BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITES AND TRANSPORTATION COMMISSION, Complainant, v. BREMERTON-KITSAP AIRPORTER, INC., C-903, Respondent.	DOCKET NO. TC-001846 BRIEF OF COMMISSION STAFF

I. Introduction

Bremerton-Kitsap Airporter's present fares were set in 1991 in Docket No. TC-911279. Since then, the Company's revenue has increased 116 percent.[1] In other words, the number of passengers the company carries, and therefore the amount of money it collects in fares, has more than doubled. It is apparent that, within that same time period, the Company's expenses—setting aside the compensation paid by the Company to Richard Asche in his role as the Company's executive—have not increased to nearly the same degree. Using conservative measures, the Company has averaged, over at least five years, a rate of return on investment of around 60 percent[2] and an operating ratio of about 83 percent[3] (providing a margin of revenues over expenses a full ten percent more than the seven percent provided by the standard 93 percent operating ratio).

[1] As indicated in the table at page 9 of Ex. 9, the Company's pro forma revenue in TR-911279 was $763,091. Test year revenues in the present case are $1,653,963, or 116% higher than in the docket setting the Company's present rates.
[2] Ex. 1 (Colbo Direct), p. 29, ll.16-18. The fact that customers have paid for the entire net investment three times over in the last five years translates to an average annual return on investment of 60 percent.
[3] Ex. 15, l. 50, col. (g); Ex. 1 (Colbo Direct), p. 27, l. 22 – p. 28. l. 22.

While Mr. Asche attributes this growth in revenue to the Company's efforts to provide an increasingly attractive service, Staff's testimony shows[4] and Mr. Asche concedes a large element of windfall owing to such factors as population growth and growth in airline travel over the intervening years.[5] But for purposes of ratemaking, the causes of the Company's increased profitability—whether characterized as hard work and business acumen or sheer luck—ultimately do not matter. What matters is that the assumptions underlying the Company's current fares have changed substantially with the result that the Company, for at least the past five years, has been receiving far more revenue than it requires, by any reasonable measure, to cover its expenses, pay taxes and provide a fair return on investment. Since its present rates were set, the Company has added additional trips to its schedule[6] and replaced its eleven-passenger vans with 21-passenger vehicles[7]—with attendant improvements in cost per passenger.[8] Most obviously, the Company only has to pay one driver to deliver almost twice as many paying passengers. Other savings related to the larger capacity vehicles include reducing the need for back-up drivers and additional vehicles during peak times. The larger vehicles have also resulted in reduced insurance costs, because premiums are paid on a per vehicle basis.[9]

Another way in which the Company's operations have changed since its present rates were set in 1991 is that it has eliminated at-home drop-off service in favor of

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[4] Ex. 1 (Colbo Direct), p. 36, ll. 1-9.
[5] Tr. at 263, ll. 5-24: "Well, it's we're kind of a supply side economics business. I mean the more trips you add, the more passengers you're going to carry. It's kind of like build a ballpark and they will come." Tr. at 268, l. 12 – 269, l. 10.
[6] Tr. at 263, ll. 5-7.
[7] Tr. at 266, ll. 23-25.
[8] Ex. 24T (Asche), p. 4, ll. 26-28.

depositing customers at central drop-off points.[10] As a result, passengers must either have someone pick them up at the drop-off point or call a taxi to complete the last leg of their trip.[11] While the Company asserts this service was self-supporting with a special fare of one dollar per mile beyond the Company's established drop-off points,[12] Mr. Asche stated that as a result of discontinuing this service, his Company has achieved efficiencies relative to other airporters that still offer this service.[13] Specifically, Mr. Asche's Company is able to schedule service so that the same vehicle that drops off passengers at the airport immediately picks up another load.[14]

The Company asserts that its fares are below those of other airporter services regulated by the Commission. While this is true, it is also true that the Company's expenses, at least judging from recent filings by those other carriers, are lower still. In any case, what other regulated entities charge in rates or fares has never been the measure of what constitutes just and reasonable rates for B-K Airporter.

With its two certificated routes, B-K Airporter has, by all indications, exploited a uniquely lucrative market for transportation services by eliminating less efficient home delivery service and taking advantage of the concentrated customer bases presented by Fort Lewis, McChord Air Force Base, and Navy installations at Bangor and Bremerton.[15]

The Company's consistent overearnings have presented the Company with what Mr. Asche describes in terms suggesting an embarrassment of riches: "We have been

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[9] *Id.*
[10] Tr. at 264, ll. 15-21.
[11] Tr. at 265, ll. 20-22.
[12] Tr. at 264, l. 25 – 266, l. 4.
[13] Tr. at 270, ll. 9-16; Tr. at 274, ll. 5-7.
[14] Tr. at 269, l. 15 – 270, l. 16.
[15] Ex. 24T (Colbo), p. 7, l. 1-5.

advised by our CPA that we cannot continue to maintain such retained earnings without attracting unwanted attention from the IRS. Thus, bonuses were paid to me to reduce retained earnings . . .”.[16] During the test year, the Company paid Mr. Asche compensation totaling $421,000.[17] Thus, instead of distributing these excess profits as earnings to Mr. and Mrs. Asche as the Company's owners, the Company opted, on the advice of its tax advisor, to pay extraordinarily large bonuses to Mr. Asche, purportedly as compensation for his work as the Company's executive. While Staff does not take issue with how the Company chose to dispose of its excess profits so as to maximize the owners' after tax income, it does take issue with fact that the Company has continued to extract such excessive profits from its customers for so prolonged a time.

