I. INTRODUCTION/BACKGROUND

This is a very important case. This is a critical moment in the development of Rainier View. The Company is in a very precarious financial condition at the moment. Depending on the results of this case, Rainier View can either continue to build upon the efforts it has made over the past decade to provide high quality service to its customers or it can slide back towards a time when it provided only marginal service and was losing the fight to meet basic customer needs.

This case is also important in that it presents to the Commission at least two unique issues: (1) the treatment of federal income tax expense; and (2) the treatment of the ready to serve charges in contracts. The federal income tax issue is unique only because Commission Staff is recommending that the expense generated from the regulated operations not be allowed to be recovered in rates. In the past, this expense has been routinely allowed. The ready to serve charge is unique because Commission Staff is recommending that this revenue be classified as operating

revenue, when the revenue has been treated in the past as a financing mechanism.[1]

BACKGROUND

Rainier View provides service to over 11,000 homes and businesses, although the service base is primarily residential. The Company provides service through 31 separate systems located primarily in Pierce County. Exhibit T-4, p. 3, l. 17-26. Rainier View has evolved from a company that was inundated with customer complaints in the late 1980s and early 1990s to a company that provides excellent service today. Exhibit T-15, p. 3, l. 3-24. The quality of its service is evidenced by the lack of complaints when Rainier View filed this rate case. As the Commission well knows, when a water company files a rate case, customers take that as an opportunity to air their grievances. This water company rate case is notable from the lack of customer complaints, even to the extent of the almost unheard of determination that a public hearing was not needed.

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[1] As a corollary, the Company has had to expend much more effort in the preparation of this rate case than it originally anticipated. The Company's own case is unremarkable in that the Company is not advocating

The Commission Staff agrees that this is a well-managed
company. TR 311, l. 4-8. Other than distributing enough money to pay the income tax obligations generated by the regulated operations, every cent generated from rates charged to customers has gone back into providing service and improving the quality of service that has been provided. Exhibit T-50, p. 9, l. 16-26.

The Company's existing rates are relatively low. While the rate increase sought in this case is approximately 13 percent, that is less than the rate of inflation since the Company's last rate case. As the rest of this Brief will demonstrate, the Company should be granted its requested increase.

BURDEN OF PROOF

The general rule is that the utility has the burden of proving that its proposed rate increase is just and reasonable. See, e.g., WUTC v. Harbor Water Co., Docket No. U-87-1054-T, Third Supplemental Order (May 1988). However, when the utility is seeking to follow practices previously established or accepted by the Commission and

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new issues. It is only when the Commission Staff theories are thrown into

Staff is arguing for a departure from those established practices, Staff should bear the burden of proof on those matters. In Re Equitable Gas Company, 59 P.U.R. 4th 80 (1984). In Equitable, the West Virginia Public Service Commission ("WVPSC") examined a consumer advocate's challenge to Equitable's use of cost-of-service methodology. The WVPSC held:

> Since the cost-of-service methodology used by Equitable in this case was a previously approved method, the burden was not upon Equitable to prove the reasonableness of its method, but was upon the party seeking to challenge that method.

This case is no different than Equitable in that Rainier View has been allowed to recover income tax expenses in the past and has been allowed to exclude ready to serve revenue in the past. It is Staff that is arguing for a departure from the established norm. As a result, it is Staff that should bear the burden of proof on these adjustments.

In addition, under the principles of civil law, Rainier View has made a prima facia case for its position on income tax expense and ready to serve charges. Staff's opposition to Rainier View's reliance on these established

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the mix that this case becomes much more complex and much more expensive.

practices is really no different than the assertion of an affirmative defense, where it bears the burden of proof. See, e.g., Robertson v. Club Ephrata, 48 Wn.2d 285, 288, 293 P.2d 752 (1956) (stating that defendant has the burden of proving affirmative defenses and plaintiff may establish a prima facia case without disproving affirmative defenses).

II. UNCONTESTED ADJUSTMENTS

In addition to the items set forth below, many of the items set forth on the Company's "per books" numbers were agreed without an adjustment being proposed. For those entries for which no adjustment is proposed, the Commission Staff has accepted the Company's number. The following discussion of adjustments relates to adjustments that were proposed either by the Company or by the Commission Staff.

A. Working Capital. The Company accepted Commission Staff's proposed working capital adjustment. S-RA-16.

B. Purchased Power. Commission Staff ultimately agreed to the Company's purchased power adjustment. C-PA-7 (Staff's original proposal was S-PA-3).

C. <u>CIAC Amortization</u>. The Staff agreed that it had made an error in the CIAC amortization and withdrew its proposed adjustment. S-RA-10.

D. <u>B&O Tax</u>. Commission Staff agreed it made an error in its original calculation. The level of B&O tax for S-RA-11 should be $5,437, <u>only if</u> the Commission accepts S-RA-2 related to ready to serve issue, which is a much disputed adjustment.

E. <u>Insurance</u>. Rainier View agreed that the inclusion of the vehicle insurance on the Mercury Cougar was inappropriate and made that adjustment on Exhibit 25, p.1, l. 23. This is a portion of Staff adjustment S-PA-5. There is also agreement on the general liability insurance, S-PA-6 and C-PA-5.

F. <u>Wages and Benefits</u>. There is agreement on the pro forma wage level and employee benefit expenses as proposed by the Company in its adjustments C-PA-1 and C-PA-3 (see, S-PA-1 and S-PA-2). There is a lingering issue related to capitalization of a portion of the wages.

The Company agrees that a portion of wages should be capitalized and has done so for the Results of Operations it is submitting with this Brief. The capitalization ratio

for the 2000 wage adjustment is 15.33%. The capitalization ratio for the 2001 wage adjustment is 14.24%.

However, the capitalized portion should be added to rate base for the period for which rates are to be in effect. This is a proper pro forma adjustment without offsetting factors. The Company's Results of Operations reflect this adjustment.

G. Treatment Surcharge Expense. There is agreement on the removal of the treatment surcharge expense, C-RA-1 and S-RA-1.[2]

H. Rate Base. There is agreement on the rate base at the restated level. S-RA-14 and S-RA-15 and Exhibit 25 at lines 43, 44 and 45.

I. Materials and Supplies. This item is agreed. C-PA-6 and S-PA-4.

J. Depreciation. There is agreement on a portion of the depreciation expense. The parties agree to the inclusion of the meter reading Jeeps and the new billing software on a beginning/end of year average.

III. CONTESTED ADJUSTMENTS

[2] Staff originally characterized this adjustment as relating to principle payments on notes, but agreed on cross-examination that it related to expense items. TR 316, l. 15-19.

This portion of the Brief discusses the items that remain in contention between Commission Staff and Rainier View.

A. Income Taxes. Commission Staff is advocating that the income tax expense from regulated operations should be the shareholder's sole responsibility. Staff takes this position even though the expense is generated from the regulated operations.

In addition, the Commission Staff has apparently taken the inconsistent position that income tax expense from line extension contracts with developers is appropriate to be recovered in the charges to those developers, however income tax expense associated with monthly operating revenues should not. TR 369, l. 18 – 370, l. 17. This is also inconsistent with the Commission approved tariff allowing recovery of income tax expense on hook-up fees. Exhibit 46.

Apparently, Commission Staff views the income tax expense from developer contracts and hook-up fees as a sort of "flow-through" tax expense that is collected and paid directly to the IRS. However, as pointed out by Ms. Ingram, this tax is paid only as a result of the effects of

the tax return. TR 219, l. 5-15. As later stated by Ms. Ingram, there is no difference between income tax on CIAC and income tax on water sales. TR 231, l. 4-7. On cross, Mr. Kermode admitted that the IRS views both CIAC revenue and operating revenue as the same. TR 370, l. 18-20.

