages
- Clearly shows how cost are allocated

Figure 12: Cost Causation Factor Criteria and Marginal Cost Units

Functional Cost Component	Cost Causation Factor	Marginal Cost Units
Transmission (Capital)	Consumption volume by customer class	$/HCF/annual
Supply (O&M)	Consumption volume by customer class	$/HCF/annual
Supply (Plant)	Consumption volume by customer class	$/HCF/annual
Supply, Adder for BDCP Delta Fix, Cap and Trade	Consumption volume by customer class	$/HCF/annual
Supply, Purchased Water / Long Run Supply	Seasonal coincident peak by customer class	$/peak HCF/annual
Local Pumping	Consumption volume by customer class	$/HCF/annual
Water Quality and Regulatory Capital	Consumption volume by customer class	$/HCF/annual
Water Purification	Consumption volume by customer class	$/HCF/annual
Distribution Storage (Plant)	Consumption volume by customer class	$/HCF/annual
Distribution Storage (O&M)	Consumption volume by customer class	$/HCF/annual
Distribution (Plant)	Consumption volume by customer class	$/HCF/annual
Distribution (O&M)	Consumption volume by customer class	$/HCF/annual
Customer Service, Billing	Number of Customers	$/HCF/annual
A&G and General Plant Adder	Percent of (Proportionate to) All Other Costs	$/HCF/annual

These cost causation factors form the basis for the determination of marginal unit costs for each functional component (and sub-component). Based on appropriate allocation criteria, the cost causation factors are also utilized for the allocation of unit marginal costs to customer classes.

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Take Away

- We can have conservation / tiered water rates that are legally justifiable
- We need to have a well documented report that shows all the math that derived the rates
  - “Show your work”
- There are limitations on the pricing of tiered rates, we can not “arbitrarily” have high rates to promote conservation / water efficiency
  - The rates needs to reflect the cost structure of the utility

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Coziahr (2024) Study

Issue	Coziahr Rate Study	What we Should do
Non-cost-based objectives	Rate design included design criteria "water conservation" and "ability to pay" – no attempt was shown to connect actual costs to services	Begin with cost basis and connect those costs to actual use – show detail of how costs are directly connected to use
Tier definitions and prices not tied to actual data	Tier widths didn't reflect water use patterns and tier prices were determined by applying standard percentages not actual cost to provide service – lack of evidence	Produce detailed analysis of water use patterns based on actual customer billing records, provide parcel specific data and calculations in cost of service report
"Peaking factors"	Post-hoc justification for tier cost differences – so support for peak costs collected in higher variable rates	Collect base and peak costs across all tiers – use data to justify cost differences, show math
Costs not attributable to specific parcels	Non-specific data and assumptions – no math was shown to attribute costs to specific parcels	Review parcel specific data contained in billing, planning, and assessor records to identify costs attributable to each parcel

Patz (2025) Study

Issue	Patz Rate Study	What we Should do
City record did not provide burden of proof	Administrative record was not sufficient to validate tiered rate analysis	Provide details of all numbers and calculations used as well as an appendix of backup data
Tier width do not connect to cost basis	Residential tiers were designed based on “typical family sizes” and survey (national) data.	Produce detailed analysis of water use patterns based on actual customer billing records, provide parcel specific data and calculations in cost of service report
“peaking factors”	Defined peaking factors, but cost allocation does not reflect the claimed percentages – did not define peaking factors for each class	Collect base and peak costs across all tiers – use data to justify cost differences, show math
No connection of actual water sources/costs to tier pricing	Cost of water is a factor in tier pricing, but no analysis of source or price data is described	Review actual source availability and historical/projected use and cost, tie costs to consumption