In this case, Staff advocates an admittedly novel regulatory response to address a uniquely prolonged period of excessive earnings by this Company. Staff recommends setting rates using a 97 percent operating ratio (instead of the usual 93 percent) and requiring the Company to maintain, for three years, an account into which it must deposit all earnings that would result in an operating ratio below 97 percent. This proposal, if adopted by the Commission, would give teeth to an important principle: that when the growth in a regulated transportation Company's revenues so consistently outpaces its expenses, and for such an extended period, that Company reduce its rates.

It is not a novel idea that when the gap between the revenues and expenses of a regulated transportation Company has unreasonably widened to the shareholders' benefit, the Company must accept a rate decrease or otherwise pass the benefits on to ratepayers.

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[16] Ex. 24T (Asche), p. 5.
[17] Ex. 1T (Colbo Direct), p. 11, ll. 16-17.

Mr. Colbo testified to recent instances in which this has occurred.[18] They include a reduction in the recycle rates of 12 solid waste companies as a result of a sustained, significant increase in commodity values; a reduction in rates of three solid waste carriers when price competition with regard to "tip fees" charged by transfer stations reduced disposal fees substantially below levels included in the carriers' rates; and elimination of a fuel price surcharge collected by another airporter service when it became apparent that fuel prices had moderated.

Five years of demonstrably excessive earnings thoroughly disposes of any argument a regulated Company might make that a reduction in rates has not been long-since justified. Where a Company's earnings have been excessive for five years, the law authorizes the Commission to set aside the usual prohibition against taking past overearnings into account in setting rates and specifically requires the Commission to "take official notice" and "consider such facts in fixing rates."[19] Staff's proposal to: (1) set fares to achieve a 97 percent operating ratio, and (2) require the Company to maintain, for three years, a trust account into which the Company must place any overearnings (as discussed in further detail below), gives effect to the mandate of RCW 81.04.360 while still providing the Company with a return on investment that is within a reasonable range.

II. Contested Adjustments

The following table represents the pro forma adjustments that are contested by the parties.

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[18] Ex. 1T (Colbo Direct), p. 34, l. 19 – p. 35, l. 16; *see also* Ex. 16, p. 3 listing WUTC dockets in that last ten years in which the Commission has required rate decreases after formal proceedings rather than the increases that were sought by the utilities.
[19] RCW 81.04.360

Table of Contested Adjustments			
Contested Operating Expense Adjustments	**Company**	**Commission Staff**	**Difference**
company case costs	$100,000	$0	$100,000
executive officer salary (plus associated payroll tax)	($282,119) + ($4,089)	($355,000) + ($6,884)	$72,881 + $2,795
affiliated interest facility lease	$0	($22,930)	$22,930
industrial insurance premium refund	$10,767	$7,178	$3,589

Each of these adjustments is described, in turn, below.

A. Case costs.

Staff opposes the Company recovering any of its legal and expert witness costs incurred in this case in rates because of the Company's long history of unsupported rate applications, including this case.[20] Additionally, the theory of Staff's complaint is that, because this Company has had such a prolonged period of excessive earnings, the Company should have long-since taken a voluntary rate reduction. This is not an instance where the Company is prosecuting a rate case on a fairly arguable belief that its fares are not sufficient.

The Company argues it should recover, on an annual basis in permanent rates, the $100,000 that Mr. Burton estimates to be the Company's cost of defending this complaint.[21] Apparently in partial recognition of the untenability of its position on the recovery of rate case costs, the Company is not seeking to recover in rates any expenses in this tariff filing that it incurred prior to May 14, 2001—the date the Company requested to withdraw its filing.[22]

Ordinarily, the expense a Company incurs in litigation, including litigation of rate cases, is recognized as an expense to be recovered in rates. But this is not without

[20] Ex. 17T (Colbo Rebuttal), p. 2, ll. 12-15; Ex. 9, p. 9, col. (k).
[21] Ex. 34T (Burton), p. 12, ll. 11-17.

exception. The Commission has previously rejected part or all of a company's claimed rate case costs on the basis that they were excessive.[23]

There are important policy reasons to disallow rate recovery of legal expenses in the context of a complaint by the Commission to reduce excessive rates. It would be a dangerous precedent to allow case costs for defending a Commission-initiated rate complaint, particularly if it were done without regard to the ultimate reasonableness or successfulness of the Company's litigation position or without some reasonable limitation based on the amount at issue.

$100,000 is shockingly high given the nature of this case. There are no intervenors in this case. The contested issues are few and not particularly complicated. The Company required only one expert witness who filed only twenty pages of testimony. Staff presented the testimony of only one witness. Under these circumstances, it is difficult to see why the Company needed two senior attorneys, neither of whom lacks experience before this Commission, to represent it in this matter. Moreover, Mr. Burton's $100,000 amount is estimated, not actual. If the Commission decides to allow the recovery of some portion of the Company's legal expenses in this proceeding in rates, it should insist on proof of the Company's actual expenses.

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[22] Ex. 32 (Burton), p. 12, ll 8-17.

[23] *WUTC v. Sno-King Garbage Company, Inc.*, Docket Nos. TG-900657, TG-900658, Fourth and Fifth Supp. Orders, (Dec. 1991) (Commission found no benefit to ratepayers from the amounts spent on expert and attorney fees in the case and denying their recovery in rates as exorbitant and imprudent); *Petition of PSE*, Docket No. UE-920433, Fifteenth Supp. Order (Dec. 15, 1993) (Commission affirmed rejection of portion of PSE's rate case expenses partly in response to Public Counsel argument that the Company simply spent too much); s*ee also, WUTC v. Rosario Utilities, LLC*, Docket No. UW-951483, Fourth Supp. Order, pp. 7, 8 (November 25, 1996) (only $6,000 allowed, $18,000 sought).