Commission Staff's position in this case is inconsistent with both the Commission's treatment of Rainier View in the past and its treatment of other companies. As pointed out in Mr. Fisher's testimony, Rainier View has been allowed to recover income tax expense in its past rate cases. Exhibits 70, 71, 72 and 73. In addition, the Commission has expressly authorized the Company to recover income tax expense by tariff on two occasions. One was a surcharge addressed to all customers. This was to recover tax expense associated with changes generated by the 1986 Tax Reform Act. While the tax was on contributions, it was recovered from all customers. Exhibit 38. As Ms. Parker points out, this recovery was expressly authorized by Commission order. Exhibit T-50, p. 11, l. 3-18. Further, the Company has an existing tariff sheet, Exhibit 46, where it recovers income tax expense associated with the service connection charge.

If this is not enough, the Commission has repeatedly authorized the Company to recover income tax expense in contracts filed by the Company. See Exhibit 17 at p. 5, p.7, p. 13, p. 27, p. 33, p. 43, p. 58, p. 60, p. 66, p. 69, p. 73, p. 91, p. 105, p. 116, p. 130, p. 138, p. 146, p. 154, p. 162, p. 171, p. 180, p. 190, p. 201, p. 214, p. 223, p. 232, p. 241, p. 250, p. 256, p. 259, p. 266, p. 278, p. 295, p. 305, p. 324, p. 335, p. 347, p. 360, p. 368, p. 376, p. 398, p. 405, p. 416, p. 425, p. 442, p. 451, p. 469, p. 490, p. 512, p. 522, p. 533.

In addition, several of these contracts have been expressly approved by the Commission by order. For example, Exhibit 17 at p. 63 sets forth an order of this Commission which states:

> After careful examination of the Kennedy Extension Contract filed herein by Rainier View Water Company, Inc., April 3, 1991, and giving consideration to all relevant matters and for good cause shown, the Commission finds that the Kennedy Extension Contract should become effective April 18, 1991.

The Commission stated that it gave careful examination to the contract and considered all relevant matters. The Kennedy Extension Contract clearly calls for the recovery for income tax expense. Exhibit 17, p. 66. Similar orders

can be found at Exhibit 17, p. 83 (where the Commission expressly notes that the contract includes federal income tax recovery) and at p. 97. Additional Commission orders are found at p. 110, p. 122, p. 208, p. 272, p. 309, p. 318, p. 329, p. 342 and p. 353.

The Commission Staff may argue that the prior Rainier View rate considerations were not fully adjudicated cases and therefore are somehow a lesser stature to the Commission decisions in those cases. That argument suggests that for such an important issue, Commission Staff was somehow not diligent in its duties. It also suggests that the Commission itself was somehow negligent in overlooking such a major adjustment and allowing the rates to go into effect.

Staff's argument ignores that there are orders of the Commission which grant Rainier View a general revenue increase which include recovery of the income tax expense. For example, in Docket UW-930269, the Commission issued an order approving the Rainier View rate case. That Order states as the Commission Finding:

> After careful examination of the tariff revisions filed herein by Rainier View Water Company, Inc., March 12, 1993, and having given consideration to all

> relevant matters and for good cause shown, the Commission finds that the tariff revision should become effective March 25, 1993.

The Commission found that it carefully examined Rainier View’s filing. The Commission found that it examined all relevant matters. The Commission then ordered the rates to go into effect, including the recovery of income tax expense.

Mr. Kermode agreed that the Commission approved general rate increases for Rainier View that included the recovery of income tax expense in 1992, 1993, 1994 and 1996 (which are the four most recent cases for the Company). TR 367, l. 3 – 369, l. 12.

The suggestion by Staff that the Commission has not allowed federal income tax expense in a litigated case to a “pass-through” entity is also contradicted by the Commission’s order in WUTC v. Rosario Utilities, LLC, Docket No. UW-951483 Fourth Supplemental Order (November, 1996). In a much litigated case, a limited liability company was allowed income tax expense.

Further, this Commission has repeatedly allowed income tax expense in many dockets, including those where there was no booked income tax expense from the regulated

operations at all and for pass through entities such as limited liability companies and S-corporations. Exhibit T-50, p. 13, l. 3-27. Ms. Parker's Exhibit 52 sets out the past Commission decisions. On cross-examination, Mr. Kermode stated that he had reviewed at least some of the cases cited by Ms. Parker and agreed with her analysis. TR 366, l. 14-21.

Ms. Parker, Ms. Ingram and Mr. Ault address the Staff suggestion that somehow the shareholders of the S-corporation receive a windfall if the income tax is recovered in rates.[3] There is no windfall. As pointed out by Ms. Ingram, the income tax issue for an S-corporation has both future tax benefits and detriments. TR 264, l. 15-25. Mr. Ault points out through his illustrations that the tax laws were derived with an eye to balancing the effects of the C versus S election. Exhibit T-34, p. 12, l. 12 – p. 13, l. 5 and Exhibit 36. He did a sensitivity analysis that demonstrates the balancing effect tends to hold true no matter how long the asset is held. TR 198, l. 24 – 199, l. 14.

[3] See Exhibit T-53, p. 16, l. 13 – p. 17, l. 2.

As Ms. Parker points out, Exhibit T-50, p. 11, l. 21 – p. 12, l. 2, Mr. Kermode's examples of the "windfall" to the S-corporation shareholder (Exhibit 56) all have a fatal premise: they are all premised on the concept that there is a 100% distribution of net income. See, also, TR 358, l. 19-22. Compare, TR 377, l. 9-21 (Mr. Kermode is not advocating the Company distribute all net income). Mr. Kermode agreed that the loan agreement with CoBank actually prevents such distribution. TR 349, l. 2 – 350, l. 11. What all of this means is that Mr. Kermode presents a hypothetical with no basis in reality; it should not be given any weight.

Although Commission Staff says that it is not their intent to end up in a situation where either the Company's assets or the shareholders' personal assets, such as their home, are seized by the IRS to satisfy the tax obligations, Commission Staff never explains how the income tax obligation will be paid.[4] TR 377, l. 2-8. The way Rainier View pays the income tax obligation today is out of the regulated revenues of the Company. Rainier View pays the

[4] Not only are the assets of the shareholders at risk, but the assets of the Company as well. Exhibit T-34, p. 10, l. 23 et seq. and TR 176, l. 8 – TR 186, l.1.

taxes on behalf of Mr. Richardson directly to the Internal Revenue Service and books the payment as a distribution. Exhibit T-34, p. 9, l. 6-21. It does not make any other distribution to Mr. Richardson. All of the other revenues go into providing service. Exhibit T-50, p. 9, l. 16-26.

If these operating revenues are reduced because the income tax expense is not allowed to be recovered in rates, the IRS will still be paid. Company revenues are really the only source for the money to pay the expense. TR

35, l. 22 – 36, l. 5. This means the Company will make distributions to pay the tax expense, it will just not have the revenue built into rates to do so. In other words, the Company will have to take revenue from other sources to pay this expense. The only logical source to do so is to reduce the number of employees. See TR 35, p. 12-14.[5] The largest Company expense item is for employees. It has little ability to modify other expenses. Therefore, the Company will be forced to reduce the number of employees to generate the needed revenues to pay the tax expense. This means customer service will suffer.

It also means that we are in a downward spiral. In the next rate proceeding there will be fewer employees, so Staff would most likely propose an adjustment to reduce the overall revenues of the Company to reflect the fewer employees. That will force the Company to lay off more employees so that it can generate revenues to pay the income tax expense. This is not what good regulation should do.

