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6 **BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION**
7 **COMMISSION**
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9 WASHINGTON UTILITIES AND
10 TRANSPORTATION COMMISSION,

11 Complainant,

12 v.

13 AMERICAN WATER RESOURCES, INC.,

14 Respondent.
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DOCKET NO. UW-031284,
DOCKET NO. UW-010961 and
DOCKET NO. UW-031596 (consolidated)

OPENING BRIEF OF AMERICAN WATER
RESOURCES, INC.

18 This Brief is filed on behalf of American Water Resources, Inc. (“AWRI”). This
19 Brief will begin by providing some background information concerning the company. The
20 Brief will then discuss the background of this case. After discussing the two
21 “backgrounds” to give some context to the Brief, AWRI will then present its position on
22 the major issues. The Brief will then turn to a discussion of some of the minor issues. The
23 Brief will close with a discussion of the penalty issue.
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26 OPENING BRIEF OF AMERICAN
WATER RESOURCES, INC. - 1

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1 COMPANY BACKGROUND

2 AWRI was started in March of 1995 to focus on the management of small water
3 systems.¹ It has a business plan which is consistent with Department of Health (DOH)
4 goals to consolidate small water systems.² AWRI was encouraged to acquire small water
5 systems.³ This goal of consolidating small systems is consistent with WUTC policy.⁴

6 The company grew rapidly in an effort to reach a size where economies might begin
7 to play. It reached 157 systems serving approximately 2,000 residents in its first four years
8 of operation.⁵ However, the company was criticized for growing too fast and for being too
9 highly leveraged.⁶ The company took a number of steps to respond to these criticisms. It
10 voluntarily curtailed its expansion plans.⁷ In addition, the company consolidated so that it
11 now operates 130 systems serving approximately 1,500 customers.⁸ These systems are
12 spread across parts of several counties.⁹ Obviously, it is more expensive and difficult to
13 operate when a company serves 1,500 customers over 130 systems in several counties than
14 serving 1,500 customers on two or three systems that are close together.¹⁰

15 Many of the systems acquired by AWRI were considered problem systems. DOH
16 acknowledged that AWRI brought an enhanced level of service to many of these systems.¹¹
17 Mr. Fox invested substantial sums of money to make capital improvements.¹² The

18 _____
19 ¹ Exhibit 120T at p. 7, l. 20-23.

20 ² Exhibit 4; Exhibit 1T at p. 7, l. 4-12.

21 ³ TR 77, l. 7-11.

22 ⁴ Exhibit 30T at p. 11, l. 12-14.

23 ⁵ Exhibit 120T at p. 8, l. 11-13.

24 ⁶ Exhibit 1T at p. 12, l. 9-18; Exhibit 30T at p. 9, l. 6 – 10, l. 4. See, generally, Docket Nos. UW-980072,
25 UW-980258 and UW-980265 (consolidated) and Docket No. UW-980076, Sixth Supplemental Order.

26 ⁷ Exhibit 1T at p. 14, l. 2-10.

⁸ See, generally, Exhibit 4 and TR 66, l. 14 - 69, l. 14; TR 78, l. 12-15.

⁹ See, generally, Exhibit 4.

¹⁰ TR 78, l. 19 – 79, l. 7.

¹¹ Exhibit 4, first page of letter dated June 30, 1998.

¹² Exhibit 100T at p. 23, l. 18-20; Exhibit 120T at p. 14, l. 1-2.

1 company planned on having additional revenues from rates and surcharges to make more
2 improvements.¹³ While some additional funds came from those sources, there was not
3 enough money to do everything that was needed. As a result, AWRI ran out of money to
4 continue to make improvements and has been struggling since 1998 to obtain sufficient
5 funds to make those improvements.¹⁴ The company's financial condition is a concern to
6 DOH.¹⁵ It should be a concern to the Commission.

7 The company is attempting to provide service to 1,500 customers on
8 approximately 130 systems spread over many counties with just six employees, including
9 Mr. Fox.¹⁶ The company is currently struggling to pay expenses on a timely and consistent
10 basis.¹⁷ In an effort to control expenses during the test year, the company reduced
11 employee hours. The hours were restored after the test period when additional revenues
12 became available in the summer months of 2003.¹⁸ The company was under pressure to
13 reduce its line of credit¹⁹ and has since replaced the line of credit with a lower cost loan.
14 However, the company is still struggling financially.

15 Although not directly involved in this case, it is important to understand where
16 AWRI stands with the DOH. AWRI has entered into a settlement agreement with DOH.²⁰
17 Under the terms of that settlement agreement, AWRI is to perform certain engineering
18 studies to update its Comprehensive Water Plan. There is nothing in this case that will
19 provide AWRI with the funds to pay the engineers to perform those functions.²¹ In

21 ¹³ See, e.g., Exhibit 120T at p. 17, l. 20 – 18, l. 3.

22 ¹⁴ See, e.g., Exhibits 2, 3 and 21.

23 ¹⁵ Exhibit 1T at p. 9, l. 13-15.

24 ¹⁶ There were seven employees during portions of the test period. One position remains unfilled.

25 ¹⁷ Exhibit 120T at p. 20, l. 6-9; Exhibit 93.

26 ¹⁸ Exhibit 100T at p. 24, l. 1-7.

¹⁹ Exhibit 138; See, also, TR 274-5.

²⁰ Exhibit 6.

²¹ TR 74, l. 3 – 76, l. 15.

1 addition, AWRI's update to its water system plan and the update to its SMA filings are past
2 due. There is no money to perform these functions.²²

3 The company has a capital improvement program (CIP) that identifies critical
4 needs. The CIP is in the record as Exhibit 7. Ms. Lahmann testified that the projects listed
5 in the CIP need to be taken care of.²³ On cross-examination, Ms. Lahmann stated that
6 those items are important.²⁴ DOH expects AWRI to have the funding available to make
7 those improvements.²⁵ However, AWRI does not have the means to accomplish the capital
8 improvement program.²⁶ This case does not address those capital needs.

9 There are new requirements contained in HB 1338. Exhibit 123 and Exhibit 27 at
10 p. 7 and p. 11-14 project the engineering cost of complying with this new requirement at
11 approximately \$50,000.00 for the Group A systems and \$2,500.00 per Group B system.²⁷
12 This case does not address the source of funding to meet the new legislative requirements.

