26 May 2006

Mr. Rob Scott, Chair
Crane Lake Water and Sanitary District
P.O. Box 306
Crane Lake, Minnesota

Regarding: **FY 2006 Rate Recommendations**

Dear Mr. Scott;

In response to your request, Environmental Financial Group, Inc. (EFG) is pleased to submit this final letter report of rate structure and billing recommendations to the Crane Lake Water and Sanitary District (District) and its Western Service Area (WSA) project.

BACKGROUND

In November of 2005, EFG submitted a draft memorandum detailing an examination of various rate schedule options. That draft analysis was developed using budgeted expenses for FY 2006 and available billed flow data through August of 2005. In late March, EFG submitted a second draft memorandum with an options analysis that included a revised rate revenue target based on Board input.

This final letter report was developed following input and discussion at a public meeting conducted on 28 April 2006 and a review of subsequent correspondence. Following the 28 April 2006 public meeting, the District directed EFG to: 1) revise 2006 revenue requirements to include an appropriate operating contingency, 2) re-examine the estimated annual flow volume that might be affected by an “excess volume charge”, 3) revise the options presented in the 30 March memo accordingly, 4) provide recommendations as to how the District might periodically adjust customer base charges in response to historical billed flow data, and 5) recommend a rate structure and provide additional supporting recommendations. In response to this request, EFG has prepared this final letter report.

SCOPE AND LIMITATIONS

This letter report relies on billing data, revenue requirements, and other accounting and financial information that has been developed by others and provided to EFG for its use. Aside from a review of its reasonableness, validation of this information is beyond the scope of EFG’s assignment. Further, the rate structure recommendations described herein are highly dependent on the number of WSA customers, the total number of billing units represented by those customers, and conformance of actual costs to budgeted 2006 operating expenses. Deviations in these parameters will affect the financial results described herein. These effects may be material. EFG strongly urges the District to closely monitor its revenues and expenses through the upcoming summer season and be prepared to adjust rates, fees and charges accordingly.

RECOMMENDATIONS

At this juncture, EFG offers the following recommendations for your consideration.

1. **2006 Revenue Requirement.** Establish base and volume charges sufficient to collect $115,300 on an annual basis. Even though 2006 is almost half over, it is important to increase rates to mitigate a revenue shortfall. Since rate increases similar to that described herein carry some risk of changes in customer behavior and overall reduction billed flows, the District should add a 10 percent operating contingency ($9,330) to the amount recovered through user charges. This contingency is reflected in the total specified above. This revenue requirement reflects an expedited use of capital reserves. The District should examine its cash reserves before establishing its 2007 revenue requirement.

2. **2006 Rate Structure Options.** The following table provides rate structure options, without recommendation, updated from the 30 March memorandum and including a new option #8.

Option[1]		Base Charge, $ per month	Volume Charge, $ per thousand gallons	Excess Volume Charge, $ per thousand gallons
Option #3:	Original Rate Schedule	$ 56.00	$ 12.52	n/a
Option #5:	Volume Charge Only	n/a	$ 46.12	n/a
Option #6:	Base Charge Only	$ 76.87	n/a	n/a
Option #7:	Original + Excess Volume Charge[2]	$ 56.00	$ 12.52	$20.07
Option #8:	Original + Excess Volume Charge[2,3]	$ 56.00	$ 12.52	$20.07

[1] Options from the 30 March memorandum have been updated to reflect a 10% operating contingency.
[2] These options have been adjusted assuming no budgeted flows affected by an excess volume charge.
[3] Option #8 is similar to #7 except that it also includes customer base charge adjustments beginning in October 2007.

3. **2006 Recommended Rate Structure.** Immediately establish a base charge of **$56.00** and a volume charge of **$12.52** per thousand gallons for FY 2006. Establish an excess volume charge of **$20.07** that would be applied to the amount of monthly billed flow for each customer that exceeds 7,500 gallons multiplied by that customer’s number of assigned EDUs. The Base Charge is sufficient to collect $84,000 based on 125 EDUs. The Volume Charge is sufficient to collect $31,300 based on 2.5 million gallons of annual flow. The Excess Volume Charge is designed to recover that revenue that would have otherwise been collected through a base charge commensurate with the total billed flow for that month. Note that this charge is in no way related to available capacity in the WSA system or treatment facility. No budgeted flows have been included in this rate, rather it serves as an incentive for customers to live within their EDU assigned flows. Keep these rates in effect through the end of fiscal year 2006 and adjust them in January 2007 based on budgeted 2007 operating expenses. Due to recent construction and fossil fuel inflation and the potential for changes in the number of customers, it is not possible to accurately forecast FY 2007 rates at this time.

4. **Adjusting Customer Base Charges.** Notify customers now that beginning in October 2007 the District intends to adjust customer base charges based on billed flow data through September 2007. This advance notice is the fairest way to implement this kind of rate structure change. Establish a program whereby the base billing units would be redefined each October based on the most recent 24 months of billed flow data. This would be a program in which customers tell the District what they should be charged through their actual billed flow record. Establish this program by ordinance.

5. **Residential Base Charge Billing Units.** Beginning in FY 2008 and annually thereafter, establish one billing unit as equal to the average monthly billed flow from that 50 percent of permanent residential customers with the highest billed flow records for the most recent 24 month period. This provides a base billing unit that is appropriately conservative. EDUs should remain as the basis for engineering design, assessment and hookup fee purposes. Charge each residential customer (permanent and seasonal) one billing unit multiplied by the published unit base charge plus a volume charge applied to each customer's metered flows.

6. **Commercial Base Charge Billing Units.** Beginning in FY 2008 and annually thereafter, assign billing units to commercial customers based on each customer's billed flow record for the most recent 24 months. Divide their average monthly billed flow over that period by the number of monthly gallons that are defined as one (1) billing unit in No. 5 above to define each customer's unique number of billing units. Charge each commercial customer a base charge equal to their assigned billing units multiplied by the published unit base charge plus a volume charge applied to each customer's metered flows.

7. **Assumed Excess Volume Flows.** A re-examination of the billing records provided to EFG by the District has revealed that adjustments in early 2005 due to frozen lines, grinder run-time metering problems, and other undocumented billing adjustments had not been made. This resulted in *1.7 million gallons* of "excess volume flow" being estimated for 2005 based on nine months of 2005 data. The 30 March memorandum subsequently included an Option #7 that an assumed 1 million gallons of systemwide flow would be discharged annually by customers in excess of the flows stipulated in their EDU assignments. An examination of the corrected data indicated that *no* excess volume flow is evident in the 2005 historical record. This points up the difficulty of working with that early billing data and supports EFG's recommendation that customer base charges not be adjusted until additional billing data is available--until billed flow adjustment procedures can be documented and grinder pump station calibrations can be completed. As such, an "excess volume charge" rate structure that targets a specific volume of flow cannot be recommended at this time.

We thank you for the opportunity to work with the District on this important project. Please call me if you have any questions or comments. Thank you.

Very Truly Yours,
ENVIRONMENTAL FINANCIAL GROUP, INC.

/s

Scott E. Harder, PE
President/CEO