In response to a question from the Bench, Mr. Kermode came up with his theory that the paper wealth of the shareholders would not change if they are forced to pay the income tax expense for the Company's regulated operations out of their own pocket. TR 376, l. 3-18. This theory is apparently premised on the concept that if the income tax expense is paid by the owners out of their savings, then there is additional retained earnings in the Company. To Mr. Kermode, this, therefore, means the wealth of the owners remains the same. This argument shows how little understanding Staff has of the actual operations of a regulated water company. There is always the need for

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[5] See, also, Exhibit T-15, p. 3, l. 26 et seq.

additional expenditures.[6] There is no certainty that there will be additional retained earnings if the federal income tax expense is paid by the owners out of their savings. More likely, the expenses of the Company's operations will eat up any theoretical retained earnings.

In addition, the Commission has to consider what removal of recovery of income tax expense in rates would have on the Company's ability to attract investment. Water companies are not cash cows. As this Commission knows, water companies generally do not issue dividends. The return on investment for a regulated water company is completely controlled by this Commission. How could a water company attract investment if it were to tell investors that the return on their investment is generally limited to somewhere in the neighborhood of 12%, the income generated by operations will be retained by the

[6] Mr. Kermode agreed there are increasing responsibilities on the Company. TR 308, l. 17 – 309, l. 17.

company to meet additional operational and investment needs and they will have to pay the income tax on the income generated by the regulated operations of the company itself? That is an investment opportunity no one would accept.

For decades, courts in various jurisdictions have held that a utility is entitled to recover income taxes through the proper adjustment of the utility's rates. Courts have consistently held that to find otherwise would result in an unreasonable penalty imposed on those who do not elect to operate as a traditional C corporation.

For example, in 1966, the Supreme Court of New Mexico reversed the judgment of the New Mexico Public Service Commission with respect to income taxes paid by a sole proprietor doing business as Hobbs Gas Company. Vernah S. Moyston, d/b/a Hobbs Gas Company v. New Mexico Public Service Commission, 76 N.M. 146, 412 P.2d 840, 850 (1966). The Court reasoned:

> The statement, that the Company is in the same position as a utility stockholder, is incorrect because Mrs. Moyston pays income taxes on 100% of the taxable income of the utility, while a stockholder pays taxes on the amount declared as a dividend which is paid out of corporate income by a vote of the directors of the corporation.

The Court concluded:

> It is clear that the Company's operations are and have been subjected to federal and state income taxes in substantial amounts, and that rates which fail entirely to take such taxes into account as operating expenses are unfair, unjust, unreasonable and discriminatory.

412 P.2d at 850-51 (emphasis added).

The Supreme Court of Texas came to a similar conclusion. In Suburban Utility Corporation v. Public Utility Commission of Texas, 652 S.W.2d 358, 360-61 (Texas 1983), the Texas Court held that a water corporation designated as a Subchapter S corporation was entitled to recover income taxes paid by its shareholders in its base rate.

In coming to this determination, the Court reasoned:

> The income taxes required to be paid by shareholders of a Subchapter S corporation on a utility's income are inescapable business outlays and are directly comparable with similar corporate taxes which would have been imposed if the utility operations had been carried on by a [Subchapter C] corporation. The elimination from cost of service is no less capricious than the excising of salaries paid to a utility's employees would be.

652 S.W.2d at 364 (emphasis added).

The Court then held:

> We therefore hold that Suburban is entitled to a reasonable cost of service allowance for federal income taxes actually paid by its shareholders on Suburban's taxable income or for taxes it would be required to pay as a conventional corporation, whichever is less.

652 S.W.2d at 364. This is all Rainier View proposes.

There are a few states that have decided this issue counter to the majority rule as outlined above. See, Consolidated Water Utilities, Ltd. V. Arizona Corporation Commission, 178 Ariz. 478, 875 P.2d 137, 142 (1993). The Arizona Court of Appeals acknowledged the holdings of Hobbs Gas Company and Suburban Utility Corporation. However, the Court stated that Arizona's Corporation Commission "is unique in that no other state has given its commission, by whatever name called, so extensive power and jurisdiction." 875 P.2d at 142 (citations omitted). Based on the "unique" power given to the Arizona Commission, the Court held that the issue of allowing or disallowing income taxes expenses for a Subchapter S corporation was the "exclusive field" of the Commission.

In Florida, by way of the rules of the Florida Public Service Commission, "income tax expenses shall not be allowed for Subchapter S corporations, partnerships or sole proprietorships." See, FAC 25-30.433(7). However, even this seemingly iron-clad rule is subject to exceptions if the Subchapter S corporation can provide a "fully supported alternative" to the rule. See, FAC 25-30.433.

On the other hand, in alignment with the majority of the states, the Federal Energy Regulatory Commission ("FERC") has recognized that pass-through entities, such as Subchapter S corporations, are entitled to have income taxes included as operating expenses. See, e.g., Lakehead Pipe Line Company, Limited Partnership, 71 FERC ¶ 61,338 (1995); Northern Borders Pipeline Co., 67 FERC ¶ 61,194 (1994).

In Riverside Pipeline Company, Limited Partnership, 48 FERC ¶ 61,309 at ¶ 62,017, FERC stated:

> On another matter, we note that since Riverside is a partnership, it is not subject to federal taxation as an entity. Instead, the tax obligation incurred through operations of a partnership are reported on the individual tax returns of the partners. It is our practice to regulate partnerships as though they were tax-paying corporations. We will, therefore, require Riverside to record in its accounts provisions for income taxes consistent with the manner in which income taxes are provided for in Riverside's rates. It appears from the application that Riverside properly proposes to include such provision for income taxes, including deferred taxes, in its rates.

48 FERC at ¶ 62,017 (emphasis added).

Like FERC, the Wisconsin Public Service Commission ("WPSC") has also decided that pass-through organizations should be entitled to include income taxes as operating

expenses. In the Final Order of Application of CenturyTel of the Midwest-Kendall, Inc., 2815-TR-103 (October 31, 2001), the WPSC held: "It is appropriate to include income taxes in Kendall's 2001 test year revenue requirement." CenturyTel of Kendall, at 7. CenturyTel of Kendall was originally a C corporation, but by the test year had voluntarily reorganized as a limited liability company. CenturyTel of Kendall, at 15.

Rainier View should not be punished for choosing a corporate structure other than that of a C corporation. It is clear that the income tax that would accrue to Rainier View if it were a C corporation should be included in its operating expenses. As Ms. Parker testified, Rainier View is operating as if it were a C-corporation. Further, the income tax expense is a cost of doing business. TR 287, l. 15 – 288, l. 18. On the other hand, adopting the Staff's view of this matter will render a result that is "unfair, unjust, unreasonable and discriminatory." See, Hobbs Gas Company, 412 P.2d at 850-51.

There is one other lingering issue related to the income tax expense: the deferred tax component of rate

base. As pointed out in Exhibit 1, the Company has not kept a side record of this issue because it is not required to do so. Nor, did Commission Staff ask that such a calculation be made in this case. Contrary to Mr. Kermode's assertion that this is a difficult item to calculate, and hence in Mr. Kermode's view, a reason for not allowing the income tax expense,[7] Ms.
Parker points out that this is a very straightforward matter that can normally be calculated with little difficulty. Exhibit T-50, p. 12, l. 7-27. In real terms, the numbers to gauge whether this adjustment is needed were entered into the record during Mr. Kermode's cross-examination. First, Mr. Kermode agreed that there are additional tax timing differences that can contradict the timing difference for depreciation. TR 355, l. 4-14. Now the numbers: Mr. Kermode agreed that taxable income for Rainier View was decreased from book income by $213,302 for tax depreciation in excess of book depreciation. He also agreed that there were other timing differences that increased taxable income from book income such as $186,384 for hookup fees, $121,708 for CIAC and $2,567 for

[7] Exhibit T-53, p. 17, l. 4-20.

amortization of surcharges. TR 355, l. 15 – 357, l. 5. This means that the amount that would increase the taxable income exceeded the amount of decrease for tax depreciation in excess of book depreciation. These figures provide a valuable cross check that in this case an adjustment for tax depreciation exceeding book depreciation is either not needed at all or is so small as to be immaterial.