14 BACKGROUND OF CASE

15 This case involves a complaint against the current level of company rates. It is also
16 a reopening of the prior case and involves a penalty assessment against Mr. Fox. This is
17 indeed an unusual case.

18 Mr. Fox submitted testimony in Exhibit 120T in which he expressed his frustration
19 with traditional regulatory theory, in general, and the way AWRI is treated, in particular.
20 Commission Staff responded with voluminous testimony. The apparent purpose of most of

22 ²² Exhibit 1T at p. 8, l. 16 – 10, l. 19.

23 ²³ Exhibit 1T at p. 17, l. 9 – 18, l. 6.

24 ²⁴ TR 77, l. 12 – 78, l. 11.

25 ²⁵ Exhibit 1T at p. 15, l. 2-19.

26 ²⁶ Exhibit 120T at p. 32, l. 4-20.

27 ²⁷ See, also, Exhibit 120T and p. 6, l. 7-9.

1 that testimony is to attempt to show that AWRI is treated just like any other water
2 company.²⁸ However, one need only look at this case to know that Commission Staff's
3 efforts to explain how AWRI is treated like any other company are futile. AWRI is not
4 treated like any other water company.

5 Mr. Fox believes that Commission Staff have treated AWRI and himself in a way
6 that is unfair and not consistent with the treatment of other companies. Commission Staff
7 denies it. Ms. Parker agrees with Mr. Fox. Ms. Parker states, "I believe that years ago
8 Staff made some personal judgments with regard to the sole shareholder of the company
9 that distorts their ability to objectively view decisions made by the management of this
10 company."²⁹

11 Looking at this case demonstrates that Mr. Fox's fears are not unfounded.
12 Commission Staff has fabricated out of thin air an adjustment related to the Birchfield
13 Water System. They have created regulatory value for assets when that regulatory value
14 does not exist. They have refused to acknowledge, and probably will refuse to
15 acknowledge in their brief, that there simply is no adjustment that is appropriate for
16 Birchfield. The pursuit of the Birchfield adjustment with such vigor when there is
17 absolutely nothing that should be adjusted certainly raises the question why Staff is
18 pursuing such a course of action.

19 The fact that Commission Staff strongly criticized AWRI's leveraged capital
20 structure in an earlier proceeding, and now criticizes AWRI for having taken steps to
21 address that earlier criticism would give anyone cause to wonder. This issue is described in
22 greater detail later in the Brief.

24 ²⁸ TR 93, l. 21 – 94, l. 1.

25 ²⁹ Exhibit 100T at p. 4, l. 7-10.

1 Commission Staff describes Mr. Fox’s sale of the Country Water system as being
2 done for “personal profit.”³⁰ However, all of the proceeds from the sale of Country Water
3 were invested in AWRI.³¹ It should be remembered that Country Water and AWRI were
4 totally separate legal entities. Mr. Fox would have been completely within his rights to
5 take the proceeds from the sale of Country Water and use those proceeds in investments
6 with potentially higher returns, use the money to go on vacation or buy a new car, or put
7 the money in a retirement account. However, he did none of these things. He invested the
8 proceeds in AWRI. For that action, Mr. Fox should be praised, not criticized.

9 Commission Staff has required AWRI to bid construction jobs if V.R. Fox
10 Company, an affiliate, is interested in doing the job and the job is more than \$5,000.00.³²
11 How is that treating AWRI like any other water company? That is action that imposes
12 additional costs and time delays on AWRI that other water companies do not have to face.
13 Staff agrees this is a restriction which is not put on other companies.³³

14 Commission Staff’s proposal of a “regulatory liability” related to the Docket
15 Account is certainly not the way every other water company is treated. Staff agrees this is
16 unusual.³⁴

17 The company brought at least two suggestions to Commission Staff on ways to
18 address problems with the Docket Account.³⁵ Staff did not respond with anything other
19 than saying no to suggestions. There was no suggestion by Commission Staff of another
20 methodology that might work. Instead, Commission Staff brought a complaint.³⁶

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22 ³⁰ Exhibit 30T at p. 13, l. 4 – 14, l. 8.

23 ³¹ Mr. Eckhardt agrees. TR 98, l. 9 – 99, l. 5. See, also, Exhibit 120T at p. 19.

24 ³² Exhibit 120T at p. 16, l. 1-6.

25 ³³ Exhibit 30T at p. 23, l. 1-2.

26 ³⁴ TR 94, l. 26.

³⁵ Mr. Eckhardt acknowledges that the company made the proposals. Exhibit 30T at p. 37, l. 10-11.

³⁶ As the old saying goes, one does not have to be paranoid to think that someone is following them.

1 The point Mr. Fox is making in Exhibit 120T is that Commission Staff has not been
2 helpful to AWRI in addressing the problems that AWRI faces.³⁷ In fact, it appears that
3 Commission Staff is trying to find ways to punish AWRI. This process started early on.
4 As Mr. Fox testifies, when the company first came under regulation it had trouble
5 understanding the record-keeping requirements. Instead of helping the company, the Staff
6 simply waited for the company to make mistakes and then criticized them for those
7 mistakes.³⁸

8 In Docket 010961, the company was put on very restrictive standards on the use of
9 funds. What other water company has had such restrictions placed upon it? Staff agrees
10 this is unusual.³⁹

11 Part of Commission Staff's response is to argue that Mr. Fox does not understand
12 regulation.⁴⁰ Commission Staff tried to carry that point home in cross-examination.
13 However, Mr. Fox demonstrated that he does understand regulation.⁴¹ What Mr. Fox is
14 doing in his testimony is making the point that traditional regulation does not work very
15 well for small water companies. Most people, in candid moments, would agree with that
16 proposition.

17 As another example, Commission Staff tries to argue that Mr. Fox does not
18 understand regulation because he suggests that a reserve be established.⁴² As pointed out
19 in the cross of Ms. Lahmann, most other types of water companies have reserves and have

21 ³⁷ It is really puzzling to the author of this Brief why Staff is not more helpful with AWRI. Commission Staff
22 have been very helpful with other water companies on numerous occasions. They have helped water
23 companies face difficult problems and worked with those companies to come up with solutions. In the case
24 of AWRI, it seems that door for help is always closed.

