BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Petitioners, v. RAINIER VIEW WATER CO. INC., Respondents.	DOCKET NO. UW-010877 POSTHEARING BRIEF OF COMMISSION STAFF

I. Introduction/background

This case represents the first filing for a general rate increase by Rainier View Water Co., Inc., (Rainier View or Company) since 1996. [1] The Company has requested an increase in its rates to produce additional revenue. Commission Staff reviewed the Company's proposal and recommended that the Company's rates be decreased by $119,820. Staff has proposed adjustments to remove the income tax expense proposed by the Company, to reduce the amount of salary paid to the Company's owner, to adjust the amount paid for vehicle insurance, and to remove the surcharge revenues from the Company's net income. In addition, Staff advocates including the revenue the Company collects from Ready to Serve charges that developers pay under contracts in the Company's regulated revenues, reduction of rate base to reflect the replacement of the cost of the Lincoln Navigator used by the owner with the cost of a less expensive vehicle, and added working capital. Staff and the Company agree on many adjustments, such as increases in the wage and benefits costs for Company employees, the rent

[1] The Company made a previous filing for a general rate increase on September 29, 2000, in Docket No. UW-001489. After the filing was suspended by the Commission and the matter set for prehearing conference, the Company withdrew the filing.

expense,[2] materials and supplies, purchased power, the increase in general liability insurance, and certain changes to depreciation and vehicle insurance expense.

II. Uncontested Adjustments

A. The Company Should be Allowed to Include an Amount for Working Capital in Rates.

Staff calculated an amount of working capital for the Company, increasing rate base, as the Company had not included any adjustment for working capital. *See* S—RA-16. Staff believes that it is appropriate to allow an amount for working capital to be included in rate base because the Company invests in goods and services, the costs of which are not included in the rates that customers pay. Therefore, the Company has capital invested in an asset that is not plant or equipment, but is nevertheless an asset. In its adjustment RA-16, Staff calculated the amount of working capital on which the Company should be allowed to earn a return as $231,387. The Company concurs in this adjustment.

B. Staff Concurs in the Company's Proposed Adjustment to Purchased Power Expense

In its filing, at S—PA-3, Staff recommended an increase in the Company's expense for purchased power in the amount of $39,935, for a total expense of $213,831. This amount was estimated by reviewing the costs for purchased power from the three companies that Rainier View Water purchased power from, and calculating the amounts of the adjustment. The Company, in its C—PA-7, calculated a greater amount for this expense. Due to the volatility of the markets for electric power in the past year, and with the knowledge that one of the power suppliers, Puget Sound Energy, currently has a request for a rate increase pending before this

[2] This agreement was reached after the hearing and after the brief outline was prepared. Therefore, the discussion of this item appears in section III. C. of the brief, under Contested Adjustments, to avoid confusion over where it should be placed.

Commission, Staff concurs in the Company's figure, and its proforma adjustment of $46,345 to the test year expense amount. The figure agreed on to be included in rates is $220,241.

C. CIAC Amortization Adjustment, S—RA-10, Should be Removed

In its prefiled testimony, Staff recommended that there be an amortization of CIAC, reflected in Staff's adjustment S—RA-10, in the amount of $5,443. After reviewing this adjustment and Mr. Ault's testimony related to it (Ex. T-34, page 15), Staff concurs that this adjustment is not necessary. Staff's adjustment S—RA-10 should be removed.

D. B & O Tax Amounts should be Adjusted

In the event that Staff's proposals regarding treatment of the Ready to Serve revenue that the Company collects is accepted, the Company will incur a greater liability for Business and Occupations (B & O) tax. Staff's adjustment S—RA-11, adds the amount of $2,735 to the Company's test year expenses. After discussion with the Company, Staff agrees that this number is properly calculated as $5,437, which is an increase to Taxes other than Income.

E. The Amount of Insurance Expense for the Insurance on the Mercury Cougar should be Removed, and the Expense for General Liability Insurance Increased.

1. Vehicle insurance on Mercury Cougar

Staff proposed a restating adjustment, S—RA-7, to reduce the amount of the insurance on Company vehicles that RVW pays, to remove the insurance for a 1984 Mercury Cougar. This vehicle is not used for Company business, and the cost of insurance on it should not be charged to the ratepayers. The Company agrees with that portion of Staff's adjustment. The parties therefore agree that the amount of vehicle insurance expense should be reduced by $796.00. *See* Exhibit 57, line 8, and Exhibit T-15, p. 27, line 5.

2. General Liability Insurance

The Company's premiums for General Liability insurance increased substantially after the test year. The amount is known and measurable, and should be included in rates. Staff calculated the amount of the increase as $37 less than the amount proposed by the Company (*See* S—PA-6 and C—PA-5), and the Company concurred in Staff's figure. The parties agree that the amount of $69,854 should be included in rates for General Liability insurance.

F. Pro-forma Wage Level and Employee Benefit Expense

The Company and Staff agree that the Company's employees received a wage increase both at the end of the test year, and in December, 2001. S—PA-1, 2 C—PA-1, 3. The amount is known and measurable, and should be $778,381, from Exhibit 25, line 10, less the capitalize portion, in the amount of $23,999 (see below).

1. Issue of capitalization of portion of wages is contested

In his rebuttal testimony, Mr. Fisher states that the difference between salary and wage amounts for Staff and the Company is the capitalization of the wage increase. *See* Exhibit T-15, p. 28, lines 18-19. In its revised pro-forma income statement, Exhibit 25, the Company does not reduce its pro-forma adjustment for salary increases by the amount of capitalized labor costs. This is a change from the Company's originally filed pro-forma income statement (Exhibit 5) which capitalized 15% of the expenses attributable to employee wage increases. This practice of capitalizing a portion of the wage expense to reflect the costs of employees working on capital projects is required by regulatory accounting. Mr. Fisher cites as a reason for the change, "although Mr. Kermode removes a portion of the salary as capitalized, he does not increase rate base by the capitalized portion." Exhibit T-15, p. 28, lines 19-22. Mr. Fisher also states that "Mr. Kermode told the Company that the Staff would oppose any recovery of salary in rate base"

Id. p. 23, lines 5-6, and "If the Company is not allowed to recover the sums through an addition to rate base, then the entire amount should be recovered as operating expense." *Id.* , lines 11-13.

Mr. Fisher misunderstands the concept related to the pro-forma recognition of increase wages in rate making. Staff does not oppose the recovery of capitalized salaries in rate base, as Mr. Fisher acknowledged on cross examination:

> Q Oh, so in prior years the Company capitalized labor costs?
> A Yes.
> Q A portion of them. Has staff made an adjustment to remove any costs from rate base associated with capitalized labor costs?
> A No. (Answer continues with explanation).

Tr. p. 77, lines 4-10. The line of questioning continues at page 78 of the transcript as follows:

> Q So it's your position that Staff needs to add something to rate base in order to recognize that?
> A Correct.

The Company fails to understand that while the Commission recognizes the prospective nature of the income statement, it, in turn, uses an average historical rate base. The portion of the wages that the Company says "simply disappears" (Exhibit T-15, p. 23, line 8) actually relates to a future rate base and is not the rate base under consideration in this proceeding. The pro-forma wage increases shown on Exhibit 25 are overstated by the amount of wages related to capital projects. Lines 10 and 11 of Exhibit 25 are overstated by $23,999 and $1,045 respectively.

G. Treatment Surcharge

The treatment surcharge amount relates to revenue received through an approved surcharge that pays for both debt service and treatment costs. Staff's adjustment S—RA-1

removes $190,201 related to principal payments and adjustments to prior period amounts[3] from Treatment Surcharge Revenue. The Company agreed (C—RA-1) to adjust its number to Staff's proposed amount. Staff also stipulates to the Company's adjustment to reduce the related B & O tax by the amount of $10,062.

H. The Company and Commission Staff Agree on the Amount of Rate Base

The Company and Staff agree on the utility plant in service, accumulated depreciation and net CIAC numbers. These are found at lines 43, 44 and 45 of Exhibit 25 (p. 1) and are labeled by Staff as adjustments S–RA-14 and S—RA-15.

1. Depreciation (meter reading jeeps, billing software)

The Company and Staff agree on the amount of depreciation expense attributable to the Company's purchase of jeeps used by its staff who read the customer's meters, and for the billing software that the Company acquired after the close of the test year. Both of these expense amounts are known and measurable, and necessary for the Company. *See* adjustments S—PA-9, and C—PA 8 and 9.