Even if the Commission decides to allow some portion of the Company's expenses in this case to be counted toward the Company's revenue requirement, it should, at a minimum, require amortization over a reasonable period. Mr. Burton treats his estimate of B-K Airporter's total litigation expense from the date the Company sought to withdraw its complaint as an annually recurring expense, rather than as a cost to be amortized over a number of years. Mr. Burton's failure to amortize his proposed case costs over a reasonable number of years is clearly inappropriate. On cross-examination, Mr. Burton admitted he wasn't sure if the expense of a rate cost would be repeated in a year. In defense of his treatment of the case costs as an annually recurring expense he could only offer that "there may be additional costs or other costs that will take its place."[24] This utterly fails the "known and measurable" test for pro forma adjustments. As Mr. Colbo testified, "To include the full amount in the expense base used to determine rates would imply that such costs would be recovered in the next year and again each year thereafter unless rates were adjusted after the first twelve months."[25] The Commission routinely amortizes reasonable rate case costs over three years.[26] In this

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[24] Tr. at 331, ll. 19-21.

[25] Ex. 17T (Colbo Rebuttal), p. 2, ll. 16-19. The Commission stated in *WUTC v. Rosario Utilities, LLC*, "[t]he proper mode of recovery [of legal expenses in prosecuting a rate proposal] is to amortize the expense over the period between expected occurrences or over a reasonable period." *WUTC v. Rosario Utilities, LLC*, Docket No. UW-951483 (1996 Wash. UTC Lexis 43), p. 16 (November 25, 1996); *see also WUTC v. American Water Resources, Inc.*, Docket Nos. UW-980072, 980258, 980265, 980076, Sixth Supplemental Order, p. 30 (January 21, 1999) (adopting three year amortization of rate case expenses on the ground that "[I]t is not typical or usual for a small water Company, or any well run utility for that matter, to file for annual rate increases").

[26] Ex. 17T (Colbo Rebuttal), p. 2, ll. 19-20.

case, Staff recommends amortizing any allowed costs over five years, due to the unusual nature of this filing.[27]

B. Executive Compensation and Associated Payroll Taxes

1. Staff's use of Mr. Asche's actual monthly salary amount for executive compensation reflects the Company's own number, properly treats Mr. Asche's bonuses as distributed profits rather than part of his executive compensation, and is well-supported by objective analysis.

During the test year, for his work as the Company's executive, Mr. Asche received $66,000 in wages and $355,000 in bonuses.[28] The Commission should find only the $66,000 that Mr. Asche actually received as wages during the test year as an operating expense for purposes of determining the Company's revenue requirement. By the Company's own admission, it was only as a tax avoidance strategy that the $355,000 was paid to Mr. Asche as compensation, purportedly for his work as the Company's executive rather than as distributed earnings to him as a shareholder. Mr. Colbo's contention that "these large bonuses more properly represent distribution of profits, not operating expenses for ratemaking determinations,"[29] is not contested by the Company.

Staff's proposed $66,000 allowance for executive compensation does not rest solely on the fact that it was the Company's own figure for wages paid to Mr. Asche during the test year. Staff also presented considerable objective, empirical evidence of the reasonableness of this amount.[30]

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[27] Ex. 17T (Colbo Rebuttal), p. 2, ll. 20-22.
[28] Ex. 1T (Colbo Direct), p. 11, ll. 15-21.
[29] Ex. 1T (Colbo Direct), p. 12, ll. 11-12.
[30] Some of the analysis in Mr. Colbo's direct testimony was directed at demonstrating that the executive compensation amount set forth in the Company's pro forma income statement in support of its proposed rate increase—i.e., $421,000—was completely unrealistic in light of the size and complexity of companies that typically pay their executives in that range. Because the Company did not attempt to justify this full

As shown on page 10 of Exhibit 9, the executive salaries paid in 1999 by other regulated airporter services with total revenues comparable to that of B-K Airporter were generally lower and in only one case somewhat higher than B-K Airporter's test year wages of $66,000 for Mr. Asche. Grayline of Seattle d/b/a Evergreen Trails, with pro forma revenues of $2.3 million (compared with B-K Airporter's actual test year revenue of $1.65 million) paid $64,121 in executive compensation in 1999. Wickkiser International, Inc., with its $2.85 million in pro forma revenue, paid $59,500 in compensation to its executive. Centralia-SeaTac Airport Express, at $470,911 in pro forma revenue recently sought $36,000 in executive salary. Setting aside Shuttle Express's $250,000 annual executive compensation (which, as Mr. Colbo pointed out in his testimony is based on more than 7.4 times as much revenue as B-K Airporter[31]) only one other regulated bus Company—Capital Airporter (with $960,024 in pro forma revenue) paid a higher executive compensation amount than B-K Airporter's $66,000. It should be noted that the $91,000 in executive salary that Capital Airporter did pay was distributed among 2.5 full-time equivalent employees (FTE's) and the Company had only 1.5 FTE's that it classified as "management" in contrast to B-K's three management level employees.[32]

Another measure employed by Staff to verify the reasonableness of the $66,000 allowance for executive compensation was a survey of salaries paid to executives of transit authorities in Washington state with revenues less than $10 million. Among those

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$421,000 amount in defending against Staff's complaint, these "upper end" comparisons have become less germane—such as Mr. Colbo's comparison to the $410,900 in executive compensation allowed by the Commission in the recent rate case of Avista Utilities, a Company with $351 million in regulated revenue at page 17 of his testimony.