25 ³⁸ Exhibit 120T at p. 17, l. 12-17.

26 ³⁹ Exhibit 30T at p. 36, l. 15-19; TR 94, l. 7-10.

⁴⁰ See, e.g., Exhibit 30T at p. 4, l. 6-10; p. 6, l. 12-15.

⁴¹ TR 245-253.

⁴² Exhibit 30T at p. 7, l. 16 – 8, l. 2.

1 the flexibility to establish assessments.⁴³ A regulated company does not have the authority
2 to establish assessments. DOH's rules require a reserve and one of the exhibits from DOH
3 requires that AWRI be able to respond to emergencies and short term needs without rate
4 relief from the Commission.⁴⁴ This suggests the establishment of a reserve.⁴⁵ That letter
5 tells AWRI that it needs to be able to respond to emergency situations without the need to
6 obtain a surcharge from the Commission. There are only two ways to do this. One is for
7 the company's owners to have extra cash standing by. The other is to establish a reserve.
8 Mr. Eckhardt testified that Commission Staff's position is that the Commission does not
9 have the authority to allow a reserve.⁴⁶ That may be an overly restrictive reading of the
10 Commission's authority. It certainly reflects a very conservative attitude when in other
11 settings the Commission gives a broad interpretation to acting in the public interest.

12 One troubling aspect about this case is apparently no one explored whether the
13 Commission Staff recommendation coming out of this case would make the company more
14 financially viable or less financially viable.⁴⁷ Ultimately, rates must be fair, just,
15 reasonable and sufficient. One would think that for a water company which must meet
16 tests of financial viability to have an approved Comprehensive Water Plan, Commission
17 Staff would take that issue into account in its recommendations as to what level of rates are
18 fair, just, reasonable and sufficient. However, that was not done. The reality is that

23 ⁴³ TR 71, l. 18 - 73, l. 4.

24 ⁴⁴ Exhibit 6 at Section 2.8.

25 ⁴⁵ Exhibit 2.

26 ⁴⁶ TR 96, l. 15 - 97, l. 25.

⁴⁷ TR 73, l. 12 - 74, l. 3.

1 Commission Staff’s recommendations would make the company less financially viable in
2 both the regulatory and real world senses of that term. The company is struggling to meet
3 operating expenses today.⁴⁸ Commission Staff’s recommendation would severely cut the
4 revenues the company currently receives. As Ms. Parker succinctly stated: “Commission
5 Staff’s proposal is completely out of touch with reality.”⁴⁹

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7 MAJOR ISSUES

8 1. Manager’s Salary – P-6.

9 Commission Staff would place Mr. Fox’s salary at approximately \$24,000.00. The
10 company is proposing that Mr. Fox’s salary be set at \$60,000.00. As explained by Ms.
11 Parker, at one point, Mr. Fox’s salary was reduced to \$24,000.00 at a time when he had a
12 manager in place who was receiving \$60,000.00. Later, in an effort to control expenses,
13 AWRI did not fill a vacancy position in the manager’s position and Mr. Fox assumed that
14 role.⁵⁰ Mr. Fox is not asking to be paid \$84,000.00 in salary (his prior \$24,000.00 plus the
15 \$60,000.00 for the manager), but only to be paid commensurate with the job he is
16 performing -- that of manager.

17 Staff argues that Mr. Fox’s salary was reduced because of concerns over
18 management and high levels of customer complaints.⁵¹ Mr. Eckhardt even states it is a
19 “tragedy” that customers have not received the level of service they deserve.⁵² The
20 company has had financial difficulties. However, even during a period of financial

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23 ⁴⁸ Exhibit 120T at p. 20, l. 6-9; Exhibit 93; TR 151, l. 10-18.

24 ⁴⁹ Exhibit 100T at p. 3, l. 20-21.

25 ⁵⁰ Exhibit 100T at p. 15, l. 5-22.

26 ⁵¹ See, Exhibit 41T at p. 11-12.

⁵² Exhibit 30T at p. 6, l. 11-12.

1 difficulties, under Mr. Fox's leadership the company has been able to improve customer
2 service. In fact, as evidenced by the only objective evidence in the record, the level of
3 complaints, service has improved dramatically.⁵³ Even Mr. Eckhardt grudgingly agreed
4 that the level of complaints was a factor in evaluating a manager and company
5 performance.⁵⁴ Mr. Ward also agrees that reducing complaints shows improved service.⁵⁵
6 As demonstrated by Exhibit 32, the total number of complaints fell from a high of 49 in
7 2000 to three in 2003. The number of non-billing related complaints fell from a high of 45
8 in the year 2000 to one in 2003.⁵⁶ Despite Mr. Eckhardt's characterization of a tragedy, the
9 numbers show otherwise. Substantial improvement has been made.

10 AWRI's position on Mr. Fox's salary is very reasonable. By looking at Exhibit 94,
11 it is clear that compared to other water companies, placing Mr. Fox's salary at \$60,000.00
12 would still leave AWRI in the lower end of the range of companies. Using the salary per
13 customer as a comparison, AWRI is currently the third lowest among companies that have
14 had rate proceedings in the last several years. Increasing the salary to \$60,000.00 would
15 move AWRI to sixth lowest out of the 24 companies. In other words, a salary of
16 \$60,000.00 per year would produce a result where the rates that the customers pay for
17 manager's salary is in the lowest one-fourth of the 24 companies the Commission has
18 reviewed in recent years.

19 In looking at the manager's salary as a percentage of revenue on Exhibit 94, AWRI
20 is currently second lowest. Increasing the salary to \$60,000.00 would make AWRI the
21

22 _____
23 ⁵³ Exhibit 32.

24 ⁵⁴ TR 95, l. 19 - 96, l. 14.

25 ⁵⁵ TR 135, l. 2-16.

26 ⁵⁶ From Mr. Eckhardt's testimony, the improvement is even more dramatic. Complaints have fallen from a
high of 76 in 1998 to today's levels. Exhibit 30T, chart at top of p. 10.

1 fifth lowest of the companies. Again, this demonstrates that the request by AWRI is very
2 reasonable.