B. Owner's Salary. Commission Staff adjustment S-RA-4 proposes to disallow a major portion of Mr. Richardson's salary. Commission Staff would allow Mr. Richardson a salary increase that only reflects the growth in the rate of inflation since 1993. TR 312, l. 10-14. In fact, by the time Mr. Kermode is through with the salary adjustment, Mr. Richardson's salary level is reduced to below what it was in 1993. Exhibit 55. In making this recommendation, Mr. Kermode:

(1) does not take into consideration the growth in the size of the Company;

(2) does not take into consideration the growth in complexity of the Company's operations and the regulatory environment;

(3) does not take into account the relative amount paid to Mr. Richardson compared to what has been allowed owner's salaries in other rate proceedings; and

(4) does not take into account the success of Mr. Richardson's leadership in the development of Rainier View in meeting customer needs since 1993.

While Mr. Kermode focuses on the rate of inflation, the fact is that Mr. Richardson has never received an increase in his salary greater than that given to the rank and file employees in Rainier View. For example, if the overall increase in salary to the rank and file employees is on average 4% in a year, Mr. Richardson's increase was less than 4% in that year. Exhibit T-15, p. 21, l. 22 - p. 22, l. 6. The fact of the matter is that salaries and wages for water company employees have increased faster than the rate of inflation because their jobs have gotten more complex and there is more competition for those employees.

Contrary to Staff's inflation-only basis, Mr. Ault's testimony demonstrates that Mr. Richardson's salary level is reasonable compared to the salary provided to executives of companies in the Pacific Northwest. Mr. Ault looks at a

number of comparisons. Of these, he would place most reliance on the Millman and Robertson survey of Northwest companies. TR 147, l. 22 - 153, l. 12; TR 160, l. 13 - 161, l. 3. He used information from it related to privately held corporations and he used information related to companies of Rainier View's size. In fact, the information he used had a median sales volume of $4,000,000. This compares favorably to Rainier View's test year revenue of $3.7 million. TR 149, l. 18-24. Mr. Ault also looked at Census Bureau data and a Wall Street Journal survey. TR 160, l. 13 - 161, l. 3.

In addition, Mr. Fisher testified that among the factors that were used was another salary survey. This is the Northshore survey (Exhibit 30) which was used as a tool to find out what the competition is paying. TR 73, l. 10-15.

The amount proposed to be covered from Mr. Richardson's salary in rates is $83,258. This is 2.40% of revenues. It is 1.60% of rate base (using Exhibit 25 for revenue and rate base figures). Ms. Parker demonstrates that Mr. Richardson, on a relative comparison basis, has less of an impact on customer rates than salaries allowed

other owners of companies in Commission rate proceedings. Exhibit 51. Mr. Richardson's compensation is on the low end, if not the absolute lowest, of compensation as percentage of revenue and percentage of rate base allowed owners of other water companies. All of this analysis overwhelms the paucity of Staff's analysis -- premised solely on the rate of inflation.

Even if just the gross percentage of growth in the customer base from 1993 is considered, Mr. Richardson is underpaid. In 1993, he was allowed $44,721 in compensation in rates and the Company served 4,600 customers. The Company serves 11,307 customers today. If the same percentage relationship held, Mr. Richardson should receive $109,924 in rates based upon the growth in customers, instead of the $83,258 proposed by the Company.

As pointed out by Mr. Fisher, Mr. Kermode even penalizes Mr. Richardson. This penalty comes about under Mr. Kermode's theory because he capitalizes a portion of the wage, even though his starting point already reflected a reduction in the wage level due to capitalization. In other words, the 1993 starting figure was post-

capitalization, not pre-capitalization as treated by Mr. Kermode. Exhibit 55; Exhibit T-15, p. 19, l. 14-17.

What does Mr. Richardson do for the Company? As evidenced by Exhibit 29 and Mr. Fisher's testimony, Exhibit T-4, p. 4, l. 12-18; T-15, p. 22, l. 8-25, Mr. Richardson provides leadership and direction for this Company. It is worth remembering that this Company has evolved from a time in the late 1980s and early 1990s as a very troubled company to a company today that is among the best of the water companies. As Mr. Kermode agreed on cross-examination, it is a well-managed company. TR 311, l. 4-8. Mr. Kermode agreed that the customer complaints have decreased dramatically. TR 311, l. 9-18. Mr. Kermode agreed that the Company is facing increasing complexity from increased regulation and obligations. TR 308, l. 10-19. See, also, Exhibit T-4, p. 5, l. 8 – p. 6, l. 15.

The Commission should recognize that it is through Mr. Richardson's leadership that Rainier View has risen from a company with many problems and many unhappy customers to a company in 2002 that has very few unhappy customers and has been able to solve the problems to date. In the past, the Commission has taken into account the efforts of companies

to make improvements in service. It should do so in this case. In WUTC v. Pacific Power & Light Company, Cause No. U-86-02, Second Supplemental Order (September 19, 1986), the company argued for general wage increase based, in part, on the good performance of the company. The Commission Staff opposed more than a cost of living increase. The Commission ruled in the company's favor, holding:

> The Commission has in numerous cases, rejected the Commission Staff arguments regarding productivity and merit increases. This case is no exception. The Commission will accept the company's general wage increase adjustment as proposed. Management should have the flexibility to reward good performance and increases in productivity.

Cause No. U-86-02, p. 11.

The overwhelming evidence is that Mr. Richardson's salary level is justified. The salary is justified in terms of the increased size and complexity of operations. The salary is justified in terms of what other executives in similarly sized corporations earn. The salary is justified in terms of what is allowed for other regulated companies on a relative basis. The salary is justified based on the performance of the Company. All Staff can say is the salary increase exceeds the rate of inflation. Staff must provide more to support its proposed adjustment.

The Commission should not be in the position of saying to the owner/officer, “thank you for doing a very good job, but we are going to cut your salary.”

C. Rent Expense. Commission Staff originally proposed cutting the rent expense by arguing, like it did with owner salary, that the rent expense should only account for an increase in inflation. Exhibit T-56, p. 11, l. 10-15. However, like with owner salary, Staff’s analysis did not take into account the increased size and complexity of the Company’s operations. TR 328, l. 18 – 329, l. 4.

Mr. Kermode agreed that the Company’s operations are well run. TR 311, l. 4-8. He also agreed that based on his own first hand observation, the Company’s office space is not gold plated. TR 328, l. 11-17.

Very recently, Staff informed the Company that it would now accept the Company’s number. If the Commission needs further support for the Company’s position, please see Exhibit T-15, p. 24, l. 12 – p. 26, l. 17, Exhibit 32 and TR 81, l. 1 - TR 82, l. 10.

D. Owner’s Vehicle Expense. This adjustment affects rate base, insurance expense and depreciation. Here, Commission Staff is proposing to disallow the owner’s vehicle expense

in the form of a Lincoln Navigator and substitutes in a Chevy C-35 as a surrogate. Exhibit T-53, p. 12, l. 8-15.

The apparent sole rationale for this position is the statement that the rate payer should not pay for a luxury vehicle. Ibid. However, there is no Staff analysis as to whether the overall level of expense is a reasonable level of expense.

It was demonstrated through the examination of Mr. Fisher, TR 85, l. 15-18 and TR 133, l. 2 - 134, l. 2., and in Mr. Fisher's rebuttal testimony, Exhibit T-15, p. 30, l. 25-28 and on cross, TR 131, l. 2 – 132, l. 2, that this vehicle is more like a company vehicle than it is Mr. Richardson's personal vehicle. It is used to transport Company staff to meetings on a regular basis. It is used by both Mr. Blackman and Mr. Fisher, in addition to Mr. Richardson, on official company business on a regular basis.