[31] Ex. 1T (Colbo Direct), p. 15, ll. 2-3.

four entities, Staff's analysis shows an average annual executive salary of $66,952—remarkably close to Mr. Asche's $66,000 in test year wages.

Staff's analysis in arriving at this average of small transit agency executive compensation is in fact very generous to the Company. For example, Staff could have drawn the class of comparable public operations far more restrictively based on total revenue. Page 12 of Staff's Exhibit 9 shows that the executives of the transit agencies closest in size to B-K Airporter in terms of total revenue (Cowlitz Transit authority with $1.9 million and Mason County Transit Authority with $1.7 million) made only $15,861 and $52,000 a year, respectively. The reason for the surprisingly low $15,861 figure for Cowlitz Transit's executive is that running the transit authority represented only one quarter of his overall job responsibilities, for which he received a total salary of $63,444. Staff counts his total salary toward the average. The two other transit authorities considered in this under $10 million category were Clallam and Island Transit, both with total revenues approaching $5 million as compared with B-K Airporter's $1.6 million. These executives made $84,238 and $68,124 respectively.

Additionally, as Mr. Colbo points out in his testimony,[33] the transit operations of these county systems are significantly larger, and more complex and diverse than is the operation of B-K Airporter. Indeed, Mr. Ashe describes B-K Airporter in terms suggesting that it is less complex, even, than other regulated airporters: "we have no door-to-door service, and we serve a large military customer base. This concentrates our

[32] Ex. 9, p. 10, cols. (b) and (f) at line 10.
[33] Ex. 17T (Colbo Rebuttal), p. 7, ll. 9-13 ; Ex. 19.

customer base configurations and involves significantly different demographics, markets, and operational considerations."[34]

2. The Company has failed to provide a convincing alternative method of determining reasonable executive officer salary.

Rather than offering any kind of objective peer group comparison of his own, Mr. Burton, on behalf of the Company, simply presents unpersuasive criticism of Staff's comparisons and instead offers an executive compensation amount based on no objective criteria at all.

The Company's response to Staff's comparison of Mr. Asche's compensation with that of other WUTC-regulation airporter services is to pretend that it doesn't exist. Mr. Burton's only criticism of Staff's survey of regulated private transportation Company officer compensation is his allegation that the information is unreliable.[35] However, Mr. Burton presents no evidence of his own to demonstrate this asserted lack of credibility or validity. B-K Airporter had the ability to conduct discovery of the methodology of Staff's survey and to assemble information with which to try to impeach the Staff's findings, but the Company did not do so, either in Mr. Burton's reply testimony or on cross-examination of Mr. Colbo. Additionally, Mr. Colbo's rebuttal testimony further clarified the terms utilized in the exhibit about which Mr. Burton expressed confusion in his testimony.[36] The Commission should adopt Staff's adjustment to executive compensation.

[34] Ex. 24T (Asche), p. 7, ll. 2-5.
[35] Ex. 32T (Burton), at p. 9, l. 20 – p. 10, l. 9.
[36] Ex. 17T (Colbo Rebuttal), at p. 4, l. 14 – p. 5, l. 12.

a. The Company's criticisms of Staff's comparisons introduce concepts of risk that are not properly considered in fixing executive compensation.

The Company's most vehement objection to Staff's method of verifying the appropriateness of the $66,000 executive compensation amount is aimed at Staff's comparison of Mr. Asche's compensation to that of public sector transit agency executives. According to Mr. Burton, "It is not the size of the revenues or the scope of the operations that should invoke the correlation, but the entrepreneurial risk factor and the day-to-day operations, profitability, performance and pressures on the business executive that should gauge the amount of the compensation."[37] In essence, Mr. Burton argues that executives of private regulated bus companies require more compensation than their public sector counterparts because of the risk that *the Company* might not make money.

Taken to its extreme, this argument would justify the owner-operator of an airporter service with a single van drawing a larger salary than the executive of King County Metro. Clearly the complexity of the job and the size of the operation are not entirely overshadowed by whether the executive is in the public or private (regulated) sector. Mr. Burton's statement ignores the fact that public executives do have to concern themselves with their agencies' bottom line, and the range of skills demanded of them is unquestionably more complex than what is required to run an airporter service with two routes and no door-to-door service. Moreover, Mr. Burton's arguments gloss over the fact that B-K Airporter is not a fully competitive enterprise but a regulated monopoly that is allowed to increase its rates if it can demonstrate it is not bringing in enough revenue to

[37] Ex. 32T (Burton), p. 8, ll. 16-19.

meet expenses. Mr. Asche's description of the "supply side" nature of his business does not bring to mind a market in which there is vigorous competition for scarce customers.[38]

But there is a more fundamental problem with Mr. Burton's suggestion that the Commission should give credence to an "entrepreneurial risk factor" in determining an appropriate level of executive compensation. The purpose of executive compensation is to compensate the executive for his or her work on behalf of the Company. Whether the executive also happens to be the Company's largest shareholder should have no bearing on how much compensation is appropriate to the job (or jobs) the executive actually performs. As Mr. Colbo pointed out on cross-examination, the problem is really to determine what the owner would have to pay someone with the requisite skills, in an arm's-length transaction, to do the job.[39] This issue was somewhat confused in both the Staff's and the Company's testimony by the use of the term "owner allowance" when what is really at issue is executive compensation.

Return on the owner's investment—i.e., the allowance of a profit to reward the owners for placing their money at risk—is an entirely separate issue, though there is an opportunity to improperly confuse the two when dealing with a closely held Company such as B-K Airporter.