3 As Ms. Parker points out, Mr. Fox is the lowest paid AWRI employee.⁵⁷ That is
4 just not right. Ms. Parker also points out that the \$60,000.00 rate was established by the
5 Commission as the market rate for a manager.⁵⁸

6 One final rationale offered by Commission Staff for not increasing the manager's
7 salary is that there is too much use of outside consultants.⁵⁹ However, on cross, it was
8 pointed out that the company is actually making less use of consultants than occurred in the
9 last rate case.⁶⁰ While Mr. Fox agreed that he does seek the advice of outside consultants
10 on major issues, he makes the final decisions.⁶¹ There is really no good reason to keep Mr.
11 Fox's salary at \$24,000.00.

12 2. Employee Salaries – P-3 and P-10.

13 The test year level for salaries was \$169,096.00. Commission Staff would reduce
14 this amount by \$23,102.00 to a level of \$145,994.00.⁶² Under Staff's approach, this
15 represents six part-time employees.

16 AWRI's position is that the level of salaries for employees should be \$216,967.00.
17 Company Adjustments P-3 and P-10 account for this increase above the per books amount.
18 The purpose of Adjustment P-3 is to reflect that company personnel worked at reduced
19 hour levels during a portion of the test period while the company was trying to be sure it
20 lived within its means. Those hours were reinstated in July of 2003 and have continued at

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22 ⁵⁷ Exhibit 100T at p. 15, l. 15-22.

23 ⁵⁸ Ibid.

24 ⁵⁹ Exhibit 41T at p. 12, l. 9-17.

25 ⁶⁰ TR 135, l. 16 - 136, l. 14.

26 ⁶¹ See, TR 229, l. 13-21. Note this discussion continues for several pages.

⁶² Exhibit 41T at p. 5, l. 1-7.

1 the full amount ever since. Commission Staff knows that the staffing level was reduced
2 during a portion of the test period; that the full amount has been in place since July and
3 knows the employee level that is being used today.⁶³ For Commission Staff to propose a
4 reduction just proves Mr. Fox's point that it appears that Commission Staff is out to harm
5 the company.

6 Adjustment P-10 is to reflect an increase in cost of living. The employees have not
7 had a cost of living increase in at least two years. It was agreed that under normal
8 circumstances a cost of living increase is valid.⁶⁴ What is interesting is Mr. Ward's refusal
9 to agree that a cost of living increase should be allowed in rates if it is known and
10 measurable.⁶⁵

11 Ms. Lahmann testified that regulation is growing more complex.⁶⁶ She agreed that
12 it is harder to operate a water system with many small systems spread across several
13 counties.⁶⁷ It is very difficult to imagine how a company can do the things that Ms.
14 Lahmann described as far as testing, maintenance, reading source meters, visiting small
15 systems at least once a week and major systems on a daily basis with less than six full-time
16 employees.⁶⁸ A more salient question is how do just six employees keep all of the financial
17 books in order, respond to customer inquiries, read the meters, do the billing, do the testing,
18 and keep basic maintenance going?

19 AWRI will admit that it is subject to some criticism on the issue of the level of
20 employees. In the past, the company has requested additional employees and then failed to
21

22 ⁶³ TR 130, l. 20-25; TR 131, l. 2-18.

23 ⁶⁴ TR 139, l. 17-20.

24 ⁶⁵ Ibid.

25 ⁶⁶ TR 65, l. 6 – 66, l. 8.

26 ⁶⁷ TR 78, l. 12 – 79, l. 7.

⁶⁸ TR 66, l. 14 – 71, l. 17.

1 hire them. Unfortunately, circumstances always seemed to arise that made that not
2 possible. In the Docket Account, more employees were allowed. However, with the sale
3 of View Royal, the company could not meet the necessary base level in order to expand
4 and use the Docket Account for new employees. Under the conditions in Docket UW-
5 010961, the company had to have at least seven full-time employees and had to be
6 spending a minimum of \$17,000.00 per month before it could use the Docket Account to
7 hire more employees. With the sale of View Royal, it did not have the financial resources
8 to maintain seven full-time employees without the Docket Account resources. The
9 company wanted to hire new employees, but Ms. Parker advised the company that it did
10 not have the financial resources to do so unless some way could be found to use the Docket
11 Account.⁶⁹

12 The company approached Commission Staff about resetting the baseline to reflect
13 the View Royal sale, so that Docket Account monies could be used for hiring additional
14 employees. However, the Commission Staff said it would not support such a proposal.
15 The Staff did not offer an alternative. In any event, AWRI has decided not to ask for
16 additional employees in this proceeding. Instead, all AWRI is asking is that the
17 Commission recognize the level of employees in the test period at the level the employees
18 are working today and give those employees a cost of living increase.

19 3. Rate Case Costs – P-9.

20 This case is quite complex. It involves a complaint against the company. It
21 involves reopening the prior rate case. It involves a penalty against Mr. Fox.⁷⁰ This case
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24 ⁶⁹ Exhibit 100T at p. 28, l. 1 – 33, l. 2.

25 ⁷⁰ It should be noted that no portion of the rate case cost that is being requested relates to the penalty. Those
26 costs have not been included in the amount submitted to date.

1 involves complicated adjustments to rate base. This case involves a new concept for a
2 water company dealing with a “regulatory liability.” This case involves a substantial
3 adjustment that is pure fiction (the Birchfield adjustment). This proposed adjustment
4 caused the company to suffer a great deal of expense in gathering documents and preparing
5 to defend itself against an imaginary item.

6 As Mr. Eckhardt himself points out, the company has been before the Commission
7 on a regular basis: seven rate cases and four surcharge filings in eight years.⁷¹ Thus, it
8 could be argued that the full amount of the rate case expense should be included in initial
9 rates. It is clear that to use a three year amortization would simply be a way of reducing
10 revenues to the company, and would not reflect the frequency of major regulatory actions
11 involving AWRI. On this basis, the company is proposing that the rate case costs
12 contained in Adjustment P-9 be amortized over two years. Exhibits 91, 92 and 96 provide
13 the basis for the company’s adjustment.

14 4. Acquisition Adjustment – R-11.

15 Ms. Parker proposes an acquisition adjustment for rate base. Adjustment R-11.⁷²
16 This adjustment is predicated on the concept that if the company acquires systems below
17 their historical cost it should be allowed to use the historical cost (adjusted for
18 depreciation) in rates. The Commission should not always use the lower of acquisition
19 costs or current rate base. To do so does not set rates which are just, fair, reasonable and
20 sufficient. Rather, that is simply a way of keeping rates lower than they otherwise should
21 be.