The Commission Staff's surrogate has no real rationale. Mr. Kermode simply took this vehicle off the Company's depreciation list. In reality, the surrogate is a flatbed pickup truck. Exhibit 62. It could hardly be used for the same purposes that Mr. Richardson's vehicle is

used, to transport multiple Company representatives to meetings on a regular basis. Hanging off the sides of the flatbed chassis just is not a feasible option. Although reluctant to do so, Mr. Kermode finally admitted on cross-examination that a surrogate should have a relationship to the actual use of vehicle. TR 330, l. 16-21.

Commission Staff may suggest that the vehicle is provided to Mr. Richardson as a matter of convenience and he should use the mileage method for reimbursement of vehicle expense. However, given the frequency of use for Company business and the use by other employees, the mileage expense reimbursement method would not be practical.

The Company believes that Mr. Richardson’s vehicle is a prudent choice and is not an unreasonable burden on the customers. If the Commission does believe that there needs to be an adjustment made in this expense category, then Mr. Fisher has suggested use of the expense related to a Ford Expedition. That expense level is set out on Exhibit 22. However, in light of the fact that it is used so heavily for Company purposes, a 60% reduction (to comport to Mr. Richardson’s salary adjustment) should not be made. This

at least provides a vehicle that is consistent with the use for which Mr. Richardson's vehicle is intended, i.e. for Company purposes, rather than the flatbed truck suggested by Commission Staff.

E. Rate Case Costs. The Company's adjustment is C-PA-4 which represents its best estimate of costs for this rate proceeding. The Staff uses a far lower number stating that the original estimate provided by the Company several months ago is the one that should be used. Exhibit T-56, p. 23, l. 18-26.

Obviously, the closer in time one is to an event, the better and more accurate the estimate can be. In fact, Mr. Fisher testifies that based upon actually going through the case, the expense is greater than what is proposed in C-PA-4. Exhibit T-15, p. 31, l. 18 – p. 32, l. 4.

Please remember that the major issues in this case are ones that were created by Commission Staff's suggested adjustments. The Staff is the source for the Company's expenditure at the level in C-PA-4. Had the Staff not suggested the income tax adjustment or the ready to serve charge adjustment, the Company's rate case expense would be lower by a substantial amount. However, the reality is the

Company had to undertake substantial efforts to address those adjustments (which exceed $300,000). Its costs in this area are prudent and should be allowed.

A related issue is the prior year's rate case expense. Commission Staff objects to inclusion of these amounts on the theory that the Company voluntarily withdrew its prior filing and those costs should not be included in this rate proceeding. Exhibit T-56, p. 10, l. 12-17. However, as Mr. Fisher testifies, the majority of the costs were incurred because of the major issues that are up for decision in this case -- income tax expense and ready to serve charges. If not already incurred, these costs would have been necessary this year and would have increased the present year's rate case costs. Exhibit T-15, p. 23, l. 15 – p. 24, l. 10. Therefore, the Company's position should be accepted since these costs were incurred as a result of Staff's proposal of these adjustments.

F. Legal Costs (Silver Creek Case). The Company has proposed an adjustment, which the Commission Staff opposes, to recover the costs it has incurred in defending the Silver Creek complaint case. C-PA-10. The Company agrees that this is an out-of-period adjustment. However, it is

the type of expense for which there are no offsetting revenues and meets the Commission's standard definition as a pro forma adjustment. WAC 480-09-330(2)(b)(ii). As Mr. Fisher points out, the Company was forced to defend its contract with Silver Creek against the claims of competing developers seeking the limited water resources available in the Rainier View area. The Silver Creek contract provides substantial benefits to customers in the form of a 4.5 million gallon storage tank and other improvements. Exhibit T-15, p. 36, l. 19 – p. 37, l. 16. The Company's actions not only resulted in protecting those assets, it prevented perhaps substantial other claims and damages that would have had an adverse affect on the customers. Exhibit T-15, p. 36, l. 13 – p. 37, l. 9.

Further, the Commission has allowed this type of recovery in the past. The Commission has used a three or five year amortization of these types of legal expenses depending upon the size of the expense level relative to the company's operations, with the longer period of time being used when there is relatively greater expense so that the amount reflects a reasonable burden on the customers. Mr. Kermode admitted as much on cross-examination. TR 335,

l. 4-24; TR 400, l. 14 – 401, l. 1. In this case, the amount should be recovered over three years given its relative size. It was a prudent expenditure by the Company. It falls within existing Commission precedent for recovery of such expenses. See, North Bainbridge Water Company, Inc., Docket No. UW-000546; Paradise Lakes Country Club, Docket No. UW-000280; and Rainier View Water Company, Inc., Docket No. UW-960823.

G. Ready to Serve Revenue. This is the other major new issue raised by Commission Staff. Commission Staff takes the position that its proposed adjustment, S-RA-2, to include the ready to serve charges in the regulated operating revenue is appropriate. There are at least three reasons why the Staff's adjustment should not be adopted. First, it is inconsistent with the prior treatment of these charges for Rainier View. Second, it will have an adverse affect on the Company's ability to provide service to its customers. Third, it is inconsistent with prior Commission policy and rules.

This issue took up perhaps most of the time for the cross-examination of Mr. Fisher. By the time all was said and done, the Company believes the record is clear.

Without going into specific citations for this general overview, the following material is supported by Mr. Fisher’s testimony at Exhibit T-15, p. 8, l. 3 – p. 17, l. 17, and the cross-examination of Mr. Fisher at TR 36, l. 6 – 57, l. 6.

The Company entered into the line extension program to respond to the 1986 Tax Reform Act imposing a tax on CIAC as ordinary income. The Company discussed this program extensively with Staff. After implementing the program, Staff became concerned that the Company’s use of the program was causing its rate base to decline. Staff requested that the Company come up with a program to address that issue. The Company committed, in a letter to the Staff, to attempt to address that issue. Over several months, the line extension program was revised in consultation with Staff. The revisions incorporated “buy-back” and developer financing elements. The “buy-back” and developer financing elements were based upon the Company’s analysis and experience in dealing with developers. The program consisted of the Company purchasing certain assets of the developers, rather than accepting them as contributions. The Company developed a set price to

purchase those assets. Based on the Company's experience that a majority of a developer's lots will sell out in two years, the Company developed a 5-year amortization schedule, using the set price of $600 per lot, with a 2-year cross over (the point at which the Company begins to pay out to the developer more than it receives from the developer) to set a $15 per lot per month "ready to serve charge." This was the financing mechanism discussed with and approved by the Staff. See Exhibits 3 and T-15, p. 12, l. 11 - p. 13, l. 28.

The "ready to serve" name is a historical accident. As Mr. Fisher testified, it could have been any of a number of names such as a standby fee or a developer financing fee or other names. The name was chosen at the suggestion of a developer that the name would have acceptance within the developer community. TR 107, l. 15-24.

Not all of the contracts have a ready to serve fee in them. Only those that are the "interior development" contracts have that fee. This is because the fee is associated with building lots. The Company recognized that not everything should be acquired through debt and purchased some developer assets through line extension

contracts that were associated with the exterior improvements to the development. The majority of the contracts, however, were for the "interior development." TR 104, l. 9 - 109, l. 25.

This program allowed the Company to address financial viability issues, preserve rate base and provide the strength so that the customers would benefit from the Company's ability to attract low cost financing.