The Company emphasizes that Mr. Asche is involved in all aspects of the business, even acting as driver on occasion. This is not a basis for concluding that Mr. Asche "deserves" a higher salary. To the contrary, it indicates that the higher level functions typically performed by an executive (and for which one would earn executive

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[38] Tr. at 263, ll. 5-24: "Well, it's we're kind of a supply side economics business. I mean the more trips you add, the more passengers you're going to carry. It's kind of like build a ballpark and they will come."

pay) do not occupy all of Mr. Asche's time on the job. It makes clear that B-K Airporter does not require the full-time services of what one would ordinarily consider a chief executive officer.

b. The Company's own suggested officer salary is transparently opportunistic and is really based on no analysis at all.

The Company argues that an appropriate adjusted executive compensation for Mr. Asche, together with an amount representing a benefits package, is $138,881. The Company derives this figure by plucking a number from a Staff work paper related to a 1998 proposed rate increase filing by the Company, and adjusting it using a consumer price index.[40] Mr. Burton also adds an amount representing a benefits package, even though Mr. Asche does not receive a benefits package from the Company.[41] Although Staff presented the memo to the Commission at an open meeting to support Staff's recommendation to suspend the Company's filing, the Company withdrew its filing after the Commission suspended the Company's proposed fare increase in Docket No. TC-980036.[42] The figure was nothing more than one Staff member's preliminary estimate of a reasonable executive payroll for purposes of deciding whether to recommend suspension.[43] It was not based on any peer group analysis of the type performed by Staff in this case.[44]

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[39] Tr. at 248 (Colbo).
[40] Ex. 32T (Burton), p. 7, ll. 5-20 ; Tr. at 311; Tr. at 319, l. 21-321, l. 6.
[41] Mr. Colbo did not adjust for a hypothetical benefits package because 1) Mr. Asche does not pay himself benefits, and 2) because of the offsetting consideration of the greater complexity of the job responsibilities performed by the public transit executives surveyed, whose salaries Staff found to be comparable to Mr. Asche's wages.
[42] Ex. 9, p. 9.
[43] Tr. at 109, l. 23-112, l. 20.
[44] Tr. at 119, l. 21-120, l. 9.

On cross-examination, the Company's accounting witness claimed his salary adjustment was also based on a comparison to salaries paid to executives of log trucking companies before their deregulation[45] as well as to research allegedly performed on Internal Revenue Service proceedings that addressed executive compensation.[46] The Commission should reject these comparisons. They have all the hallmarks of after-the-fact rationalization and are patently unrealistic comparisons when compared to those of Staff.

C. <u>Building Rent (Affiliated Interest Transaction)</u>

The Company pays $60,000 annually in rent for the facility out of which it operates in Bremerton.[47] The Company pays this rent to Richard Asche and his wife, who own the real property.[48] Because Mr. Asche and his wife are also the 99 percent shareholders of Bremerton-Kitsap Airporter,[49] this transaction constitutes a transaction with an affiliated interest within the meaning of RCW 81.16.030.[50] Under that statute, the Commission is authorized to:

> . . . exclude from the accounts of the public service Company any payment or compensation to an affiliated interest for any services rendered or property or service furnished, as described in this section, under existing contracts or arrangements with the affiliated interest unless the public service Company establishes the reasonableness of the payment or compensation. In the proceeding the commission shall disallow the payment or compensation, in whole or in part, in the absence of satisfactory proof that it is reasonable in amount. In such a proceeding, any payment or compensation may be disapproved or disallowed by the commission, in whole or in part, if satisfactory proof is not submitted to the

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[45] Tr. at 321, l. 22.
[46] Tr. at 325, l. 3.
[47] Ex. 1T (Colbo Direct), p. 19, ll. 17-19.
[48] Ex. 24T (Asche), p. 5, ll. 7-10.
[49] Ex. 1T (Colbo Direct), p. 19, ll. 15-17.
[50] RCW 81.16.010 defines "affiliated interest" as "Every . . . person owning or holding directly or indirectly five percent or more of the voting securities of any public service Company . . ."

> commission of the cost to the affiliated interest of rendering the service or furnishing the property or service described in this section.

The Commission has consistently used this statute and its identical counterpart in Title 80 RCW (RCW 80.16.030) to protect ratepayers from possible harm from affiliated transactions. Such transactions are disfavored under the law of regulated utilities because:

> A Company might be tempted to divert functions to unregulated affiliates so that stockholders might earn a higher unregulated return from the affiliate than they might from a regulated entity, with the ratepayers consequently responsible for higher expenses than might be experienced in an integrated regulated Company.[51]

The regulated Company bears the burden of demonstrating that the payment is a reasonable amount; if it does not do so, or if it does not show the cost to the affiliate, the Commission is instructed to disallow payment.[52] The standard for a reasonable price is the lower of the competitive market price or the affiliate's cost plus a fair return.[53]

Staff's restating adjustment for the rent the Company pays for its facilities lowers the Company's booked rent to reflect Mr. and Mrs. Asche's actual costs incurred in purchasing the building and real estate, the interest associated with that investment, and a return on the net depreciated investment. Mr. Colbo depreciated the life of the buildings over 30 years without any salvage value and imputed a debt cost of 5.0 percent on the outstanding debt balance, based on the Asche's actual cost.[54] He allowed a return of 15 percent on the Asche's equity.[55]

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[51] *WUTC v. US WEST Communications, Inc.*, 15th Supplemental Order, Docket No. UT-950200, 169 PUR4th 417, 455 (1996).
[52] *Id.*
[53] *Id.*

[54] Ex. 1T (Colbo Direct), p. 19, l. 19 – p. 20, l. 3.
[55] Ex. 23; Tr. at 175-176.