22 In this case, AWRI acquired some systems for more than their rate base calculation

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24 ⁷¹ Exhibit 30T at p. 6, l. 12-15.

25 ⁷² Ms. Parker’s work papers for the adjustment are in Exhibit 89.

1 (historical costs adjusted for accumulated depreciation). The company has not been
2 allowed to recover the investment when the acquisition cost was higher than rate base. As
3 Ms. Parker points out, Staff testified in UW-980072 that if the company purchased systems
4 at less than historical cost, it could include the systems at the rate base number.⁷³ AWRI
5 acted on this incentive. AWRI searched for and acquired many systems for less than rate
6 base. It should be allowed to use the rate base figure for those acquisitions.⁷⁴ To do
7 otherwise discourages the consolidation of stand-alone systems, which is inconsistent with
8 policies of the State of Washington.

9 5. Birchfield Gain on Sale – RB4.

10 The Birchfield gain on sale adjustment proposed by the Commission Staff is
11 outrageous. Commission Staff's apparent position is that unless AWRI can prove there
12 were two separate water systems, the value of all improvements, including those not made
13 by AWRI and which were never given to AWRI are a regulatory asset of AWRI.⁷⁵ This
14 position shows how poorly Staff understands basic principles.

15 The Birchfield Water System as operated by AWRI has ten actual connections and
16 is approved for an additional 27 connections for a total of 37 approved connections.⁷⁶ As
17 shown on Exhibit 27, the future, expanded Birchfield Water System will serve 1,000
18 customers in a much larger area.⁷⁷ Six thousand feet of eight inch main and 2,700 feet of
19 12 inch main were constructed for this future expansion.⁷⁸ Thirteen fire hydrants were
20 installed for this future expansion.⁷⁹ AWRI did not pay for a penny of this -- not one single

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22 ⁷³ Exhibit 100T at p. 21, l. 7 and following.

23 ⁷⁴ Or, is this a case where Staff mislead the company?

24 ⁷⁵ Exhibit 41T at p. 31 and following; see, also, Exhibit 86.

25 ⁷⁶ TR 84, l. 18-19; TR 120-121.

26 ⁷⁷ TR 83, l. 23 – 84, l. 9; Exhibit 27 at p. 14.

⁷⁸ TR 84, l. 20-24; TR 121, l. 7 – 122, l. 10.

⁷⁹ TR 84, l. 25 – 85, l. 5.

1 penny. It is not uncommon for the developer to pay for future expansion and deed over the
2 facilities when needed.⁸⁰ Yet, Staff cannot understand this basic proposition.

3 The Commission Staff has had available to it the documents that showed that there
4 were absolutely no gain from the sale of the Birchfield System. Exhibit 27 at page 5 shows
5 that the Birchfield System includes 6,000 feet of eight inch main and 2,300 feet of 12 inch
6 main for future use. Those assets were never part of the assets transferred to AWRI.
7 Indeed, AWRI does not need that level of investment to serve the ten customers that were
8 on the Birchfield System. Nor, does it need 13 fire hydrants for a handful of customers. If
9 the maps that are in Exhibit 27 are even given a cursory review, it is obvious that the future
10 Birchfield System will be much larger than the existing Birchfield System. That is the
11 obvious explanation for the construction of 6,000 feet of eight inch main, 2,300 feet of 12
12 inch main and 13 fire hydrants.

13 Mr. Ward is proposing a major adjustment for Birchfield. Yet he admitted that he
14 has never even seen the system.⁸¹ After much hemming and hawing, Mr. Ward admitted
15 that Exhibit 88 contains a complete list of the assets for the Birchfield system that are on
16 the AWRI books.⁸² Mr. Ward admits that he has no evidence that AWRI paid for the
17 improvements for future use (mains, etc.).⁸³ He admits that the Birchfield wells are not in
18 the AWRI rate base.⁸⁴ Mr. Ward has nothing except speculation.

19 Staff makes much to do about the three wells for the Birchfield system. However,
20 all of that is a smokescreen. First, as Ms. Lahmann testified, all that is needed for 37
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23 ⁸⁰ TR 82, l. 15-25.

⁸¹ TR 118, l. 15-17.

24 ⁸² TR 118, l. 10 - 119, l. 15.

⁸³ TR 123, l. 5 - 124, l. 15.

25 ⁸⁴ TR 125, l. 25 - 128, l. 6.

1 connections is one well.⁸⁵ Second, the wells are not included as assets having any value on
2 Exhibit 88. Finally, the fact is that AWRI did not pay a penny for the wells.⁸⁶ That means
3 the wells have never been paid for by customers. The wells have not been a “burden,” in
4 Staff’s terms, on customers.

5 Exhibit 142 shows invoice after invoice after invoice where V.R. Fox, Inc., not
6 AWRI, paid for the construction of those parts of the water system above and beyond what
7 were on the books of AWRI.⁸⁷ The Declaration of Ms. Woods in Exhibit 85 confirms it.⁸⁸
8 The engineering contracts show the work is for V.R. Fox Company, not AWRI. Staff
9 admits those invoices do not include trenching, bedding material and labor.⁸⁹

10 Mr. Fox’s concerns about Commission Staff’s attitude toward AWRI are warranted
11 when Commission Staff makes something up and refuses to acknowledge what is clearly in
12 front of it.

13 6. View Royal Gain on Sale – RB3.

14 Commission Staff proposes a gain on sale adjustment for the View Royal sale.
15 Although AWRI does not agree with the concept, AWRI recognizes that gain on sale
16 adjustments have been made by the Commission from time to time.⁹⁰ The theory for gain
17 on sale adjustment is that the rate payers, through paying for depreciation in rates, have
18 helped pay for the asset and therefore should be entitled to some portion of the gain. That
19 theory holds less viability when, as here, the asset is held for only a short period of time.

20 Further, the gain on sale adjustment should not be made in a circumstance where
21 _____

22 ⁸⁵ TR 83, l. 10-16; Exhibit 25.

23 ⁸⁶ TR 314, l. 12-20.

24 ⁸⁷ Please note that the documents in Exhibit 142 do not constitute all of the invoices. Those were the invoices
25 that could be produced within the timeframe available. Nor do the invoices include the labor.