I. The Expense Amounts for Materials & Supplies to be Included in Rates are Agreed.

The Company and the Staff agree on the materials and supplies adjustment as proposed by the Company, which is C—PA-6 and labeled by Staff as PA-4.

III. Contested Adjustments

A. Including an Expense Item for Income Taxes in Rates Results in Excess Return for the Company's Shareholders and Imposes an Unfair Burden on Ratepayers

Rainier View Water Company, Inc., is a corporation whose shareholders have chosen Subchapter S (Sub-S) status. The meaning of Sub-S status to a corporation is that the Company

[3] The Company obtained an accounting order from the Commission in Docket No. UW-010030, on March 28, 2001, authorizing a change in accounting treatment for funds collected through the treatment surcharge.

is a tax-reporting entity, not a tax-paying entity. In other words, the Company itself incurs no federal tax liability, even if it has net income. A Sub-S corporation reports the income to the Internal Revenue Service (IRS) and to its shareholders, and it is the shareholders who incur the tax liability. Because the Company itself does not incur any federal tax liability, Staff has recommended a restating adjustment, S—RA-13, to remove the imputed amount of income tax from the Company's results of operations.

Discussion of this issue must be focused separately on the two separate issues, federal tax on contributions-in-aid-of-construction and federal tax on earned income.

1. Federal Tax On Contributions-In-Aid-Of-Construction (CIAC).

Both Staff and the Company agree that the Company should collect the federal tax liability associated with contributions-in-aid-of-construction (CIAC). CIAC represents a form of contributed capital that is carried on the company's balance sheet. The company is not allowed to recover any costs associated with a contributions-in-aid-of-construction nor are they allowed a return on CIAC. In other words the customers do not pay for CIAC. Because customers do not pay depreciation or a return on rate base related to CIAC, CIAC does not increase the rates that customers pay.

When the 1988 Tax Reform Act imposed the tax on contributed property, Commission Staff worked closely with the regulated companies to work out a solution to the imposition of the tax that would allow companies to continue to accept contributed plant and also collect the funds to pay the tax liability to the IRS. The Commission decided to allow companies to act as a conduit, providing that the taxes paid by the contributor to be passed on directly to the IRS. The premise is that neither the owners, the company, either a C corporation or S corporation, nor the

customers are harmed, nor do they benefit from, the requirement that the contributor of utility plant be responsible for the federal tax.

In its Docket U-87-1054-T, the Commission determined that the person or entity contributing the plant could be assessed an additional amount (the "CIAC gross-up") to cover the tax liability. The Commission sent this order to all regulated water companies with a letter dated July 29, 1988. *See* Appendix A. The tax on contributed plant, except on service connection fees, was repealed by Congress in 1996, retroactive to July 15, 1996, and thus is no longer collected by companies. As Ms. Ingram noted, the Company's tariff provides for collection of this tax on service connections. *See* Exhibit 46.

The federal tax on CIAC ("CIAC tax") is a tax assessed on a form of capital, it is carried on the balance sheet as a liability and is then removed when paid. The tax is not part of the cost of service, nor does it ever appear on the company's income statement. The CIAC gross-up methodology merely insures that the owner has sufficient funds to pay the tax on the contributions for which no revenue is collected. Again, the CIAC gross-up is meant to be a straight pass-through to the IRS. All of the contracts and orders contained in the Company's Exhibit 17 that include income tax are related solely to the federal tax on the contributed plant, not to federal tax on the operating income of the Company. Tr. p. 88, line 24 to p. 89, line 3.

2. Federal Tax on Operating Income

The sole shareholders of the Company are Neil Richardson and his wife. Tr. p. 192, lines 18-22; p. 232-3. Mr. Richardson receives a salary from the Company, and receives a return on investment at the rates allowed by the Commission. The shareholders of a corporation choose to be taxed on the Company's earnings as a Sub-S corporation (Tr. p. 165, lines 3-6). Staff assumes that the shareholders made that choice to benefit their own self-interest and with full

knowledge that even though the corporation itself would not be taxed, they, as shareholders, would be responsible for the federal taxes. Shareholders can choose to change to a C corporation if that form will better meet their needs. Indeed, there is no testimony in the record of any negative consequences to the customers or to the Company if the shareholders elect to change to a C corporation.

As shown by Mr. Kermode in Exhibit 56, allowing the owner of a Sub-S corporation to collect personal federal tax from the ratepayers, will materially increase the equity return provided to the owner. The question of unjust enrichment must be considered. This stands in stark contrast to the CIAC pass-through tax where the "no harm no benefit" principle holds. Simply because the Company has net income and Mr. and Mrs. Richardson, by virtue of their stock ownership, incur an income tax liability, is not a reason to include an imputed federal tax on operating income in rates. The Company currently distributes the amount necessary to pay the income tax liability of the Richardson's[4] from its net operating income. Most Sub-S corporations, as Mr. Ault points out, do this as a matter of routine (Exhibit T-34, p. 8); *See also* Tr. p. 166, lines 14-17 (Parker). However, to include a specific expense amount, a premium above the allowed return, for that distribution in rates would give the shareholders an excess return on their investment. If, as the Company contends, the rates of a Sub-S corporation should include a provision for the personal income taxes of its owners, it could be argued that the rates of a C corporation should also include provision for the personal income taxes incurred by its shareholders. This would be dismissed as absurd on its face, yet this is no different than what is being proposed by the Company.

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[4] Of course, it would only be appropriate for a regulated company to distribute funds sufficient to pay the shareholder's tax liability that is attributable to the income of the regulated company, not on tax liability from other sources of income.

It is uncontested that by paying dividends to its shareholders, a C corporation does not become liable to the shareholders' income tax on those dividends. Tr. p. 233, line 21 to p. 234, line 4. It is important to recognize that when the shareholders of a C corporation receive dividends, they receive that return on a pre-tax basis (that is pre-tax for the shareholder, post-tax for the corporation); they must pay any tax liability out of those funds or other income that they receive from other sources. Simply because the shareholders of Rainier View have elected to take advantage of the Sub-S status, which eliminates income tax at the corporate level, the Company's customers should not be required to pay the personal income taxes of its owners.

A recurring theme in the company's argument regarding the imputation of federal taxes is "the regulated rates of the Company generate a tax obligation and that it is perfectly equitable for rates to the customers to include a component to recover the federal income tax associated with the obligation generated by those regulated operations." (Exhibit T-15, p. 39, lines 13-16). However, this argument has a serious disconnect between whose tax liability the ratepayer is obligated to pay. It is not disputed that the corporation is a separate entity independent of its owner. *See* Exhibit 37. Yet here the company is requesting the Commission to "pierce the corporate veil"[5] in order to provide for the collection of funds in rates to pay personal income taxes of its owners. Ratepayers are obligated to pay the income tax liability incurred by the corporation, but they are not and should not be obligated to pay the income tax liability of a shareholder. The effect of providing an imputed federal tax, as Mr. Kermode states in his

[5] Mr. Ault provided citations to several cases (Exhibit 37) that discuss the effect of incorporation. Each of these cases discusses the "alter ego" concept, and that of "piercing the corporate veil". It is notable that the only circumstances in which piercing the corporate veil is authorized by t he courts (or advocated by corporations) is when there has been an abuse of the corporate structure, either to avoid legitimate obligations or criminal or near-criminal activity is involved. Commission Staff is not suggesting that Rainier View Water or the Richardsons have been or are, abusing the corporate structure. We assume the Company is not, either.

testimony, (Exhibit T-53, p. 16) is to provide an excess return on investment cloaked in the guise of income tax. The return allowed by the Commission to be earned by a company is based on the return expected by the market. This allowed return is *always before* consideration of the effect of personal income taxes. Therefore, if first, a fair return is allowed a company, and then on top of that, the company is also provided rates to pay the shareholder's personal income tax, the shareholder has a windfall, as again shown in Mr. Kermode's schedules (Exhibit 56).

3. Proper Tax Rate for Imputed Taxes

If, for argument purposes only, the Commission allows imputed income taxes in the Company's expenses for ratemaking purposes, the issue of the proper tax rate must be addressed. First, it is important to note that the Company uses a 34% flat rate to compute its imputed income tax. The customers lose any benefit of the lower brackets.[6] Mr. Ault provided the apparent reason for the loss of the benefit of the lower tax brackets at hearing in response to questions related to Exhibit 36:

> Q But you apply that as a flat tax. Isn't it true that to correctly compute the tax you have to include the lower tax bracket?
>
> A You would have to include the lower tax brackets. But keep in mind, I have not personally examined Mr. Richardson's personal tax return, but Mr. Richardson is drawing a salary of approximately $140,000 or $150,000. So that salary is going to push him through a number of the lower levels in his personal income tax return.