There are two equally important bases for adjusting the Company's test year facility lease expense to the cost-plus-fair-return amount calculated by Mr. Colbo. The first is the Commission's established rule on proper imputation of expense for affiliate transactions discussed above. A second but related reason is the imprudence of leasing the building when the Company might have purchased it itself at a lower cost. As Mr. Colbo testified:

> Particularly in light of the fact that the Company has no debt, it would clearly have lowered the Company's expenses to have purchased the property itself rather than leasing from Mr. Asche at well above his cost. It was imprudent for the Company to enter into this lease when it could have purchased the building itself.[56]

The Company submitted an appraisal report, Ex. 30, as evidence that the amount the Company pays in rent is slightly below fair market rental value. The Company argues that it should be allowed to pass on to ratepayers the entirety of what it pays Mr. and Mrs. Asche under this non-arms-length lease. The Company does not refute Mr. Colbo's calculation of Mr. and Mrs. Asche's cost of providing the facility, nor the return that Mr. Colbo's analysis would provide them on that investment.

On cross-examination, counsel for the Company elicited Mr. Colbo's agreement that if Mr. and Mrs. Asche wanted to lease the building to someone other than their Company they were free to do so, with the result that the Company might have to pay the same amount (*assuming the accuracy of the Company's appraisal*) in an arms-length transaction. Mr. Colbo agreed there would be some irony in this. But ironic as this result

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[56] Ex. 17T, p. 8, ll. 9-13 (Colbo rebuttal); S*ee Re United Cities Gas Company*, 140 PUR4th 382, 406 (Kansas St. Corp. Comm. 1993) (accepting an adjustment decreasing operating expenses of a gas company where regulated entity failed to show its lease of assets from a wholly-owned subsidiary provided ratepayers with use of those assets at a

might be from the Company's perspective, this kind of disallowance is the tool the legislature has provided to discourage regulated companies from "contracting out" parts of their operations to unregulated affiliates. From a regulatory perspective, it is eminently preferable for the regulated Company to either provide the service or property (or in this case, the facility) itself, or to acquire it through an arms-length transaction, than for the Commission to be drawn into contests of expert testimony on the fair market value of property and services supplied by affiliates. The problem is well-illustrated by another of the contested issues in this case—how to determine an appropriate executive compensation when the Commission is not able to rest on the assurance that the parties to the transaction (who are in fact the same person) have negotiated it at arm's length. Staff did not hire an appraiser of its own to verify the Company's appraisal and should not have to—unless it wanted to make the case that the market value is in fact *lower* than the affiliate's expense plus a fair return. Under the Commission's standard, if cost plus a fair return is less than what the Company represents to be fair market value, the Company may only pass on to ratepayers the cost plus a fair return.

The Commission should allow the Company to pass on to the ratepayers only Mr. and Mrs. Asche's cost plus a reasonable return as calculated by Mr. Colbo.

D. Industrial Insurance Premium Refund

During the test year, the Company received a refund or premium adjustment from the Washington Department of Labor and Industries (DLI) and C3HRM, a retrospective rating firm, totaling $10, 767.[57] The Company removes this revenue from expenses for

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lower cost *than utility ownership* or leasing from an independent, third-party lease Company).

[57] Ex. 32T (Burton), p. 6, ll. 20-24.

purposes of determining the Company's revenue requirement, asserting that they relate to periods outside the test year (the DLI refund was for the period July 1, 1998 to June 30, 1999 and the C3HRM refund covered 1998-1999).[58]

Staff amortizes these refunds over three years on the grounds that these refunds (or additional premiums due) are on-going, "truing-up" premiums paid versus actual claim experience. To fully zero out the credit as Mr. Burton proposes would negate any of the savings or charges from this or any future adjustment *ever* being passed on to ratepayers.[59] Staff's adjustment increases (debits) expenses by $7,178, thereby leaving one-third of the originally booked credit in the test period. The remaining two-thirds of the refunds are amortized (debited) by $3,589 each year for the next two years.[60] Staff's proposal would yield a more normalized basis upon which to set permanent rates and should therefore be adopted by the Commission.

E. Operating Ratio

1. Five years of excessive earnings justify setting fares to achieve a 97 percent operating ratio.

The Commission uses operating ratio analyses rather than utility rate of return principles to determine the revenue requirements of transportation companies. As a result, transportation companies' allowed rates of return can, and often do, exceed those allowed for utility companies.[61] The Company argues that fares should be set based on a 93 percent operating ratio, which the parties agree has been customary for auto transportation companies. There is reason in this case, however, to depart from the 93

[58] Ex. 32T (Burton), p. 6, l. 24 – p. 7, l. 3.
[59] Ex. 17T (Colbo Rebuttal), p.1, ll. 18-23.
[60] Ex. 1T (Colbo Direct), p. 11, ll. 4-10.

percent operating ratio to the high end of the "zone of reasonableness," within which the Commission may exercise its discretion to fix rates,[62] as a way of taking account of five years of excess earnings as required by RCW 81.04.360. The Supreme Court affirmed the concept of a zone of reasonableness in upholding rates set by the Interstate Commerce Commission for railway transportation services:

> There is no suggestion in the report that the rates have been so reduced as to be less than compensatory. True, they do not reach the maximum beyond which charges would be excessive. On the other hand, they do not pass the minimum beyond which charges are too low. A "zone of reasonableness" exists between the maximum and the minimum . . .[63]

RCW 81.04.360 (titled "Excessive earnings to reserve fund") provides the following:

> If any public service Company earns in the period of five consecutive years immediately preceding the commission order fixing rates for such Company a net utility operating income in excess of a reasonable rate of return upon the fair value of its property used and useful in the public service, the commission shall take official notice of such fact and of whether any such excess earnings shall have been invested in such Company's plant or otherwise used for purposes beneficial to the consumers of such Company and may consider such facts in fixing rates for such Company. [Emphasis added.]