As set out in Exhibit 17, there was substantial discussion between the Company and Staff concerning the development of the ready to serve charge. Mr. Fisher testified that it was standard operating procedure for the Company to confer with Mr. Finnigan, send him to meet with the Staff as its representative and then confer again with him concerning the results of those meetings. In addition, it is standard operating procedure for the Company to review and approve correspondence sent by Mr. Finnigan to the Commission before it was sent. TR 121, l. 12 - TR 122, l. 10. Under RCW 5.45.020 such standard practices are admissible as competent evidence. See, Roderick Timber Co. v. Willapa Harbor Cedar Products, Inc., 29 Wn. App. 311, 316, 627 P.2d 1352 (1981); Zillah Feed Yards, Inc. v.

Carlisle, 72 Wn.2d 240, 259, 432 P.2d 650 (1967). In both of these cases, invoices were admitted to include as evidence the substantive information in the invoices. Likewise, the substantive information recorded by Mr. Finnigan as to various meetings with the Commission Staff is competent evidence under RCW 5.45.020. In addition, under Chmela v. Department of Motor Vehicles, 88 Wn.2d 385, 391, 561 P.2d 1085 (1977), the receipt of hearsay that is both credible and the best evidence reasonably available is acceptable in agency proceedings as long as the hearsay is not the sole basis of the agency's decision.

As stated in Mr. Fisher's testimony, the ready to serve charge was established to respond to the urging of Staff to develop additional rate base for the Company so that it could meet tests of financial viability. Exhibit T-15, p. 12, l. 11 – p. 14, l. 12.

In addition to allowing the Company to be financially viable (which benefits the customers), this developer extension program had a substantial benefit to customers through Rainier View's ability to then enter into a working relationship with CoBank. Exhibit T-15, p. 15, l. 10 – p. 16, l. 17. Mr. Kermode agreed that the Company's

relationship to CoBank has been a substantial benefit to customers. TR 348, l. 10-17.

As testified by Mr. Fisher, the line extension program was designed to offset the payments the Company was making to developers. The Company looked at a five year amortization of the purchase of line extensions at a 6% rate of interest and using its experience that on average the development should sell out in two years (by that, it is meant that the developer has sold the lots to residential customers), the ready to serve charge was set at $15 per month per lot. If the interest rate had been higher, the amortization period different or the amount being paid to the developers for their improvements was higher, then the ready to serve charge would have been higher. The charge is nothing more than a financing mechanism.

The Commission allowed Rainier View to exclude these revenues from its regulated revenue calculation in its 1996 rate case. Mr. Fisher testified that he discussed this item with Ms. Ingram, who was the Commission Staff analyst at the time, and the ready to serve charges were excluded from regulated revenue. Exhibit T-15, p. 17, l. 20 - p.

18, l. 4. Ms. Ingram confirmed she was a Staff member at the time the ready to serve charge was developed. TR 250, l. 1-8. Staff had the opportunity to cross Ms. Ingram about the 1996 case, but for whatever reason chose to pass. In any event, it is uncontroverted that Mr. Fisher discussed the handling of these revenues with Commission Staff for the 1996 rate case and those revenues were excluded from regulated revenue.

The second reason for not accepting Staff's adjustment on this issue is because this adjustment will have an adverse affect on the level of service the customers receive. What Staff's adjustment does on paper is very different from what it does in reality. On paper, it looks as though the Company has an additional $154,066 in revenue that it can use to pay employees and meet other expenses. In fact, the Company has legally binding obligations under contracts approved by this Commission to
use those funds to pay the developers for their line extensions.

There are many analogies that can be used to regulation, but for this issue perhaps a teeter-totter illustrates this effect. If operating revenues are pushed

up on one end, on the other end a lower revenue requirement is created. Since the Company has a legal obligation to pay this $154,066 to developers, if the Commission Staff adjustment is accepted, it will need to obtain the revenue to pay operating expenses in other ways. Here again, the only choice it really has is to reduce employee expense. This adjustment is equivalent to approximately five FTEs. This will mean that Rainier View will have five fewer employees to meet customer needs, to answer customer questions, to repair leaks, to install hookups for new customers and to meet the rest of the operating requirements of the Company.

Finally, Staff's adjustment is contrary to stated Commission policy. The Commission has stated that it does not include ready to serve type of charges for regulatory threshold purposes. This has been a long standing position of the Commission. In an Interpretive Statement issued under Docket UW-930006, the Commission determined that a "standby fee"[8] would not be used in determining jurisdiction over a water company. Thus, that fee would

[8] As used in the Interpretive Statement, a standby fee was broadly defined as a fee that "denotes only a potential customer, one who is not receiving service."

not be included in the water company’s average annual gross revenue per customer, which was the statutory threshold in RCW 80.04.010 to determine jurisdiction. The Commission stated “Only persons who actually receive water or whose applications to receive water have been accepted by the water system should be considered by customers.” There are no persons receiving water in exchange for the ready to serve charge in the sense used in the Interpretive Statement. While the developer contracts state that water is being made available to the developer for use during construction, as Mr. Fisher testified, what is done, in fact, is that water is used during construction only to test and pressurize the mains that are constructed. After this is done, then the water is shut off because of the danger related to other construction activities (the installation of additional items such as telecommunications lines, cable TV lines, and road construction activities). Only when there is an actual customer is the system then “heated up,” to use Mr. Fisher’s words. TR 122, l. 15 - 123, l. 18.

When the Commission went through its major rule adoption for water companies in 1999, it refined the concept of a standby charge as:

> a charge imposed by some unregulated companies for having transmission and distribution infrastructure installed but without the current ability to provide water. It is also sometimes referred to as a system-readiness fee. The Commission does not authorize this type of charge for regulated water companies.

WAC 480-110-245.

In any event, the Commission carried forward the concept that ready to serve charges are not included as regulated revenue. In WAC 480-110-255(3), the Commission stated that it will not consider ready to serve charges in calculating the annual revenue a company receives from its customers for regulatory jurisdictional threshold. Logically, if these charges are not considered revenues for regulatory jurisdiction thresholds, they should not be counted as regulated revenues in determining a company's operating revenues and expenses.

Mr. Kermode argues that if ready to serve revenue is not included as operating revenue, then depreciation expense, estimated power expense and a prorated portion of overhead need to be removed. Exhibit T-53, p. 8, l. 15-23.

However, this is not true. As Mr. Fisher testified, the plant does not go into operation until there is a customer. As Mr. Fisher describes, this is the time the system is "heated up." TR 123, l. 10-18. In the review of Exhibit 63, the water system illustrations, Mr. Kermode agreed that the entire system for the development would be needed to serve the first customer. TR 308, l. 2-9. What this means, is that the plant is placed in service at the appropriate time, when a customer is actually there. That customer pays his or her own tariffed rates. The ready to serve charges have nothing to do with depreciation expense, power expense or overheads.

Mr. Kermode also argues that the ready to serve revenues "are obviously utility related," relying on NARUC definitions. Exhibit T-53, p. 8, l. 4-5. In part, Mr. Kermode relies on the NARUC definition contained in Exhibit 47. However, as pointed out by Ms. Ingram, there is nothing guaranteed about these revenues. Exhibit T-45, p. 12, l. 13-23. As Mr. Fisher repeatedly emphasizes, the developer line extension program is a financing program, not meant for any other purpose. Exhibit T-15, p. 12, l. 20 – p. 15, l. 8.

The primary point is that in Rainier View's case, these charges are not charges associated with either the provision of service or for capital recovery. Instead, these charges are a financing mechanism designed solely to provide the Company with the mechanism to increase its rate base to meet Staff concerns about financial viability and to benefit customers through the development of a company that has the economic strength to attract debt financing on financially beneficial terms.

H. Bad Debt Expense. The Company is proposing a restating adjustment of bad debt expense in the amount of $53,723 for a total restating amount of $53,096. Exhibit 25. Commission Staff is proposing a bad debt expense of only $18,526. Exhibit 54.