Tr. p. 167, line 19 through 168, line 3. Staff strongly opposes any attempt by the Company to transfer any tax benefits of the lower tax brackets to the owner. This would mean that not only are rate payers being burdened with an imputed corporate income tax expense that does not exist,

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[6] Mr. Ault provided the brackets in response to Bench Request No. 7. Tax is not paid on all income at the maximum level, even if the total income for the taxpayer reaches the top bracket. The first $43,850 of income is taxed at the 15% rate, the next $62,100 is taxed at the 28% rates, etc.

they lose, to the shareholders, any benefit of the lower tax brackets that they would have received if the Company was an actual C corporation. This is patently unfair.

4. Flow-through methodology.

Mr. Kermode in his testimony (Exhibit T-53, p. 17, lines 7-20) recommended that if the Commission decides to impute income taxes, that the best approach would be to use tax basis depreciation expense to compute the income tax expense. This methodology captures for customers any benefits that the shareholders would otherwise receive through accelerated depreciation that would normally be captured in the deferred tax amount and would also capture the tax benefits related to contributed plant.

What Mr. Kermode suggests is simply the flow-through method of computing income taxes. This method of recognizing income taxes was commonly used by state commissions before the passage of the depreciation normalization requirement. Because Rainier View is a Sub-S corporation, it does not fall under the normalization provisions of Section 168 of the Internal Revenue Code.[7] Therefore, the Commission is free to use this method which would allow the ratepayer at least some benefit of the large tax basis differences testified to by Mr. Ault. As he noted in his prefiled testimony, "there are significant differences between asset basis for tax and regulatory methods." Exhibit T-34, p. 11 line 24 to p. 12, line 3. An additional benefit of the use of the flow-through method of computing income taxes, this method would compensate for the lack of deferred taxes.

5. Summary

Staff's recommended treatment of the federal tax on CIAC and the federal tax on operating income are consistent. In both situations, the nature of the transaction is transparent to

[7] Rainier View does not come within Section 168 of the Internal Revenue Code because it has no income tax liability. Copies of this section of the Code is attached as Appendix C.

the customers, the company, and the shareholders. In contrast, the Company recommends the Commission continue to require customers to pay the federal tax on operating income, exactly as if the Company was a C corporation. Of course the shareholders have chosen to change to a Sub S corporation because that better serves the shareholders self-interest. The result, as demonstrated in the Mr. Kermode's Ex. 56, both the Company and the shareholders are better off. The Company's position seems to say that so long as the customers are no worse off than they would be under a different corporate structure, let the Company choose which ever structure it wants to use and let the owners and shareholder keep all of the savings.

Now that Staff has recommended the Commission not require the customers to pay the shareholders tax liability, the shareholders say they may need to reconsider their choice to become a Sub S corporation and may have to change to a C corporation. There was no testimony during the case that changing to a C corporation would have any negative impact on the customers.

At hearing, there were many questions relating to whether other regulated companies were treated similarly in the past, and whether this company was, in the past, allowed to include income taxes in its rates. This is the first contested case proceeding in which the Commission has specifically considered the question of imputation of income tax expense to a Sub-S corporation. As the Commission is well aware, in many instances when a matter is resolved without a hearing, Staff may allow different treatment of certain items, or not recommend the removal of certain expenses, in order to reach a settlement. However, when a matter is contested at hearing, different positions may be taken.

B. The Salary for Mr. Richardson, the Company's Owner, Should be Set Commensurate with his Responsibilities and Job Duties.

Staff has recommended that the salary for Mr. Richardson be set at $41,548, reflecting 60% of his time spent on water company business. Staff RA-4, Exhibit 55. Staff does acknowledge that if the figures that Staff used as the starting point to calculate Mr. Richardson's salary had already been reduced to reflect Mr. Richardson spending only 60% of his time on Rainier View Water, then Staff's recommendation should be recalculated accordingly. However, the information provided to Staff, and the evidence at the hearing, still does not begin to justify a salary of $99,511 (Exhibit 20, p. 6) for Mr. Richardson as requested by the Company. To provide a salary commensurate with those of companies with nearly seven times its revenue is certainly not warranted.

When Staff requested detail from the Company on the job duties and responsibilities of various management employees, in an informal data request by Staff long before this matter was noted for hearing, Mr. Richardson's job responsibilities were defined as "50% Owner, Board Chairman, all managers/supervisor report to and receive direction." (Exhibit 29). After Staff filed its testimony, and (after company filed its rebuttal testimony) the company supplemented its response to Staff's informal data request, by letter from Mr. Finnigan dated January 23, 2002. *Id.* Even this information provides scant detail of what work and responsibilities Mr. Richardson exercises. Mr. Richardson purportedly makes the major decisions for the company. However, in his testimony at Exhibit T-15, page 7, Mr. Fisher describes the company's financial situation, then describes the financial controls that *he* instituted to address the Company's "precarious financial position." Mr. Richardson's participation in this decision process is not mentioned. Mr. Fisher does not describe any direction from or consultation with Mr. Richardson to implement these controls; he states that *he* eliminated all overtime, deferred construction

expenses, and maintenance, etc. The Company bears the burden of supporting the payments made to owners. The Company has failed to do so.

In his testimony, Frank Ault provides his opinion that the amount of salary the Company proposes to pay Mr. Richardson is reasonable. In support of his opinion, he refers to several sources with information about the compensation paid to executives of other companies. The Career Journal source is simply an internet site that Mr. Ault found to obtain two online surveys (Exhibit 39) that provide the median salaries for Senior Executives in Startup companies. Mr. Ault provides no support for why this information is in any way relevant to the salary for a regulated water company. Mr. Ault admitted that the site did not contain any more detail about the companies. (Tr. p. 155, lines 19-23). In addition it should be noted that the annual revenue categories for the companies surveyed *starts* at $10 million, a significantly higher annual revenue than Rainier View has. The survey provides no other information as to the types of enterprises included.

The second part of Exhibit 39 provides information from an internet site on salary and direct compensation amounts for Private Companies, again with very little information on the actual companies whose information is included. However, the information on the exhibit does indicate that the typical company in the survey has annual sales of nearly $26 million, has been in business for 33 years, and has 167 employees. *See* Exhibit 39 and Tr. p. 157. By contrast, Rainier View, while privately owned, has annual revenues in the range of $3.5 million, and has only 24 employees. *See* Exhibit T-4, p. 3, line 27. These surveys are obviously not appropriate comparatives for purposes of judging the reasonableness of Mr. Richardson's salary.

Mr. Ault also referred to a Milliman & Robertson survey of Northwest companies, but again, the revenue categories for the companies surveyed outrun Rainier View by a factor of 6;

the smallest revenue category of the business surveyed was $0-24.9 million. (Tr. p. 149, line 18). While the median revenue for the companies in that bracket is close to that of Rainier View, there was no average, or mean, revenue provided, and thus we cannot determine the true range within the $25 million where Rainier View might fall. Thus, although Mr. Ault researched salaries for start-up companies and large private companies, he did not attempt to research salary levels provided by publicly traded water companies. Tr. p. 161, lines 17-22.

Notably, Mr. Ault did not consider, nor even review, the Northshore Water District Salary survey (Exhibit 30) that the Company uses as a reference for setting the salaries for many of its employees. Tr. p. 161, lines 7-12. The survey reports information for the salaries and other benefits paid by cities and water districts in Western Washington. At page 30 of Exhibit 30, the average salary for the position of general manager for the entities that participated in the survey is shown as $8,478 per month, which calculates to $98,532 per year. The Company informed Staff that Mr. Richardson spends only 60% of his time on water company business (Exhibit 29); 60% of the average salary amount from the survey is $58,119.20. A portion of the salary amount should also be capitalized to conform with the Company's prior practice, and regulatory accounting principles.

Page 32 of Exhibit 30 shows that most of the cities and water districts whose information is reported require the General Manager to have a 4 year degree and a certification of some sort, yet we have no such information about Mr. Richardson's qualifications. Half of the participants in the survey whose general manager salaries go into the calculation of this average have more than twice the number of employees that Rainier View has (Exhibit 30, p. 6). The survey does not provide information about the number of customers served by the city or district systems who contributed information to the survey. The first page of Exhibit 30 is not part of the actual

Northshore Utility District wage and benefit study, but was apparently prepared by the Company. (Tr. p. 73, line 22 to p. 74, line 4). No verification of the source of this information was provided by the Company, other than Mr. Fisher identifying, on redirect examination, the types of entities represented by the names at the tops of the columns.