This statute directs the Commission to take "official notice" of a five year period of excess earnings, and whether those excess earnings were invested "for purposes beneficial to the consumers of such Company." Of key importance to Staff's recommendation in this case is the provision authorizing the Commission to "consider such facts in fixing rates for such Company." While Staff has found neither legislative

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[61] *See WUTC v. Sno-King Garbage Company, Inc.*, Docket Nos. TG-900657, TG-900658, Fourth Supplemental Order, p. 10 (1991).
[62] *See In re Application TV-1831,* Cause No. TV-1831 (1986 Wash. UTC Lexis 35), pp. 5-8, citing *U.S. v. Chicago, Milwaukee, St. Paul & Pacific Railroad Co.*, 294 U.S., 79 L.Ed. 1023, 55 S.Ct. 462 (1935).

history nor case law casting light on the proper application of this statute, it seems obvious that to "consider such facts in fixing rates" means to set rates lower than might otherwise be the case. Thus, this statute presents an exception, in the event of exceptional gains by the Company, to the rule against retroactive ratemaking. The rule against retroactive ratemaking ordinarily requires that when determining each of the terms of the revenue requirement formula or when calculating the amount of revenue to be collected under proposed rates, the Commission cannot adjust for past losses or gains to the utility or consumers. The reason there can be a statutory exception to the rule against retroactive ratemaking is that the rule itself is said to derive from statute. In its final order in a rate proceeding, the Commission is directed by RCW 81.28.230 to fix rates "to be *thereafter* observed and enforced."[64] The rule is not constitutional. Excessive profit statutes, requiring refunds to customers based on past overearnings by rate regulated companies, have been upheld against constitutional challenges.[65]

It is also important to realize that Staff's approach would still afford the Company the opportunity to recover all of its expenses, including depreciation expense, and to earn a return on investment of 8.29 percent.[66] Such a rate of return on investment places Staff's proposal within the "zone of reasonableness" within which the Commission has the discretion to fix rates. The modified operating ratio, "Lurito-Gallagher" formula

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[63] *Chicago, Milwaukee, St. Paul & Pacific*, 55 S.Ct. at 505-506.
[64] *See Public Utility Comm. v. United Fuel Gas Co.*, 317 U.S. 456 (1943)(interpreting the "thereafter" language in the Ohio statute as the basis of the rule).
[65] *See John Deere Ins. Co. v. State,* 463 So.2d 385 (Fla. App. 1985); *see also, Narragansett Electric Co. v. Burke,* Nos. 84-73-M.P., 84-232-M.P. & 84-343-M.P. at 2-4 (R.I. 1986) (approving a commisssion order requiring a utility to make refunds to ratepayers in situations in which a utility earned well in excess of its authorized rate of return).
[66] Ex. 6, line 76.

utilized by the Commission in setting rates in the solid waste industry derives an individual revenue requirement based on a company's unique balance sheet. As Mr. Burton's own testimony demonstrates, that formula can result in an operating ratio that is higher than 93 percent.[67] In fact, the Commission has previously authorized rates designed to achieve a 98 percent operating ratio for at least one solid waste Company.[68] Although Staff does not advocate the use of the Lurito-Gallagher formula in this case, Staff does recommend an individualized approach to determining an appropriate operating ratio in this case. Evidence brought to light in this case indicates that B-K Airporter has a lower-than-usual exposure to risk that warrants a lower-than-usual return on investment. The Company has a 100 percent equity capital structure; it pays no interest. Moreover, a 97 percent operating ratio is, in effect, what the Company has experienced in the last five years when bonuses have been included in the "Owner Salary" account.[69]

Staff used various measures to determine the extent to which the Company has overearned during the five calendar years prior to and including the test year. Staff first determined that the bonuses paid to Mr. Asche over the five years total $1,055,000.[70] As discussed previously, these large bonuses more properly represent distribution of profits, not operating expenses for ratemaking determinations.[71] Even when the owner compensation amount used in 1991 to set present rates is adjusted upward for inflation

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[67] Ex. 32T (Burton), p. 15, ll. 7-12, p. 16, l. 17 – p. 17, l. 16.
[68] In Docket No. TG-960510, at p. 3 of the Staff memo presented on May 29, 1996 recommending approval of a rate filing by Eastside Disposal. The rates approved were designed to achieve a 98.06 percent operating ratio for garbage collection.
[69] Ex. 1T (Colbo Direct), p. 30, ll. 15-22 ; Ex. 15, p. 1, line 54.
[70] Ex. 1T (Colbo Direct), p. 28, ll. 11-12.
[71] Ex. 1T (Colbo Direct), p. 12, ll. 11-12.

through each of the succeeding years, Mr. Asche's total actual compensation during the five years still exceeds the indexed-for-inflation 1991 salary by $981,564.[72]

Staff applied another measure to determine the extent to which this excessive executive compensation—when properly viewed as distributed earnings—represents *over*earnings. Mr. Colbo applied Staff's major adjustments in this case (before depreciation related items) to arrive at an operating ratio for each of the five years.[73] The average operating ratio for the five years is 82.82 percent—an astonishing ten percent better than the standard 93 percent. This difference translates to $808,788 in profits during the five year period above what the owner would have received under a 93 percent operating ratio.[74] Thus, it is apparent that the excessive compensation paid to Mr. Asche during the five year period comes close to the amount by which the Company earned in excess of a 93 percent operating ratio during the same period.