26 ⁸⁸ Exhibit 72 at p. 2-3.

⁸⁹ TR 121, l. 16 – 125, l. 11.

⁹⁰ Obviously, that occurred with AWRI’s sale to Pen Light.

1 the company is attempting to respond in a way that it reasonably perceives is the direction
2 the Commission desires the company to move.⁹¹ In the Sixth Supplemental Order in
3 Docket Nos. UW-980072, UW-980258, and UW-980265 (consolidated) and Docket No.
4 UW-980076 (“Sixth Supplemental Order”), AWRI was severely criticized about its capital
5 structure and the fact that Mr. Fox was the primary debt holder.

6 In that docket, Commission Staff strongly advocated that AWRI should be required
7 to reform its capital structure. Staff argued that there is an inherent incentive in the form of
8 a higher available return on equity relative to debt that ought to encourage Mr. Fox to retire
9 debt in favor of equity. Staff also criticized AWRI over its debt structure because most of
10 the debt was from Mr. Fox and Staff argued that this provided Mr. Fox, in essence, “a
11 secured income” from those debt payments. The Commission cited Commission Staff’s
12 position as a basis for its decision. The Commission also stated “We observe, too, that
13 while AWRI’s extraordinary high debt ratio places the company at high risk of business
14 and financial failure, as principal creditor, Mr. Fox will enjoy a favorable position if
15 bankruptcy ensues.”⁹² These are strong criticisms of the company and Mr. Fox’s position
16 as debt holder.

17 The Commission rejected a hypothetical capital structure advanced by the
18 company, relying in part on Commission Staff’s arguments that hypothetical adjustments
19 that understate actual debt do little, if anything, to actually increase safety: the actual debt
20 obligation remains unchanged. Instead, the Commission approved an eighty percent debt
21 ratio as an incentive for AWRI to achieve that actual capital structure and AWRI was

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24 ⁹¹ After initially denying the obvious, even Mr. Eckhardt agreed doing what the Commission directs is
reasonable. TR 112, l. 15 – 113, l. 3.

25 ⁹² See, discussion in transcript at TR 102, l. 2 – 105, l. 9.

1 instructed to improve that ratio further. In fact, the company was warned there would be
2 consequences from a failure to improve the capital structure.⁹³

3 In addition to the strongly worded discussion in the Order, the Commission's
4 findings state as follows:

5 17. AWRI's actual capital structure includes more than ninety percent debt,
6 largely in the form of shareholder loans. A hypothetical capital structure
7 reflecting eighty percent debt and twenty percent equity should be adopted
8 to encourage AWRI to reform its actual capital structure to a more balanced
9 debt to equity ratio such as fifty percent debt, fifty percent equity.

10 18. Interest on shareholder loans should be imputed at 10.50% (200 basis points
11 above the prevailing prime rate during the relevant period) to provide for
12 reasonable interest and to encourage AWRI to reform its capital structure to
13 include significantly more equity and less debt.⁹⁴

14 Thus, relying, in part, on Commission Staff arguments, the Commission soundly criticized
15 AWRI over its capital structure and instructed it in no small way to change that capital
16 structure.

17 As Mr. Fox testified, he had no funds that he could invest to infuse equity into the
18 capital structure. He tried to find other investors, but was unsuccessful.⁹⁵ The only means
19 he had to make changes in the capital structure were to sell off assets and use the proceeds
20 of those sales to retire debt. All Mr. Fox was trying to do was to follow the direction, the
21 very strong direction, that the Commission gave him. That is the same direction that
22 Commission Staff recommended leading to the Sixth Supplemental Order.

23
24 ⁹³ See, discussion at pages 8 and 9 in the Sixth Supplemental Order.

25 ⁹⁴ Sixth Supplemental Order at p. 34.

26 ⁹⁵ See, e.g., TR 314, l. 2-11.

1 Now, Commission Staff seems to imply that Mr. Fox sold View Royal primarily to
2 benefit himself. Mr. Ward begins his discussion of this issue by using the term “windfall”
3 and accuses Mr. Fox of “trafficking” in water systems.⁹⁶ Nothing could be further from the
4 truth. With the sale of View Royal, Mr. Fox was able to retire a substantial amount of debt.
5 He was able to respond to the Commission’s criticism through his position as debt holder.
6 His personal debt was retired and AWRI was left with only bank debt.⁹⁷

8 Staff takes the position that paying off the debt is not in the best interest of the
9 company and the customers.⁹⁸ Mr. Ward goes on to criticize the change in capital
10 structure.⁹⁹ This is completely opposite of what Staff argued in the prior cases. It is
11 inconsistent with what the Commission ordered in the Sixth Supplemental Order cited
12 above.

13 Staff also implies that Mr. Fox, as sole shareholder, can simply re-characterize debt
14 as equity. Both Mr. Fox and Ms. Parker point out that is not feasible in this case. The debt
15 held by Mr. Fox was actually debt he borrowed from banks based on his reputation and
16 borrowing strength. He then relented the money to the company. AWRI could not borrow
17 money directly.¹⁰⁰ To be blunt, Staff mischaracterized the debt payments from AWRI to
18 Mr. Fox as a “second income” as quoted in the Sixth Supplemental Order. Unfortunately,
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21 ⁹⁶ Exhibit 41T at p. 22, l. 14-18.

22 ⁹⁷ Commission Staff’s criticism of the leveraged capital structure in the prior case and Mr. Fox’s standing as
23 debt holder when compared to the current criticisms of retiring the debt and increasing equity to levels the
24 Commission sought reaches levels of incredulity that even metaphors to Kofka and Alice in Wonderland
cannot do justice.

24 ⁹⁸ Exhibit 41T at p. 25, l. 8-16.

24 ⁹⁹ Exhibit 41T at p. 25, l. 17 - 26, l. 3.

25 ¹⁰⁰ TR 204, l. 1-15.

1 the Commission accepted Staff's mischaracterization as fact. A pass through is not a
2 secured income.

3 Instead of saying to the company, "we appreciate that you took the Commission
4 order seriously, now let's address the next problem," the company is lambasted by Staff.
5 The primary recommendation by Staff is an astounding allocation of ninety plus percent of
6 the gain to customers.¹⁰¹ Ultimately, this appears to be too much even for Staff, since they
7 immediately provide an alternative that is essentially a 50/50 sharing.¹⁰²
8

9 AWRI does not believe any gain on sale adjustment is appropriate. First, as the
10 Commission noted, the customers do benefit from the safer capital structure that the
11 Commission ordered AWRI obtain. In theory, Mr. Fox benefits from the higher return on
12 equity.¹⁰³ There is a sharing of benefits.