C. Staff Concurs that the Rental Expense Included in the Company's Filing is Reasonable

Staff originally proposed an adjustment, S—RA-6, to reduce the amount of rent expense included in rates. Staff had concerns that the amount of the rent appeared to increase dramatically over that contemplated in the Affiliated Interest filing made by Neil and Paula Richardson and approved by this Commission in 1990 (*See* Exhibit 31). After the hearing, in which Mr. Kermode was questioned relating to the square footage the Company used in 1989 and present, (Tr. p. 327-8) Staff reviewed its position on this expense. In other cases, the Commission determines the rental value of property that is held by an affiliated interest by starting with the original cost of the property and allowing a fair return on that investment. In this case, the Company was unable to provide Staff with any original cost information, because the property has been owned by the Richardson family since the 1930's. The Commission's order approving the transfer of the water company from Richardson Water to Rainier View also addressed the affiliated interest issues (Exhibit 31) expressly reserving the right to examine the prices paid for affiliate transactions in future proceedings.

The lease for the office and yard space that existed in 1989, the time of the application for transfer, provided a formula for an annual change in the amount of rent paid, using the Consumer Price Index. The Company currently has exclusive use of approximately 3.4 times the space that it used at the time of the lease, with an annual rent expense in the first year of the lease at $14,100. Considering only the amount of additional space used by the Company at this time

would bring the amount of rent nearly up to what the Company has requested; if adjustments were made for changes in the CPI since 1989, the amount of rent expense would likely exceed what the Company is requesting. Therefore, Staff withdraws its adjustment S—RA-6. The amount of rent expense for leased space should be set at $49,740.

D. The Company Should not be Allowed to Include the Cost of a Luxury Vehicle for use by the Owner in Rates Paid by Customers

1. Includes Rate Base, Insurance Expense, and Depreciation

The Company has included in its assets (and thus rate base and depreciation expense) the cost of a Lincoln Navigator used by Mr. Richardson on Company business and for personal use. Staff removed the cost of this luxury vehicle from rate base, depreciation expense and vehicle insurance expense, replacing those costs with the costs of a Chevy C-35 truck that was listed in the Company's depreciation schedule. S—PA-5, 9. On cross examination at hearing, Mr. Kermode testified that he used the cost of the most expensive vehicle on the Company's books (except for the Navigator) and substituted this cost for that of the Navigator. *See* Tr. p. 330, lines 1-3. In Mr. Fisher's rebuttal testimony, he ridicules Mr. Kermode's use of the particular Chevy C-35 as a cost surrogate, and suggests that the Commission substitute the costs of a Ford Expedition, for the Lincoln Navigator. *See* C—PA-9. It is not Staff's intent that Mr. Richardson be required to actually use the vehicle whose costs were substituted for the costs of the Navigator, but that the costs attributable to the Chevy C-35 are more reasonable costs to be borne by the ratepayer. In fact, a more reasonable manner of addressing the issue may be to pay Mr. Richardson a mileage reimbursement for use of his vehicle for Company business, as the company does for other employees. (Tr. p. 86). Although Mr. Richardson would have to keep records and request reimbursement from the Company, such requirements are not unreasonable. In fact, many persons keep such records for income tax purposes, in order to either claim the

expense for tax purposes as a deduction, or to calculate the compensation owing due to their use of a personal vehicle for business purposes.

Mr. Fisher, in his rebuttal testimony, recommends that the Commission substitute a Ford Expedition, another very large sports utility vehicle for the Lincoln Navigator, and provides a calculation of cost. His justification for the need for a similar vehicle was the asserted frequent use by the Company to transport up to five persons to meetings, thus saving on reimbursement for mileage expense. However, from Mr. Fisher's testimony on cross-examination, even with the additional information elicited by the Company's legal counsel on redirect, it does not appear that having an oversized vehicle available as a Company-purchased vehicle is essential to the Company's business. Taking his testimony at Tr. p. 85 and Tr. pp. 131-132 together, a vehicle is needed approximately 15 times per month to transport more than one person, and once per month "or more often" to transport 5 persons to a meeting. As Mr. Fisher acknowledged on cross examination, many vehicles are capable of carrying 5 passengers.[8] Certainly, even having two persons drive their personal vehicles and seeking reimbursement from the Company would be a lesser expense than including the costs of the Lincoln Navigator in rates.

Staff's proposed substitution of costs is reasonable. In the alternative, all costs of a vehicle for Mr. Richardson's personal use should be removed from rates, and if he wishes compensation for his transportation expense, he can seek reimbursement for use of a personal vehicle on a mileage basis.

[8] Assuming that the Company's asserted need of a vehicle to carry 5 persons to meetings is a sufficient justification for providing the full cost, depreciation, and costs of insurance in rates. Staff does not believe that need has been shown, but did not propose removing the cost of a vehicle for the owner's use entirely, only that it be reduced to a more reasonable level, using cost information that can be verified from the Company's records.

E. The Company Should not be Allowed to Recover the Costs of the Rate Case Filed in 2000, Which was Withdrawn.

The Company has requested that it be allowed to include in rates the money it spent in the year 2000 in preparing a general rate case, which it filed under Docket UW-001489, and later withdrew. Staff's adjustments S—PA-7 and RA-5 remove the expenses related to the 2000 filing. The Company states that "a good portion" (T-15, p. 24, line 6) as much as 60% (Tr. p. 125) of those costs were incurred on issues related to the issues litigated in this case. The issues of income tax, treatment of the Ready to Serve revenues, and the salary of the company owner were discussed with the Company on at least three prior occasions: in relation to the general rate filing in 2000, at the prehearing conference in this case, in a meeting with staff after the prehearing conference, and were listed in the prehearing conference order as issues. Despite its knowledge that Staff considered these to be issues in this case, the Company did not address any of them in its direct case. Mr. Fisher was the only witness filing testimony in the Company's direct case. That testimony did not discuss nor provide justification for the company's treatment of Ready to Serve revenues as non-regulated income, why the company should be allowed an imputed expense for income taxes in rates, or why Mr. Richardson's salary is appropriate at the Company's proposed level.

The company was clearly aware of staff's intent to pursue these issues even before it filed its request for tariff changes. *See* testimony of Doug Fisher, Exhibit T-15 at 23. In this passage, Mr. Fisher argues why the company should be allowed to recover the cost of a previously filed rate case (UW-001489) that was withdrawn, in addition to its costs of preparing this case. He

relates that the reason the prior case (filed in September, 2000) was withdrawn in April of 2001 as follows:

> For the very first time, the Company learned that this Commission staff would propose the adjustments that it is proposing in this case related to the "ready to serve" charge and the treatment of income taxes. The Company had to begin research on those issues in that case and begin to consider how those issues might affect its filing not only for 2000, but for 2001. Based on the passage of time and the view that it would be better to prepare a case if the Company went into the case with some work done on those issues, the Company withdrew the 2000 rate case. However, a good portion of the 2000 expense was incurred to prepare for the "ready to serve" and income tax issues. The work that was done in 2000 would simply have had to be repeated this year and increase the current rate case.

Although Mr. Fisher asserts work on these issues was performed in connection with the 2000 rate filing, the Company provided no information on this issue in his direct testimony, nor did Mr. Ault, Ms. Ingram or Ms. Parker provide testimony in the Company's direct case. In fact, after receiving Staff's response testimony, the Company sought, and received, an extension of the date for it to file rebuttal testimony, by nearly a month. It is unlikely that an extension of that length of time would have been necessary if, in fact, 60% of the cost the Company incurred in the 2000 rate filing was due to its work on these issues.

In addition, the amount of rate case expense included in Exhibit 5, the Results of Operations submitted with Mr. Fisher's direct testimony, includes the amount of $18,333 for rate case expense ($55,000, amortized over 3 years; *See* C—PA-4, Exhibit 9). The amount of rate case costs in PA-4 as revised by the company in Exhibit 25, page 5, shows a total amount of $67,700, including for the first time expenses for EES (Ms. Ingram's employer) and Ms. Parker. While the legal expense amount only increased by $1,000, and the accounting expense by $2,500 (assuming "accounting" on Exhibit 9 equates with the entry for RSM on page 5 of Exhibit 25), an additional $11,700 of rate case expense is attributable to the Company's use of Ms. Ingram and Ms. Parker as witnesses in this case. The issues addressed by those two witnesses, and a

substantial portion of Mr. Ault's testimony, relate to the Staff's disallowance of the imputed income tax expense, Mr. Richardson's salary, and the treatment of the Ready to Serve revenue. The Company's claim that 60% of the cost of the 2000 case is attributable to these issues lacks credibility. The request to recover the costs of the 2000 rate case costs in rates should be rejected.