The amount proposed by Mr. Fisher is the amount that the Company wrote off related to the test period. Although the write off did not occur until April of 2001, that was because of the Company's conversion to a new billing system and the need to put that conversion in place before its billing records could accurately reflect the amount that need to be written off for calendar year 2000. Exhibit T-15, p. 35, l. 18-23.

Staff will probably argue that the Company did not write anything off for bad debt for the year 2000 and several other years. In part, they may rely on Exhibit 42. However, as explained by Mr. Ault, as a member of the firm that wrote the letter that constitutes Exhibit 42, he would not interpret that exhibit as meaning that the Company did not have any actual bad debt expense in those years. TR 185, l. 9 – 186, l. 8.

Mr. Ault's analysis shows that for the years 1997 through 2001, the Company's bad debt expense was as follows: 1997-$33,222; 1998-$29,555; 1999-$47,431; 2000-($627) and 2001-$58,198. Exhibit T-34, p. 14, l. 4-14. During this period of time, the Company acquired the Sound Water System and experienced substantial growth in customers and revenues. Mr. Fisher's testimony is that the bad debt expense for calendar year 2000 is consistent with the prior years' bad debt expenses. Exhibit T-15, p. 35, l. 3-15.[9]

Mr. Kermode admitted on cross-examination that as revenues increase, bad debt expense would increase. TR

[9] There was some discussion in the cross-examination of Mr. Fisher over the methodology used by Rainier View. As Mr. Fisher points out, the

334, l. 24 – 335, l. 1. However, Staff's adjustment fails to recognize what Mr. Kermode admits. Staff's adjustment would decrease bad debt expense as revenues increase, rather than increase the bad debt expense.

The Company is proposing that the bad debt expense for rate making purpose reflect what was actually written off for calendar year 2000 of $53,096. In Exhibit T-34, Mr. Ault suggests a possible compromise of an average of the actual bad debt expense over the past five years of $33,556.

However, the Company has demonstrated that its actual bad debt expense for calendar year 2000 was $53,066. The Staff's

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Company uses an allowance methodology for financial bookkeeping purposes. TR 132, l. 10-23.

proposed adjustment is inconsistent with its own admission that bad debt expense will rise as revenues rise. Therefore, the Company's adjustment should be accepted.

Mr. Fisher also explains why the Company's bad debt expense is relatively high. This is because of the area the Company serves with a highly transient population. Exhibit T-15, p. 35, l. 3-15. The characterization of the customer base was not challenged by Commission Staff. The Company's proposal is far more consistent with a transient customer base than is Staff's proposed bad debt expense.

I. Interest Income. Staff adjustment S-RA-12 proposes to remove interest income. This is a matter that really only has an effect if the income tax adjustment is made as proposed by the Company. If the income tax adjustment is made, then both interest income and interest expense should be taken into account.

J. Depreciation Expense. The difference between Rainier View and Staff on this adjustment is the handling of the "catch up" depreciation adjustment proposed by the Company.

What happened is that for calendar year 2000 the Company undertook a substantial review of its plant accounts with the help of its outside auditors. TR 188, l.

22 – 189, l. 11. The Company analyzed the plant accounts and determined that a number of items were either misclassified (such as pumping equipment classified as transmission equipment) or the assets had been used up prior to the expiration of its theoretical regulatory life. TR 196, l. 4-16. Exhibit 74. This resulted in a substantial adjustment to depreciation expense to bring that expense into line with the proper categorization of the assets.

The Company's original position as contained in Exhibit 5 is that these expenses should be recovered as calendar year 2000 expenses. As Mr. Ault testified, this is going to be a yearly evaluation process. TR 197, l. 12-15.

As a compromise, Rainier View proposed in Exhibit 25 and Exhibit T-34, p. 14, l. 16 – p. 15, l. 3 that this "catch up" depreciation adjustment be amortized over three years.

Commission Staff is apparently going to make some sort of argument related to Exhibit 44, concerning certain of the Indian Springs assets. However, Exhibit 44 is probably the least helpful exhibit in this proceeding. It does not

purport to constitute all of the Indian Springs assets. It does not purport to show any modification of the Indian Springs assets other than as described in the Company's testimony.

Commission Staff's apparent position on this adjustment is that there should be no recovery of additional depreciation expense. That position is not supportable. Assets should reflect their correct useful lives and there should be an adjustment for assets that are used up before their theoretical regulatory lives expire.

K. CoBank Patronage Refund. Staff proposes an adjustment, S-RA-3. Mr. Kermode states that he is increasing operating revenue by $6,708 to recognize a cash distribution received from CoBank. Mr. Kermode admits that GAAP allows the Company to either recognize the income as a direct reduction to interest expense, or, as the Company has done, recognize interest income. Exhibit T-53, p. 9, l. 10-19. However, as Mr. Fisher points out, since he had already made the adjustment for the CoBank dividend by crediting the interest income in the calculation of interest expense, Staff is double counting this item. Exhibit T-15, p. 18, l. 7-21.

IV. OTHER

A. Indian Springs. The Company and Staff agree on the amount of this adjustment. It is the treatment of the adjustment that is in some dispute. It appears that the treatment is in dispute depending upon whether a rate increase generated. Because Staff believes a rate reduction is generated, there is no need to make a pro forma adjustment to reflect the reduced rates that would be charged in the Indian Springs area.

On the other hand, if a rate increase is generated from this rate case, then the Company's C-PA-2 properly reflects the reduction in revenue from the test period.

B. Flow Through Adjustments. The Staff and the Company agree that the taxes other than income and regulatory fees need to be adjusted to reflect whatever the outcome is from the other adjustments.

V. COST OF CAPITAL

A. Interest Expense. The approach on this item between the Staff and Rainier View is markedly different.

Commission Staff takes the position that the rate charged by CoBank, the primary lender, in November of 2001 should be the rate that is used for the period of time

during which rates are in effect. Exhibit 59. Mr. Fisher suggests that the appropriate rate to use is the average rate during 2001 since CoBank uses a variable interest rate.

Although Mr. Kermode stated that he had never heard of the concept of a “snapshot” rate as applied to setting the cost of debt (TR 351, l. 3-6), that is exactly what Staff has done. They have taken a rate that is in effect for one month and confidently project that it will be the rate in place during the time the results from this case are in effect. However, that rate happens to coincide with a historical low in interest rates.

What Staff is suggesting is very dangerous. Rates from this rate proceeding will not begin to take effect until perhaps August of this year. Yet the Commission can see all the reports in the press that the recession is coming to an end. If the recession is coming to an end and investment activity begins to pick up, then interest rates will rise.

What Staff is suggesting is like playing Russian roulette with the interest rate. They have chosen a one month rate that is at or near the historical low for

interest rates and advocates that rate will be maintained for over eighteen months. Staff's position is just not credible.

The interest rate for the CoBank debt as suggested by Rainier View is a far more prudent estimate of where rates will be. The Company's position is supported by the recent report of the Federal Reserve Bank in its highly respected Beige Book.[10] As reported in the Beige Book, economic activity is trending upward. Three additional reports point to increasing interest rates in the near future. They are: (1) University of Michigan's respected annual economic forecast; (2) U.S. Department of Labor's Producer Price Index; and (3) the Federal Reserve Statistical Summary.[11] These reports support use of the Company's proposal and underscore the danger of Staff's recommendation.

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[10] The Beige Book, Summary of Commentary on Current Economic Conditions by Federal Reserve District available at http://www.federalreserve.gov/FOMC/beigebook/2002/20020306/fullreport.htm. The Commission may take official notice of this federal agency publication. WAC 480-09-750. The Company asks that the Commission do so.

[11] These reports (or summaries) can be found at www.umich.edu/~newsinfo/releases; www.bls.gov/news.release and www.federalreserve.gov/releases/G17/current, respectively. Pursuant to WAC 480-09-750, official notice should be taken. Copies are provided in Appendix A.