13 Second, according to Mr. Ward, the rate base when purchased was \$10,192.00. The
14 rate base when sold was \$164,450.00.¹⁰⁴ This means over the five years, Mr. Fox invested
15 approximately \$155,000.00 in new facilities in the system. From these figures, it appears
16 that the average rate base over the five years was \$77,129.00. If it is assumed the plant has
17 an average life of thirty years, the customers paid approximately \$13,000.00 in
18 depreciation associated with the plant. That amount, if anything, is the customer's share.

19 Under these circumstances, it would not be appropriate to use a gain on sale
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21

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23 ¹⁰¹ Exhibit 41T at p. 28, l. 9 – 29, l. 5.

24 ¹⁰² Exhibit 41T at p. 30, l. 1-11.

25 ¹⁰³ This is a theoretical benefit since all monies are used to meet company obligations and no dividends are
26 paid.

¹⁰⁴ Exhibit 41T at p. 28, l. 9-14.

1 approach to the proceeds from the sale of View Royal. Those proceeds were used to meet
2 a Commission-established objective. Those proceeds were used to respond to direct
3 Commission criticism. And, since the capital structure reflects a safer capital structure,
4 which benefits customers, they are participating in the use of the gain.

5 7. Docket Account Adjustment – R-6, P-5, RB5.

6 Commission Staff proposes that the Docket Account be treated as a regulatory
7 liability. Commission Staff argues that this will avoid any tax consequences and is
8 appropriate. Commission Staff suggested a two-year amortization of the regulatory
9 liability.
10

11 The practical effect of this approach is that it substantially reduces the revenues the
12 company has available to pay employees during the two year amortization. In essence, the
13 company is expected to have sufficient funds lying around (which it does not) to make up
14 for the reduction in revenue associated with the amortization. On the other hand, the
15 Commission Staff may be expecting that Mr. Fox invest that much money to cover
16 operating expense shortfall. Since it is obvious that such an investment would not create an
17 asset that could be depreciated, the Commission Staff would expect Mr. Fox to make a
18 donation of \$36,676.00 per year for two years to cover the difference in funds.¹⁰⁵ Or, the
19 company would have to reduce its level of employees and the circle starts again.
20

21 The reason the cash flow issue arises is that money from the Docket Account was
22 used to pay taxes associated with the sale of View Royal and from the creation of the
23

24
25 ¹⁰⁵ TR 150, l. 10 – 151, l. 9.

1 Docket Account itself, i.e., that the revenues received were treated as income for federal
2 income tax purposes. Let us look at each of these two items.

3 As to the first item, Mr. Fox testified that the tax bill came due and he did not have
4 any other funds that he could use. The reason that there was a tax bill associated with the
5 View Royal sale is simply that Ms. Parker made an honest mistake. Ms. Parker believed
6 that there was sufficient net operating loss carry forward to cover any tax on the gain from
7 the sale of View Royal. She was mistaken in that assumption.¹⁰⁶ Thus, instead of setting
8 aside a portion of the proceeds to cover tax liability, all of the proceeds of View Royal
9 were used to reduce the debt obligations of the company.¹⁰⁷ Given that a tax liability for
10 the company occurred and that the funds from the View Royal sale were used to reduce
11 debt pursuant to Commission direction, it is appropriate to allow the use of those funds
12 from the Docket Account.
13

14 The second part of the use of the Docket Account funds is to pay taxes associated
15 with the receipt of the funds themselves. Commission Staff argues that by treating the
16 receipts as a regulatory liability, the taxes consequences are avoided.¹⁰⁸ It is interesting to
17 note that Mr. Ward, when asked on cross-examination, refused to agree that Commission
18 Staff would support the company if Commission Staff is wrong. In other words, if the
19 company went back and revised its income tax return so that it did not pay income tax on
20 the monies in the Docket Account, Commission Staff would not commit on the stand that it
21
22

23 ¹⁰⁶ Exhibit 112.

24 ¹⁰⁷ Everyone will acknowledge that Ms. Parker is a skilled accountant. This just shows that even skilled
25 people can sometimes make an error.

26 ¹⁰⁸ Exhibit 41T at p. 40, l. 6-12.

1 would support the company if the company had to pay any interest and penalties in a
2 subsequent IRS audit.¹⁰⁹ That refusal by Mr. Ward speaks volumes about whether the
3 Commission Staff’s adjustment should stand.

4 Further, Commission Staff argues that if the company had used the money for
5 additional employees, then no tax liability would have been created. That is sort of like
6 saying that if one traveled to Seattle, they would not travel to Portland. It is a true
7 statement, but adds nothing. It does not reflect reality.

8
9 In addition, it ignores the fact that AWRI came to the Commission Staff on at least
10 two occasions with proposals to address the Docket Account dollars.¹¹⁰ On both occasions
11 the Commission Staff said, in essence, “No, we can’t support that proposal.”¹¹¹ Staff did
12 not say what it would support.¹¹² This is like the regulatory rock. As the story goes, the
13 farmer was building a rock fence. He instructed his laborer to bring him a rock. When the
14 laborer brought the rock, the farmer said, “That’s the wrong size, get another.” When the
15 laborer brought the second rock, the farmer again said “That’s the wrong size, get another.”
16 And so it went, on and on, until the laborer happened to stumble onto the right size rock.
17 Regulation should not be the same experience. The company brought ideas forward.
18 There was no help from Commission Staff on what proposal would be the right proposal.
19 Now, the Commission Staff wants to penalize the company through the creation of a
20 regulatory liability and the amortization which artificially reduces expense level.
21

22
23 ¹⁰⁹ TR 149, l. 4-19.

24 ¹¹⁰ Exhibit 30T at p. 37, l. 10-12.

25 ¹¹¹ TR 105, l. 10 – 106, l. 2.

26 ¹¹² See, e.g., TR 219, l. 10-18 and Exhibits 140 and 141.