F. The Legal Costs Incurred by the Company in 2001 for Defending against a Complaint (Silver Creek case) Should not be Included in Rates

The Company has proposed a proforma adjustment (C—PA-10) to recover the legal costs[9] of defending itself against a claim brought by developers in a formal complaint to the Commission in Docket No. UW-010683, filed on May 4, 2001. Clearly, these expenses fall outside the test period in this case (January 1, 2000 –December 31, 2000). While Staff does not question the supporting documentation submitted with Exhibits 12 and 23, it is to be expected that a regulated Company will incur legal costs in a normal year. The amount of these costs is not so extraordinary that the Company should be allowed to embed them in rates in this case. As noted in Mr. Kermode's testimony (Ex. T-53, p. 29), this adjustment, as proposed, is equivalent to proposing the reduction of test year's legal expense based on the mere *absence* of litigation in 2001. The mere fact that the Company has incurred legal expenses outside the test year does not provide compelling reasons to include those costs in the test year expenses. Including these costs as a specific amount in addition to the test year legal expenses will embed them in rates for future periods, even though such expenses would not be expected to be incurred in those years.

[9] From Exhibit 12, it appears the total costs the Company is claiming are $13,441.04. In his rebuttal testimony, at page 37, Mr. Fisher states that the Company would be willing to recover these costs over three years, but he does not carry this suggestion over into his Results of Operations, Exhibit 25, unless the amount the Company is requesting for these expenses is greater than the amount shown on page 1 of Exhibit 12. Staff did not independently total the amounts shown on subsequent pages of the exhibit.

G. The Unambiguous Language of the Contracts With Developers States that the Ready to Serve Charges are For Water Service. The Ready to Serve Revenues Should be Included in the Company's Regulated Revenues.

Staff's restating adjustments S—RA-2 and RA-11 include the Ready to Serve revenues collected by the Company in the test year in revenue, rather than accounting for those revenues below the line, as the Company did. In Exhibit 17, the Company submitted copies of numerous contracts with developers to install water systems. In some of those contracts, beginning in 1993 (*See, e.g.,* Exhibit 17, p. 276) the contracts include a provision that RVW will buy the installed equipment from the developer at the rate of $600 per lot, to be paid over a 5 year period. Those contracts also contain a paragraph, paragraph 15, that states as follows:[10]

> 15. Developer is developing ten (10) lots which will eventually be served by the System Extension during the period of development. Developer needs water for building, sales, irrigation of landscaping for sale and other purposes. **Owner is willing to supply such water under a "Ready to Serve" charge of Fifteen Dollars ($15.00) per month per lot**. Developer agrees to pay the Ready to Serve charge for each lot from the Date of Acceptance to the date a residential subscriber purchases a lot and becomes a customer of Owner. The Ready to Serve charge shall be billed quarterly and shall be due upon billing. Any amounts not paid within thirty (30) days of when due shall bear interest at the rate of one percent (1%) per month.

Exhibit 17, at 280 (emphasis added).

The contract language requires no interpretation; it states the ready-to-serve charge is because the developer needs water, and the company is willing to supply it, under a ready-to-serve charge. Ms. Ingram's testimony that the Company's employees and representatives have told her they had a different intent for the use of these funds, and Mr. Fisher's testimony to the same effect, does not rebut the language of the contract. To the contrary, the revenue is clearly

[10] The language in some of the contracts contains some minor variations in wording, but all are clear in stating that the developer needs water, and the company is willing to provide water, in exchange for payment of the amount of $15 per lot, per month. *See, e.g.,* Exhibit 17, at280, 336.

for a function of the utility—to provide water service—and is clearly revenue that should be counted as revenue from its regulated operations, not below the line.

The plant contributed by the developers is placed into rate base. Tr. at 89-90. The expenses associated with providing water to the Ready to Serve customers are included in rates paid by the Company's customers, as is the return on the portion of the new development for which the Company has paid the developer.

The "matching principle" is a basic tenet of accounting. The principle requires that revenues be matched with related expenses. The record clearly shows that the accounting currently used by Rainier View to account for Ready to Serve revenues violates this principle. The Company recognizes the revenue generated by the Ready to Serve charges as non-regulated, that is outside the normal function of the utility, however all the related expenses that allows the Company to provide Ready to Serve service are charged to the regulated rate payer Tr. p. 89-90. These expenses include not only depreciation and property taxes but also the interest on the debt incurred to buy the new development without which the company could not charge the Ready to Serve charge.

The Company contends in Mr. Fisher's rebuttal testimony that the " 'ready to serve' charges are a financing mechanism for purchasing rate base" (Ex. T-15, p. 4, line 15). There are only two types of financing the average business uses, debt and equity. Public utilities use an additional type called contributions in aid of construction (CIAC), which is simply capital given to the company. All forms of financing are carried on the balance sheet and do not run through the income statement when received. If the company's position is, as Mr. Fisher testified, that the Ready to Serve charges are in fact a form of financing, it is Staff's position that the Ready to Serve charges should be classified as CIAC and carried on the balance sheet with the other forms

of financing. If on the other hand the Ready to Serve charges are recognized as revenue, as they are recorded by the company, the revenue must be recognized as operating revenue and not non-utility revenue as argued by the company.

Mr. Fisher states, in his rebuttal testimony (Exhibit T-13, p. 13) that the amount of the Ready to Serve charge was calculated to provide the Company with sufficient revenue from developers to allow the Company to pay the developer for the installed water system with the developer's own money (rather than the Company's owner investing in the utility). He states that the Company estimated that most developers will sell their lots within 2 years, so the charge was calculated to give RVW the cash it needed to "buy back" the installed plant from the developers. He also testified, however, as does Ms. Ingram, that the contracts have a five year term. If RVW's predictions about the developer's sales of lots comes true, then RVW should receive the full amount from the developer within 2 years, yet it need only pay the developer for the system over a period of five years. None of the Company's witnesses stated what the Company would do with that excess income in the mean time, and where any interest on that income is booked. It is significant that the Company provides no documentation of the calculation that is contemporaneous with the imposition of the charge. Tr. p. 48-49.

The Company also insists that the developer contracts have a term of five years; that they all end after five years. However, the only term in the contract with a five year limitation is the time period used to calculate the payments from RVW to the developer. Paragraph (2) of most of the agreements contains this term. The language of the contract providing for payment of the Ready to Serve charge by the developer, quoted above, contains very specific language about when the developer's obligation ends—when "…a residential subscriber purchases a lot and becomes a customer." At hearing, Mr. Fisher again insists the contracts have a term of five years,

and also acknowledged that there may be lots in some developments that are still not sold to a customer of the Company.

In Ms. Ingram's prefiled testimony, she suggests that the Commission should eliminate the Ready to Serve revenue as a pro-forma adjustment because "Rainier View is no longer assessing these charges in their contracts." Exhibit T-45, p. 17, lines 4-6. At the hearing, it was clarified that what Ms. Ingram meant by this statement was that the Company is no longer including the Ready to Serve charges in new contracts with developers. Tr. p. 251, lines 6-10. She did acknowledge that the Company is likely still collecting Ready to Serve charges from some developers. Tr. p. 250, line 23, to 251, line 5. Thus, although contracts entered into starting in the year 2000[11] may not contain the Ready to Serve charges (and also do not include the provision that the Company pays the developer for the installed plant), contracts entered into in 1998 and 1999 did contain that term. Even if the term of the contract is limited to 5 years (and that is not just the time over which the payments to the developer are amortized) the Company can still be, and likely is, collecting Ready to Serve charges under those contracts. The Ready to Serve charge stops when the lot owner becomes a customer of RVW and begins paying regular water rates, which rates are higher than the Ready to Serve charge. The result is that RVW will receive more revenue in the future, not less. RVW says that it is possible that some lots may remain unsold at the end of the 5 year period in which RVW voluntarily (contrary to what the

[11] It appears that several of the contracts contained in Exhibit 17, beginning at page 1159, do not contain the contract terms requiring payment of a Ready to Serve charge, and also do not contain a provision that Rainier View pay the developer for the installed waster system plant. The contract whose documents are found at pages 1190 through 1202, and at pages 1204 through 1215, do contain both a ready to serve charge and the "buy-back provision. Each of these contracts was entered into in December, 2000. Staff does not dispute the Company's general statement that it is not including these terms in current contracts; it is understood that negotiations of the terms of these particular contracts took place over a long period of time, and the developer was given the choice of whether these terms would, or would not, be included in the contract.

contract says) stops requiring the developer to pay the Ready to Serve charge. However, Mr. Fisher indicated that the Ready to Serve charge was calculated at the $15 per lot per month level because, in the Company's experience, **most developers would sell their lots within two years**. Exhibit T-15, p. 13.