B. Rate of Return. The Staff approach in this area is somewhat strange. Staff goes through a lengthy DCF analysis. However, Staff apparently abandons that analysis and provides an interest coverage ratio approach based upon covenants that Rainier View must meet under its loan with CoBank. TR 351, l. 7-15.

The Company's approach is to use what it historically has been allowed as a return on equity. Exhibit 24; TR 93, l. 2-4.

The approach of Staff in its DCF analysis is highly suspect. Staff cites to the Bluefield case (Exhibit 66) as support for its analysis, but admits under cross-examination that it did not include one of the elements from the Bluefield case. TR 340, l. 12-15. In addition, one of

the five companies used by Mr. Kermode accounts for over 50% of the DCF weighting. TR 343, l. 10-15. Two of the five companies used by Mr. Kermode have been acquired and are no longer publicly traded. As Mr. Kermode agrees, they should not be included in the DCF analysis. TR 343, l. 20 – 344, l. 3; TR 345, l. 21 – 346, l. 10. Further, it is highly questionable whether any of the companies used by Mr. Kermode in his DCF analysis is a comparable investment to Rainier View. They are all substantially larger than Rainier View. Many of them are more diversified than Rainier View. Exhibits 67, 68 and 69.

Further, the Value Line analysis relied on by Mr. Kermode suggests that the investment in water companies requires a risk premium higher than that would be produced by the DCF analysis used by Mr. Kermode. As stated in the Value Line analysis, "investment is not timely in the water industry." Exhibit 64. This suggests that using the factors that are produced by the companies chosen by Mr. Kermode in their current status understates the risk premium that is required for investment. The Value Line analysis indicates that only a select couple of companies should be considered for investment and then only because

they have a decent dividend pay out. Exhibit 64. Obviously that would not apply to Rainier View, whose history is that it pays dividends out only to reflect the income tax expense to the shareholders associated with being an S-corporation.

Rainier View does agree that it is incumbent upon the Commission to set a return on an overall basis that allows the Company to meet its debt covenants to CoBank. See, e.g., WUTC v. Washington National Gas Company, Docket No. UG-920840, Fourth Supplemental Order (September, 1993). Mr. Kermode agrees that the customers of Rainier View receive a substantial benefit from the banking relationship between Rainier View and CoBank. TR 348, l. 10-17.[12]

Where does this leave us? If the Company's case is accepted in substantial whole, then using the Company's proposed return on equity will allow the Company sufficient revenues to meet its debt coverage ratios with CoBank. If there are substantial adjustments, such as Staff's income tax or ready to serve adjustment, then the return on equity may need to be higher (although in part that can be offset

[12] Staff's position is inconsistent with its position on income tax expense. Since the Company is going to have to continue to provide the

if the debt rates are increased to reflect Rainier View's proposal).

C. Capital Structure. Staff is proposing that the Company be assigned its actual capital structure, as Staff defines that capital structure. The Company is proposing use of a hypothetical capital structure. The Company originally proposed using its actual capital structure as defined by the Company. However, in light of the differences between the Company and Staff as to how to identify the Company's actual capital structure, the proposal is to use a hypothetical capital structure.

The major difference between Rainier View and Staff on the capital structure is that the Staff imports the debt associated with a surcharge into the debt component of the capital structure. This has the effect of substantially increasing the debt component of the capital structure. This, in turn, under Staff's analysis, has the rather bizarre result of transforming a portion of equity into "short term investment." This occurs because there is only a certain amount of rate base. If the debt component

money to pay the income tax expense, the Company, on that basis alone,

rises, under Staff's theory, then what was formerly equity must become something else. Staff concludes that it must become short term investment and not counted as part of the equity component of the capital structure.

In some ways, this strikes the surface as the mirror image of Enron accounting. Instead of using accounting tricks to increase the paper equity strength of a company, Staff uses accounting to decrease the financial strength of a company. Where is this short term investment? The Company would like to have that cash cushion. Is this the virtual investment that the Company can use to satisfy the IRS tax obligations?

The Company believes that under the circumstances it is best to use a hypothetical capital structure. Mr. Kermode testified on cross-examination that the hypothetical capital structure has been used most often to reduce the equity component. TR 394, l. 13-18. He does acknowledge that it has been used on some occasions to reduce the debt component of the capital structure, but implies that that is not a course the Commission has often followed and not the best methodology to use. TR 395, l.

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will probably fail to meet its coverage ratios.

6-13. In this respect, Mr. Kermode has placed himself at odds with a long line of Commission cases.

The general rule is that "[t]he Commission will use a hypothetical capital structure in establishing a company's reasonable earnings requirements. It will determine an appropriate balance of debt and equity within the capital structure on the basis of economy and safety." WUTC v. Puget Sound Power & Light Co., Docket Nos. UE-920433, UE-920499 & UE-921262 (consolidated), Eleventh Supplemental Order (September, 1993). Contrary to Mr. Kermode's assertion, the Commission has used hypothetical capital structures for highly leveraged companies. For example, see, WUTC v. The Toledo Telephone Co., Cause No. U-83-20, Commission Order (October, 1983). See, also, WUTC v. Washington Natural Gas Company, Cause Nos. U-82-22 and U-82-37, Third Supplemental Order (December, 1982) and WUTC v. Harbor Water Company, Inc., Docket No. U-87-1054-T, Third Supplemental Order (May, 1988) (90 percent debt). Hypothetical capital structures have been often used for water companies. See, WUTC v. Clarkston General Water Supply, Inc., Cause No. U-84-46, Fourth Supplemental Order

(April, 1985); and WUTC v. Rosario Utilities, LLC, Docket No. UW-951483, Fourth Supplemental Order (November, 1996).

VI. REVENUE REQUIREMENT/RATE DESIGN

Based on the foregoing analysis, the Company has a revenue deficiency of $439,249. The Company has proposed a couple of compromises. If the Commission chooses to accept the compromise positions, rather than the Company's preferred position, then the Company has a revenue of deficiency of $414,416.

Attached as Exhibits 1 and 2 are results of operation pages that show these alternative outcomes.

The Company is proposing that the revenue requirement be recovered through an increase to both the base rate and overage as set out on attached Exhibit 3 (which is an update of Exhibit 14 in the record).

VII. CONCLUSION

Rainier View will not be able to continue to provide the quality of service it provides today if the Staff position in this case prevails. The combination of converting ready to serve revenue to regulated revenue in the amount of $154,066 and removing income tax expense from rates in the amount of $167,639 means that under the

Staff’s analysis the Company suddenly has $321,705 in revenue it does not have in reality. Income taxes still have to be paid. Mr. Richardson has no other source to pay those amounts. The ready to serve revenue is dedicated as a financing mechanism for payments to developers and cannot be used to cover operating expenses.

As a practical matter, Rainier View’s only choice will be to cut employees. There may be some savings through deferred maintenance; however, most of the operating expenses are fixed. Obviously, trying to take $321,705 out of employee expense will mean a drastic reduction in staffing levels.

The Company is facing an ever-increasing number of regulatory requirements. Staff agreed that the Company has new cross-connection regulations, radon testing regulations and arsenic testing regulation. TR 308, l. 10 – 309, l. 7. This case does not even address those matters. In order for Rainier View to meet current customer needs and prepare for future requirements, the rate increase sought by the Company is very much needed.

In many ways, the Company’s regulated operations are much like a water balloon. If the regulator squeezes the

balloon on one side, the balloon bulges a little bit on the other side. If the regulator squeezes too hard, the balloon explodes and everyone gets wet.

Rainier View asks that the Commission grant the rate increase requested by the Company so it can continue to provide the level of service that it provides today.

Respectfully submitted this 19th day of March, 2002.

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Attorney for Respondent