1 Since the Docket Account is not stated separately, but is part of general rates,¹¹³ and
2 the funds have already been collected, this also is the application of hindsight, not
3 prospective treatment. As stated by Ms. Parker, this has the look and feel of
4 retroactivity.¹¹⁴

5 AGREED AND MINOR ADJUSTMENTS

6 In this section, the Brief will address Agreed and minor adjustments.

7
8 1. Agreed Adjustments.

9 First, the following is a listing of the agreed adjustments.

10 Adjustment Number	Adjustment Name
11 R-1	Restate Income
12 R-2	Remove Penalties*
13 R-3	Restate Accounting**
14 R-4	Restate Legal**
15 R-5	Restate Federal Income Tax*
16 R-7	Deferred Debit Accounts Capitalized
17 R-8	CIAC – Facility Charges Held As Cash
18 R-9	Expenditures from Capital Improvement Account
R-10/RB2	Restate Anticipated Surcharge Collection
P-1	Proforma Revenue Adjustment
P-2	Proforma Revenue Adjustment
P-7	Pierce County Permit Costs
RB1	Beginning end of year averaging***

19 *The adjustment is made to different categories by Ms. Parker and Mr. Ward, but the figure
is the same.

20 **In the post-hearing submissions to the Bench Requests, there appear to be slightly
21 different numbers submitted by the company and Commission Staff. However, since Mr.
Ward testified that he agreed with the company's numbers, and those numbers have not
22 changed, the company numbers should be used.

23 ***Ms. Parker made these adjustments in reporting the initial per books numbers to reflect
the Commission's use of beginning and end of year averages. Mr. Ward treats them as

24 ¹¹³ TR 149, l. 22 – 150, l 1.

25 ¹¹⁴ Exhibit 100T at p. 33, l. 20 – 34, l. 6.

1 though they should be an adjustment in the rate case itself. There are some minor
2 differences in the numbers, but the differences do not appear to be material from the
company's standpoint.

3 2. "Flow Through" Adjustments.

4 There are two adjustments that depend upon how other decisions in the case are
5 made. These are P-4, Interest Synchronization, and P-11, Income Tax Effects. The
6 company and Commission Staff agree on the theory for Adjustment P-4. However, they
7 use different tax rates. The company asserts that the tax rate approach presented by Ms.
8 Parker is more consistent with the purpose and intent of the adjustment.

9
10 Adjustment P-11 is an apparent attempt by Commission Staff to back into an
11 income tax number that they advocate, as opposed to a number that reflects the company's
12 actual or proforma operations. Obviously, the company disagrees with the Commission
13 Staff's presentation and theory for this adjustment.

14 3. Group B Inspections – P-8.

15 After reviewing Ms. Lahmann's pre-filed direct testimony, the company
16 substantially changed its proposed adjustment on this matter. Given that this is a DOH
17 program in conjunction with the various counties, the company was willing to accept Ms.
18 Lahmann's analysis that the inspection should take one to two hours plus travel time.¹¹⁵
19 On cross-examination, Mr. Ward agreed that this is a new program.¹¹⁶ Mr. Ward then
20 further agreed that taking into account the substantial driving times to many of AWRI's
21
22
23

24 ¹¹⁵ Exhibit 1T at p. 26, l. 12 – 29, l. 11.

25 ¹¹⁶ TR 142, l. 12-19.

1 PENALTY ASSESSMENT AGAINST MR. FOX

2 The reasons surrounding Mr. Fox’s actions in using money from the Docket
3 Account to pay the Internal Revenue Service tax liabilities incurred by AWRI are fully set
4 forth in the testimony in this case. The tax liability related to the View Royal sale arose
5 unexpectedly. It was a result of the company’s outside accountant making a good faith
6 error in estimating the available net operating loss carry forward. The tax liability related
7 to the Docket Account itself arose out of an inability to use those funds due to the fact that
8 the company could not meet the threshold contained in the Commission’s prior order for
9 access to those funds. The company attempted to solve that dilemma by approaching
10 Commission Staff on at least two occasions. The company received no help from
11 Commission Staff other than a statement that the company’s proposals were not something
12 the Commission Staff would support. Finding the right “regulatory rock” takes time. In
13 the meantime, taxes had to be paid.

14
15 In addition, the penalty is miscalculated. Mr. Fox is fined \$400.00 for the June
16 deposit not having been made until October. The “June” deposit is in reality the billing
17 made in June, with money received in July. The deposit should have been made in July.
18 Thus, it was three months late, not four. The same miscalculation occurs for the July,
19 August, September, October and November matters. These are the months the billings
20 went out, not the month the deposit was to have been made. For this reason alone, the fine
21 should be reduced \$600.00.
22

23 Mr. Fox asks that the Commission take into account the totality of the
24 circumstances. If the Commission believes that under those circumstances the penalties are

1 still appropriate, that is the Commission’s discretion. However, Mr. Fox respectfully
2 requests that the Commission further mitigate the penalties that have been assessed against
3 him.

6 CONCLUSION

7 It is obvious from the record, the company is struggling financially. However, even
8 with its financial struggles, AWRI has been able to improve customer service. Customer
9 complaints have fallen to very low levels.

10 AWRI has been trying to find ways to meet the Commission’s regulatory directives.
11 It should not be penalized for those efforts. If Commission Staff has differences of opinion
12 as to what may be the best way to accomplish Commission objectives, they should express
13 those views early on. It is just common fairness.

14 AWRI should not be continually second-guessed. While AWRI has made some
15 mistakes, it has sought Commission Staff input and been refused help. When a company
16 approaches Commission Staff to seek resolution of issues, a company should not just be
17 turned away with the comment of “we disagree.” Neither AWRI nor any other small water
18 company have the resources to challenge Commission Staff’s views before the
19 Commission, except in the most dire circumstances. The perception, right or wrong, is that
20 the Commission usually listens to Commission Staff. While there are occasions that
21 Commission Staff is overturned, those are not the rule.

22 In closing, AWRI notes that Commission Staff bears the burden of proof in the
23 complaint proceeding. AWRI believes that the Commission Staff has failed to carry that
24 burden. Even setting aside the burden of proof, AWRI believes that it has demonstrated

1 that for rates to be fair, just, reasonable and sufficient, an increase in rates is required.

2
3 Respectfully submitted this ____ day of June, 2004

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7 Attorney for American Water Resources, Inc.
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