The Company has asserted in its testimony that the developer program, and funding the "buy-back" program with Ready to Serve charges collected from the developers was discussed with and at least implicitly approved by, Commission Staff. The Commission should not be concerned with this attempt by the Company to assert an argument equivalent to collateral estoppel against the Commission. There is no evidence that the Commission has previously approved the Company's accounting treatment of the Ready to Serve revenue. Notably, nothing in the Company's testimony or voluminous exhibits even refers to how the Company would account for the Ready to Serve funds. The stipulation between the parties, Exhibit 3 in this case, states in part:

> "Commission Staff and Rainier View agree that at the time the developer buy back program and ready to serve charges were initiated, the program and charges were discussed between the Company and Commission staff, **but the accounting entries to use for the ready to serve charges were not discussed."**

In particular, there is no indication whatsoever that the Commission, nor even any members of Commission Staff, approved the Company's accounting for the Ready to Serve revenue as non-regulated revenue, or "below the line." The Company's Controller, Doug Fisher, in his rebuttal testimony, (Exhibit T-15) sponsored Exhibit 17, consisting of 1215 pages, which he describes as demonstrating the change in the developer line extension program over time. *See* Exhibit T-15, p. 8, lines 20-24. Mr. Fisher also sponsored Exhibit 18. This exhibit consists solely of copies of 56 pages from billing records apparently presented by Mr. Finnigan to the Company between 1990 and 1995. While Staff has no reason to question that Mr. Finnigan

presented these bills to the Company, the purpose of the Exhibit is an attempt to prove the content of conversations referenced in the records that constitute the exhibit.

Mr. Fisher's rebuttal testimony that refers to Exhibit 18 [specificallyT-15 page 9, lines 10-17; page 10, lines 5-8; page 11, lines 12-13; page 12, line 27 through page 13 line 4; page 13, lines 21-22 (first sentence in paragraph); page 14, lines 4-12; page 17, lines 20-end, to page 18, lines 3-5] constitute hearsay, in some cases multiple levels of hearsay, and should be given no weight. Use of attorney billing records to prove the truth and substance of interactions with the Commission and its Staff is inappropriate and should not be sanctioned; these records contain multiple levels of hearsay. While hearsay can be admitted in administrative proceedings, the general nature of the entries in the billing records, coupled with the fact that the witness was not a party to the majority of the purported conversations makes the records totally unreliable to prove the content of the alleged discussion. In many of the entries, Commission staff is not even listed as a participant. In addition, from the format of the records, without further testimony, it is difficult to even determine which "account" the entry relates to. If the records were presented only as proof that Mr. Finnigan billed the company for such interactions they would suffice for that purpose, but that is not how they are used by the Company in this case.

While staff does not believe it is necessary to review and rebut the inappropriateness of every page of Exhibit 18 in order to make its point, one specific example of how the Exhibit is cited by Mr. Fisher, and how it does not support his testimony, is particularly telling. In his rebuttal testimony, Exhibit T-15 at page 13, at approximately lines 21-23, Mr. Fisher cites to pages 35-46 of Exhibit 18 as proof that the company discussed "the developer program" with Commission staff. A page-by-page review of those pages of Exhibit 18 shows that they do not support Mr. Fisher's assertion that the Ready to Serve charge was to be used as a financing

mechanism to increase the company's equity position, without accounting for those revenues as revenue from regulated operations. For example, at page 35 of Exhibit 18, the only reference that appears that it could be related to a discussion of any financing issues is for the date 06/07/93. This entry reads:

> RAF Telephone call with Messrs. Fisher and Richardson; telephone call with Mr. Ottavelli; telephone call with Mr. Ward re "viability issue."

Messrs Fisher and Richardson are Mr. Finnigan's clients. There is no topic referenced for the telephone call with Mr. Ottavelli. The topic of the telephone call with Mr. Ward ("viability issues") is so general that it certainly does not support Mr. Fisher's testimony that the specific topic of a proposed Ready to Serve charge, or more particularly, the proper accounting treatment of a current or proposed Ready to Serve charge was the topic of the conversation. Even if it were, Mr. Ward's view of the proper accounting treatment would not be binding on the Commission. At page 40 of Exhibit 18, all of the entries are for the date 9/13/93. There is a reference to "telephone conversation with Mr. Ottavelli concerning same" (filing contract for approval) for Classic Gardens (Camelot Investments) and Dan Litzenberger(sic). No details of the subject contracts are included. Exhibit 17, at pages 220-226, does contain a contract with a Dan Litzenberg, but this contract does not include a Ready to Serve charge, to the developer. Likewise, at pages 227-235 of Exhibit 17, contains materials relating to a contract between Chuck Geltz (Camelot Investments) for a water system extension to serve the Classic Gardens short plat. This contract is in the same form as the Litzenberg contract, and, similarly, does not contain a Ready to Serve charge or terms relating to Rainier View buying the system from the developer.

At best, Mr. Fisher's Exhibit 18 contains multiple levels of hearsay, and should not be allowed to be used by the company as proof of the contents of conversations for which Mr. Finnigan billed the company.

H. Bad Debt Expense S—PA-8, C—RA-2

The purpose of including an expense for bad debt in a company's rates is to allow for the recovery of the bad debt experienced by the company *in the test year*. It is not the purpose of this expense to allow the Company to recover the cumulative effect of years of failing to actually write down specific accounts in its accounts receivable. Mr. Kermode's testimony (Ex. T-53, pp. 24-25) makes a important distinction between the mere annual *accrual* of a bad debt expense and the actual process of identifying specific bad debt experienced by the company and reducing accounts receivable (*writing off* the bad debt accounts). As Mr. Ault stated at hearing (Tr. p.181, lines 21-23) " a bad debt is a bad debt the day you sell it. You just don't know which ones they are until some time has passed." Exhibit 42 clearly states "Per conversation with Doug and Jan the bad debt accounts had not been written off in 1996, 1997 or 1998. In 1999 the Company wrote-off $57,540 of bad debt accounts…." The auditor's reference is to the actual write-off of the company's bad debt accounts, not the accrual of a bad debt expense.

The company relies on a historical annual accrued bad debt expense to support the test year expense. Mr. Fisher states: "I reviewed the historical bad debt expense and the test year actual bad debt expense. The test year expense is consistent with prior years." (Exhibit T-4, p. 14, lines 16-22). However, the Company made no attempt to show that Mr. Kermode's analysis using the average actual write-off of bad debt accounts was incorrect. Instead, Mr. Ault in his testimony (Exhibit T-34, p. 14) suggests using the same averaged approach, but uses *accrued*

bad debt expense, which has a tenuous relationship at best to the actual bad debt experienced by the company.

The record shows that over the last five years (1997-2001) the company has cumulatively recognized $167,779 in bad debt expense (Exhibit T-34, p. 14, lines 5-6). If the proforma amount is added to recognize "the actual bad debt expense in 2000" (Exhibit T-15, p. 35, line 15) of $53,096, the total amount of accrued bad debt is $220,875. However the company's auditor's work paper shows that from 1996 to 2000, the company has actually experienced only one write down of bad debt accounts, in 1999, for $57,540. As Mr. Kermode testified "…the reality is, since 1996, the Company has written off bad debt only twice, in 1999 and in the current year 2001." (Exhibit T-53, p. 24, lines 8-9). The total of the two write-offs is $110,636. This is in sharp contrast to the $220,875 recognized as an expense by the company over basically the same period. The rate payer should only pay for the actual expense incurred by the company, therefore the use of the average write down of bad debt accounts should be used to compute the test year expense, rather than the accrued expense, because of the large disparity between the two figures. The Commission should reject the Company's bad debt amount of $53,096, and adopt Mr. Kermode's amount, $18,526.

I. Interest Income

In Mr. Fisher's testimony he states that by including the CoBank patronage payments as an income item (S--RA-3) Mr. Kermode "in essence, double counts this item by not recognizing what the Company has done." (Exhibit T-15, p. 18, lines 15-16) In fact, staff removed interest income (S—RA-12) because it represents income from non-rate based investments except for the patronage payments from CoBank which is associated with long-term utility plant of the

company. Thus, by including the CoBank patronage as income (S—RA-3) and in turn removing the total interest income (S—RA-12) there is no “double counting.”