This estimate of the Company's overearnings is large enough, when considering that the Company had around $1.6 million in revenues in the test year, to invoke what the legislature likely had in mind with the term "excess earnings" as used in RCW 81.04.360.

Setting fares to achieve a 97 percent operating ratio, as compared with a 93 percent operating ratio, would amount to about a $60,000 per year difference in revenue for the Company. Over three years time, this represents $180,000 less revenue. The reason this three year total is significant is because Staff would not object to the Company filing for rates based on a 93 percent operating ratio after the expiration of three years. This $180,000 amount is significantly lower than the $808,788 amount

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[72] Ex. 1T (Colbo Direct), p. 29; Ex. 15, p. 2.
[73] Ex. 15, p. 1.
[74] Ex. 1T (Colbo Direct), p. 28, ll. 14-22.

discussed above as a cautious estimate of the Company's total overearnings over the preceding five years. Thus, Staff is not seeking to disgorge all of the Company's past overearnings to the benefit of ratepayers, but *is* seeking to benefit ratepayers prospectively by passing on to them a reasonable measure of the Company's truly extraordinary gains over the past five years.

In recognition of the Company's historic overearning, the Company's fares should be set to achieve only a 97 percent operating ratio (which results in an 8.29% return on investment[75]). A 97 percent operating ratio provides a lower margin of revenues over expenses than the Commission typically provides in setting rates for auto transportation companies (though it is not without precedent in the regulation of transportation companies in general), but it is not outside a reasonable range from a return on investment standpoint, particularly in view of the 60 percent return on investment that the Company has earned, on average, over the past five years.[76]

2. <u>To help assure that customers will receive the benefit of the fares proposed by Staff for at least three years, the Commission should order the Company to maintain an "overearnings account."</u>

To provide additional assurance that customers will receive the benefit of the 97 percent operating ratio proposed by Staff for at least three years, Staff proposes ordering the Company to maintain an escrow account into which it would be required to deposit earnings that exceed a 97 percent operating ratio over a three year period.[77] The account

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[75] Ex. 6., p. 1, col. (f), line 76.

[76] *See* f.n. 2, supra.

[77] Staff's use of a three year period, together with a 97 percent operating ratio, is an attempt to capture for ratepayers that portion the Company's overearnings, over the past five years, that are truly extraordinary. Ex. 1T (Colbo Direct), p. 37, ll. 2-5.

would be used to offset what would otherwise be the Company's revenue requirements when the Company next files to increase its fares.[78]

To prevent the Company from evading compliance with this requirement by simply raising Mr. Asche's compensation (and therefore overall expenses for purposes of calculating its operating ratio), the Company should be prohibited from paying executive compensation greater than $66,000 per year while the account requirement is in effect.

IV. Rate Design

F. Rounding to the nearest quarter for ease of making change

Staff's rate design includes rounding to the nearest quarter ($0.25) the fare necessary to generate the target operating ratio of 97 percent. The result is that, on a pro forma basis, fares would produce a somewhat higher 97.56 percent operating ratio.

This rate design feature is for the convenience of the drivers in making change for passengers. If the Company prefers the additional revenue over the convenience of a rounded fare, Staff has no objection to fares that produce a more exact 97 percent operating ratio.

G. Different Fares for the Bremerton/Tacoma and Ft. Lewis/McChord Routes

Staff presented a separation analysis allocating expenses between the Bremerton/Tacoma route and the Ft. Lewis/McChord route.[79] The Company did not contest Staff's separation analysis. Staff recommends increasing fares by $1.89 (rounded

[78] Ex. 1T (Colbo Rebuttal), p. 36, ll. 12-20; Ex. 17T (Colbo Rebuttal), p. 5, ll. 18-23; Tr. at 194, l. 24 – 204, l. 3.
[79] Ex. 6, p. 4.

to $2.00) on the Ft. Lewis/McChord route and reducing fares by $2.83 (rounded to $3.00) on the Bremerton/Tacoma route.[80]

V. Commission's Investigative Costs

Staff urges the Commission to assess B-K Airporter the Commission's costs in this proceeding pursuant to RCW 81.20.020. When the Commission deems it necessary in any proceeding "to investigate the books, accounts, practices and activities" of any public service Company "and the cost thereof to the commission exceeds in amount the ordinary regulatory fees paid by such public service commission during the preceding calendar year," RCW 81.20.020 directs the public service Company to pay the expenses that are reasonably attributable to the investigation. As noted above in the section on the Company's case costs in this matter, the Company has a long history of unsupported rate applications—including this case.[81] Staff has never assessed its cost in any of those previous filings, so there is no issue with the frequency with which the Commission has assessed investigative expenses against this Company under RCW 81.20.060 (limiting frequency of assessing expenses of a complete rate and service investigation to five years). Under RCW 81.20.020, the total amount that the Company may be required to pay is capped at one percent of the Company's gross operating revenues during that last preceding calendar year. Thus, the most the Company can be assessed is $16,634 based on 2000 revenues of $1,663,452 as reported in its annual report to the Commission. Through December of 2001, the month in which hearing in this matter was held, the

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[80] Ex. 6, p. 4, cols. (d) and (e) at line 8.
[81] Ex. 17T (Colbo Rebuttal), p. 2, ll. 12-15; Ex. 9, p. 9.

Commission had incurred $35,983.60[82] in agency-wide costs in this proceeding. This clearly exceeds the $6,633.90 that B-K Airporter paid in regulatory fees in 2000.

DATED this 5th day of February, 2002.

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JONATHAN C. THOMPSON
Assistant Attorney General

[82] Staff will provide an affidavit certifying this amount in the event that the Commission deems it appropriate to bill the Company as advocated by Staff.