J. Depreciation Expense S—PA-9, RA-9

Staff has proposed an adjustment (S—RA-9) reducing depreciation expense by $119,040. The reduction adjusts the depreciation expense on the pro-forma income statement to the amount shown on the company’s detailed asset listing. (Ex. T-53, p. 13). The Company has testified (Tr. p. 189) that the $119,040 represents a “catch-up” adjustment. The Company has not been able to detail the make-up of the adjustment even though Staff has, on a number of occasions requested such. Mr. Ault testified (Tr. p. 190, lines 20-23) that, due to the way the “catch-up” adjustment was done, no detail can be produced. Staff recognizes that the accumulated depreciation did increase by the amount of the adjustment, representing a reduction in rate base. However, a one-time write-off would not be consistent with regulatory theory, nor would the three year write-off proposed by Mr. Ault in his filed rebuttal testimony (Exhibit T-34, p. 14, line 31). Staff proposes that the amount ($119,000) be deferred as a regulatory asset with the balance amortized over the life of the remaining plant by using a 3.17% composite rate or a 32.6 year average composite life. This adjustment would increase depreciation expense by $3,774 over the amount shown on the company’s detailed depreciation schedule of $460,436. Exhibit 54, line 31.

K. CoBank Patronage Refund

It is undisputed that CoBank annually distributes a patronage refund to its borrowers. It is also undisputed that the net result of the distribution is a reduction to the interest paid by the Company to CoBank. The disagreement revolves around the apparent “double counting” cites in Mr. Fisher’s rebuttal testimony (Exhibit T-15, p. 18 lines 20-21). In this testimony, he states that “As explained by Mr. Ault, the preferred method is the method the Company has used, which is

to recognize patronage dividend as interest income." However, contrary to Mr. Fishers' reference, Mr. Ault's testimony, Ex. T-34, does not address this issue in any way. Mr. Ault did not discuss the issue of interest income or the appropriate treatment of the patronage refund by the Company. Thus, although Mr. Fisher states that this is the preferred method, Mr. Ault's testimony does not lend any support to his statement, nor explain why the Company's method is appropriate.

As stated in section II of this brief, since S-RA-12 removes total interest income after recognizing CoBank's patronage refund as income, Staff is only recognizing its impact once, not twice. Staff has made a restating adjustment, S—RA-3, to include the amount of the Co-Bank patronage refund ($6,708) in the Company's revenue. Staff made this adjustment because the Company has included an amount in its operating income for interest income. 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. The net result should be the same.

IV. Other Adjustments

A. Indian Springs (Amount agreed, treatment of it not) C—PA-2

The Company has proposed an adjustment to metered rates for the effect of the proposed change in the tariffed rates for its Indian Springs system. Under the proposed rates, customers served by the Indian Springs system would begin paying the same rates as Rainier View's other customers. This would be in accord with the Commission's order approving the purchase and transfer of the Indian Springs system in Docket UW-940766.[12] The adjustment made by the

[12] Exhibit 48 in this case references the effect of this order. "As a condition of the transfer and proposed intertie, the Indian Springs customers are being, and will continue to be, billed at the Indian Springs rates. After the cost of the proposed intertie has been recovered, the acquired customers' rates will be reviewed to determine if they should be brought to parity with other Rainier View customers."

Company assumes Commission approval of that portion of the Company's tariff filing related to Indian Springs, before the Commission has approved this change. The affect is to understate test year revenue at the proforma level. This adjustment should be recognized in the column labeled "effect of proposed rates" in Exhibit 25.

B. Flow-through adjustments

1. Taxes other than income

The Company has no adjustment that corresponds to Staff's restating adjustment S—RA-4. This adjustment is the required reduction to payroll taxes associated with the Staff adjustment to reduce Officer's wages.

Staff restating adjustment S—RA-11 increases the B & O taxes that incurred due to the inclusion of Ready to Serve revenue in total operating revenue. S—RA-11 corresponds to C—RA-1. This adjustment recognizes the incremental increase in the tax rate applied to *other service* revenue versus taxable revenue classified as *water distribution* revenue. On cross examination, Mr. Kermode agreed with the Company that the correct amount is $5,437. Tr. p. 326, lines 22-25.

The Company's adjustment C—RA-2 is associated with the Company's restating adjustment to recognize $53,723 of bad debt. The Company's adjustment reduces B & O tax by the related tax amount of the pro-forma Bad Debt. Staff agrees that this is a proper adjustment, recognizing that as bad debt changes, so does this adjustment.

Staff pro-forma adjustment S—PA-1 is related to Staff's adjustment recognizing pro-forma wage levels (*See* section II. F above). S—PA-1 corresponds to C—PA-1 except that Staff does not recognize tax related to the pro-forma wage increase for Mr. Richardson. The

Company also included a reduction to B & O taxes with C—PA-2. Staff believes this adjustment is premature and should not be recognized (*See* IV. A. above).

2. Regulatory fees

Staff adjustment S—RA-8 is simply a formula calculation to true-up regulatory expense due to the Washington Utilities and Transportation Commission regulatory fee to Staff's restated revenue figure. The Company acknowledges that this is a formula calculation to be applied to the final revenue figure determined in this case.

V. Cost of Capital

A. Interest Expense S—PA-10

1. The Company's cost of debt should be set at the most current rate

Using the Company's records, Staff compiled a listing of debt, along with the related interest rates. The notes with adjustable rates were identified and the rate currently charged, based on the current prime rate, was computed. As of the end of the test year the debt component for the Company totaled $3,747,442 with a weighted cost, as of November 2001, of 5.55% as shown on line 14 of Exhibit 59. The Total Debt figure computed by Staff is $1,136,820 greater than the company's (Exhibit 59). Lines 23 through 34 of this Exhibit reconcile those differences.

Accounting for most of the difference is $934,447 that the Company did not include in its debt listing. This debt is related to the corrosion surcharge currently collected by the Company. It appears that the Company believes that this debt should not be included in the overall capital structure because it is related to a surcharge. Normally, if the surcharge collected only costs needed to service the associated debt, that approach would be acceptable, and probably even necessary, to remove the related debt along with the related revenue and interest. However, this

is not the case here. This surcharge is unique in that it was designed to collect not only debt service costs, but also the maintenance and supply expenses associated with RVW's corrosion control program. Due to the nature of operating expenses, the surcharge could over-collect or under-collect costs related to the corrosion control program. It would be too difficult, if possible at all, to remove the debt, debt costs, related assets and depreciation, and all related corrosion expenses from the case and at the same time defer or accrue an over/under collection. As a practical matter it is better to include all costs and revenues associated with this surcharge in the general case and allow any over/under collection to be absorbed by general rates. The Company did not address this issue in its rebuttal testimony. The amount of the Company's debt should be calculated to include this amount.

The Company also misstated the amount of debt owed to developers. The Company, in its direct case (Exhibit 13) appears to have used the 1998 developers total debt figure of $445,651 and not the test year amount of $731,596. This increases the amount of debt by $285,945. The remaining amounts of the difference in the amount of debt calculated by Staff contrasted to the Company are detailed in Exhibit 59.

As discussed in Mr. Kermode's prefiled testimony (Exhibit 53) on page 23 starting at line 15, over two-thirds of RVW's debt is based on adjustable rates which are pegged against the prime rate. From the end of the test year when the prime rate was 9.5%, to the present, the prime rate has dropped 4.75 points, effectively reducing Rainier View's interest costs. Staff pro-forma adjustment S—PA-10 reflects that drop by decreasing test year interest expense to pro-forma levels. The Company has argued that the Commission should set the interest rate at the average interest rate experienced by the Company in the year 2001. (Exhibit T-15, p. 36, lines 5-7). The average, according to Mr. Fisher, is 7.42%. Exhibit 59 lists the Company's debt with interest

rates adjusted to the rate incurred by the Company as of November 2001, the most recent period before that testimony was filed. As Mr. Kermode testified at hearing, Staff's goal in setting the interest rates is to embed into the Company's tariffed rates the most current interest rate available so that the actual rates the Company pays at the time water rates are set are included in its rates. (Tr. p. 393, line 9 through p. 394, line 4). Of course, predicting interest rates is by no means an exact science, particularly in the past year. The Company has proposed setting the interest rate for debt at 7%, (Exhibit T-15, p. 36, line 8) which would provide it with a much higher return than necessary to service its debt on the variable notes. If the Commission adopted such an approach, the logical down side would be that if an average rate is used, if interest rates rose, it would be appropriate to refuse to raise the average rate embedded in rate, even though the company's expense had increased. Using a "projected average interest rate" is not sound ratemaking and should be rejected.

Staff, in its filing, used the most recent prime interest rate available at that time, 5% (December 5, 2001). Since that time, the prime rate has in fact dropped an additional 25 basis points (.25%), lowering Rainier View's interest cost even further. Although Mr. Fisher in his rebuttal testimony says that Mr. Kermode uses an "unrealistic interest rate" *See* Exhibit T-15, p. 35, line 20, the rate Mr. Kermode uses is in fact .25% above the Company's current interest rate related to the variable rate notes. The Company's use of an average interest rate for its variable rate notes should be rejected and the actual interest rates currently being experienced by the Company should be used to determine the cost of debt. If the Company is uncomfortable with the effects of increasing interest rates, they could consider converting the variable rate notes to fixed rate notes, especially in the current low rate market.

2. Interest synchronization

Interest synchronization is the process of applying (or synchronizing) the interest expense computed in the cost of capital to the pro-forma income statement. It should be noted that although the Company adjusted a portion of the CoBank loans to reflect what its interest rates would be with a prime rate of 6.75%, an interest rate below year-end levels, in Exhibit 13 the Company did not synchronize the adjustment reflected in its exhibit with the interest expense on its pro-forma income statement. That is to say, the interest expense in the filed pro-forma income statement, Exhibit 5, is not adjusted to reflect the lower rates. Staff's analysis, in S—PA-10, did synchronize the Company's interest expense with the schedule of debt, Exhibit 59, by decreasing interest expense from $344,648 to $208,047 to match the computed debt structure.

B. The Company's Composite Rate of Return Should be Set at 8.69%

There are two landmark cases that define the legal principles underlying a fair and reasonable rate of return. The Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923) and the Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 391 (1944). These decisions require that the Commission's allowed rate of return must: (1) provide a return to its owner that is commensurate with returns on investments in other enterprises having corresponding risks, (2) assure confidence in the financial integrity of the company, and (3) be adequate to maintain the company's credit worthiness and ability to attract capital. At hearing, Mr. Finnigan questioned this summary of the holdings of the cases that was contained in Mr. Kermode's prefiled testimony. As Mr. Kermode explained at that time, although the Bluefield case included as a criteria that the comparisons be to other companies in the same region of the country, that criteria was eliminated by the Supreme Court's decision in the Hope case, decided some 21 years later.

1. The Company's rate of return on equity is driven by the need to meet CoBank's required Debt Service Coverage Ratio.

In testimony and on cross examination of Mr. Kermode by Mr. Finnigan, (Tr. beginning at p. 336) there was discussion of the Discounted Cash Flow (DCF) method of calculating the proper amount of return on equity to be considered in setting the Company's rate of return. Mr. Kermode's prefiled testimony did discuss the results of using this method to set the Company's rate of return on equity. *See* Exhibit 53, pp. 32-33. However, it is important to note that Mr. Kermode's recommendation to the Commission is not based on the DCF method, but on the amount of earnings needed to meet the debt service coverage ratio (DSCR) required by the terms of the Company's loan agreements with CoBank (Exhibit 33). Staff's DCF calculation showed a return of 9.31%, plus Staff added a 150 basis point risk premium, resulting in a total of 10.81%. One of the attributes of a fair and reasonable return is that the allowed return be adequate to maintain the Company's credit worthiness. Staff recognized that the Company currently has loan covenants that require the Company to maintain a 1.25 Debt Service Coverage Ratio (DSCR), and therefore recommended that the rate of return on equity invested in ratebase be set at 15.46%, so as to meet the DSCR. (Exhibit 53, p. 33-34). The components and computation of the DSCR are shown on Exhibit 61. The Company requires this high rate of return on equity because its rate base consists of 29.24% equity and 70.76% debt. With this relatively small amount of equity, the Company requires this very high return on equity to maintain the required DSCR. The Company's capital structure will be discussed in the next section.

C. Capital Structure

Staff calculates the Company's capital structure as consisting of 70.76% debt and 29.24% debt. The Company's Exhibit 13 shows a capital structure of 44.66% equity and 55.34% debt.

The most significant difference between Staff's calculation and the Company's calculation is due to the Company's $1,136,820 understatement of debt as explained on page 30 of Mr. Kermode's testimony, Exhibit 53. This adjustment alone accounts for an increase of 8% to the debt component. In addition, Staff reduced the Company's equity component to recognize that over a half a million dollars of company assets are non-rate base investment. As of the end of the test year, $553,793 of the Company's assets financed by equity are in cash or short-term liquid assets and are not included in rate base. The process of reconciling rate base to capital structure requires that the equity component related to current assets or non-rate based investments be removed from the regulated capital structure. This adjustment accounts for a decrease of approximately 7% in the equity component. In short, the combined effect of the increased liabilities and decreased equity results in the Staff's capital structure of 29.24% equity and 70.76% debt.

The Company has recommended the use of a hypothetical capital structure containing 50% debt and 50% equity. (Exhibit T-15, p.38). As Mr. Kermode testified, (Tr. p. 396) the use of the hypothetical capital structure is to correct the effect of an equity rich capital structure. Generally, the cost of equity exceeds the cost of a company's debt. By using a hypothetical capital structure, the higher cost of an equity rich capital structure can be compensated for by providing a lower weighted cost, but maintaining the safety provided by the high equity mix. However, the same does not work with a highly leveraged company; providing a higher-cost capital structure increases the rates customers pay, but does not provide for a safer capital structure. Although a higher mix of equity to debt in setting the capital structure does provide higher coverage ratios, setting an arbitrary capital structure of 50% debt and 50% equity is simply a shot in the dark.

The use of the Debt Service Coverage Ratio to provide the proper debt coverage, as Staff has proposed, is a more appropriate approach to addressing a highly leveraged company. In contrast to the DSCR approach, that clearly shows the level of return allowed the equity component, the imputation of a higher equity element using a hypothetical capital structure merely obscures the fact that a higher return is being allowed to provide the needed financial safety.

VI. Revenue Requirement and Rate Design

A. The Company's Revenue Requirement is Less than the Revenue Generated by its Existing Tariffed Rates

Staff did not include a discussion of rate design in its prefiled testimony, because Staff's analysis showed the Company should experience a rate decrease, not an increase. Taking into account the above agreed adjustment amounts, and Staff's recommendations on the contested adjustments, Staff's analysis indicates a reduction in the Company's revenue requirement by $119,820 below the current rate levels. *See* Appendix B.

B. Rate Design

Staff believes that the recommended reduction in revenue requirement should be structured to maintain a stable cash flow, minimizing fluctuation of the base rates. Staff recommends that any reduction be placed on the overage component of the current rate structure. Staff also recommends that the reduction affected unmetered flat rate customers be in proportion to the usage portion of the metered rates. It should be noted that the revenue effect of the proposed rates computed by Staff was significantly less than the amount computed by the Company. This difference is due to the manner in which the Company computed the effect of the proposed rates. The Company's Exhibit 25 provides no reconciliation of test year revenues. Although this calculation is required by WAC 480-09-337, the Company requested a waiver of

the rule. Despite Staff's request that the Company, in this case, provide a reconciliation of test year revenues with the test year rate structure, the Company did not provide it. By using the usage data collected by Staff through a data request, a schedule of revenues was produced to perform this reconciliation. As stated above, Staff' analysis shows that the Company would under-collect revenues if the Company's proposed rate structure is adopted.

VII. Conclusion

Staff requests that the Commission adopt the agreed adjustments and Staff's recommended restating and pro-forma adjustments, and reduce the Company's rates accordingly. Although failure to mention an issue in this conclusion should not be taken as an abandonment of the argument made above, in particular, Staff advocates that:

> The amount the Company has included in rates for payment of the shareholder's federal tax be removed;
>
> The amount of salary for Mr. Richardson that is included in rates be reduced;
>
> The adjustments to rate base, vehicle insurance and depreciation be made to reflect the replacement of the cost of the Lincoln Navigator used by the owner with the cost of a less expensive vehicle;
>
> The revenue the Company collects from Ready to Serve charges that developers pay under contracts be included in the Company's regulated revenues.

In addition, Staff advocates the use of the Company's actual capital structure, as adjusted by Staff, and the use of the Debt Service Coverage Ratio method to set the rate of return.

DATED this 19th day of March, 2002.

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