NOTE: THIS ORDER SHORTENS TIME FOR PETITIONS FOR ADMINISTRATIVE REVIEW AND ANSWERS. SEE THE NOTICE TO PARTIES ON THE LAST PAGE OF THIS ORDER.

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION	)	DOCKET NO. UW-010877
Complainant,	)	THIRD SUPPLEMENTAL ORDER
v.	)	
RAINIER VIEW WATER COMPANY, INC.	)	INITIAL ORDER REJECTING TARIFF FILING; ORDERING REFILING
Respondent.	)	
. . . .	)	

Synopsis: *This order rejects Rainier View Water Company's proposed 13.6 percent rate increase, but proposes an overall rate increase of $272,870, or 9.02 percent. The Company serves over 11,000 home and businesses, serving largely residential customers, through 31 water systems located primarily in Pierce County.*

1 **Nature of the Proceeding:** Rainier View Water Company, Inc., filed with the Commission revisions to its currently effective tariffs on June 15, 2001. The Company's original proposal would increase its annual revenues by $453,157 or 13.6 percent.

2 **Procedural history:** The matter was heard upon due and proper notice to all interested parties before Administrative Law Judge Marjorie Schaer on February 13 and 14, 2002, in Olympia, Washington.

3 **Initial Order**: The presiding Administrative Law Judge proposes that the Commission reject the revised tariffs filed by the Company, and that the Commission require the Company to file new tariffs consistent with this Order.

4 **Appearances:** The parties were represented as follows:

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I. DISCUSSION

5 Rainier View Water Company, Inc., (RVW or the Company) is a public service company subject to the jurisdiction of the Washington Utilities & Transportation Commission (Commission). RVW received its general rate increase in June, 1996. On June 15, 2001, RVW filed with the Commission revisions to its currently effective Tariff WN U-2. These tariff revisions would increase the Company's annual revenues by $453,157 (13.6 percent). The Company also proposes to lower the rates charged to customers on its Indian Springs system to bring those rates to parity with the customers on its other systems. Following its investigation of the rate increase request, the regulatory staff of the Commission (Staff) has recommended that the Company's rates be decreased by $199,820.

II. DISCUSSION AND DECISION

A. Principles of Utility Rate Setting

6 The ultimate determination to be made by the Commission in this matter is whether the rates and charges proposed in the revised tariffs are fair, just, reasonable, and sufficient, pursuant to RCW 80.28.020. These questions are resolved by determining the Company's adjusted results of operations during the test year, establishing the fair value of the Company's property-in-service (rate base), determining the proper rate of return permitted the Company on that property, and then ascertaining the appropriate spread of rates charged various customers to recover that return.

7 In order to accomplish this task, the parties developed evidence from which the Commission may determine the following:

1. The appropriate test period, which is defined here as the most recent 12-month period for which income statements and balance sheets were available at the time the proceeding began. The test period is used for investigation of the Company's operations for the purposes of this proceeding;

2. The Company's results of operations for the appropriate test period, adjusted for unusual events during the test period, and for known and measurable prospective changes;

3. The appropriate rate base, which is derived from the balance sheets of the test period. The rate base represents the net book value of assets provided by investors' funds, which are used and useful in providing utility service to the public for the test period.

4. The appropriate rate of return on rate base the Company is authorized to earn;

5. Any existing revenue excess or deficiency; and

6. The allocation of the rate increase or decrease, if any, fairly and equitably among the Company's ratepayers.

B. Test Year

8 The parties have used the 12 months ending December 31, 2000, as the test period for investigation of the Company's operations for purposes of this proceeding. The use of the 12 months ending December 31, 2000, as the test year is appropriate and adopted for this Order.

C. Treatment of Federal Income Tax

1. Imputation of Income Tax

9 The opposing positions regarding the issue of Federal income taxes affect nearly every adjustment proposed in this proceeding. Hence, to avoid repetition, this issue is addressed early in the Order.

10 After the appropriate level of pro forma operating expenses, rate base, operating income and corresponding gross operating revenues are determined, the net operating income represents the amount of income RVW should have the opportunity to earn, to allow it a fair rate of return on its invested capital. The Company proposes that the amount of pro forma net operating income authorized in this case be calculated after imputing Federal income taxes for ratemaking purposes. The Company pays Federal income taxes on behalf of its owners by either distributing an amount to the owners to

pay the amount of the tax liability or by paying the IRS on behalf of the owners. RVW is an S corporation, which means that it has no primary income tax liability[1]. Instead, the liability is imposed directly on the Company's owners, even though the tax expense is generated from the regulated operations of the Company. In a C corporation, the income tax is paid directly by the company. In that circumstance, the authorized pro forma net operating income must be calculated after Federal income tax expense and "converted" to the gross operating revenue requirement amount that includes the recovery of Federal income taxes. RVW argues that the income taxes due on the net income of the company should be treated in the same manner.

11 It is true that the stockholders of a C corporation are taxed based on the taxable income generated by the company, and again when dividends are distributed. But the stockholders are taxed only on the amount of dividends distributed to them, not on the entire amount that the corporation earns. Stockholders of an S corporation do not face this same "double taxation" situation. They are taxed on the entire amount that the corporation earns, but are not taxed again on any dividends distributed to them. The Internal Revenue Code does give some tax breaks to smaller companies and individuals, which is not undesirable. The record indicates that, in the case of RVW, the Company does not distribute dividends. TR 225 and TR 279. The only amount "distributed" is the amount paid to the IRS; this amount is based on the Company's earnings. Further, in the case of an S corporation, the stockholders are personally liable for payment of the taxes, which places their personal assets at risk. TR 233.

12 The way RVW pays the income tax obligation today is out of the regulated revenues of the Company. RVW notes that it has been allowed to recover income tax expense in its past rate cases, as indicated in Exhibits 70, 71, 72 and 73. Staff accounting expert Mr. Danny Kermode agreed on cross-examination that the Commission has approved general rate increases that included the recovery of income tax expense in 1992, 1993, 1994 and 1996, which are the four most recent cases for the Company. In response to Staff's argument that the Commission has not allowed federal income tax expense in a litigated case to a "pass-through" entity, the Company argues that the Commission's order in *WUTC v. Rosario Utilities, LLC*, Docket No. UW-951483, Fourth Supplemental Order (November, 1996) is a strongly litigated case in which owners of a limited liability company, were allowed to impute Federal income tax expense due on the regulated operations of the Company to the Company (LLC).

13 RVW also argues that courts in various jurisdictions have held that a utility is entitled to recover income taxes through the proper adjustment of the utility's rates, citing *Vernah S. Moyston, d/b/a Hobbs Gas Company v. New Mexico Public Service Commission,* 76 N.M. 146, 412 P.2d 840, 850 (1966) in which the court concluded:

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[1] S Corporation is defined in 26 USC § 1361 (a)(1). C Corporation is defined in § 1361 (a)(2).

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

14 Although Hobbs Gas Company was operated by a sole proprietor, the same "pass-through" issue is presented by Subchapter S corporations, sole proprietorships, partnerships, and limited liability companies (LLCs). The so-called *Hobbs* rule was followed by the Supreme Court of Texas in *Suburban Utility Corporation v. Public Utility Commission of Texas*, 652 S.W.2d 358, 360-61 (Texas 1983). The Texas court held that a water corporation designated as a Subchapter S corporation was entitled to recover income taxes paid by its shareholders. The court stated:

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

652 S.W.2d *at* 364. RVW indicates that this tax treatment is what it proposes.

15 RVW does describe court decisions that have decided this issue by not allowing pass through of income tax responsibility, but also notes that the Federal Energy Regulatory Commission and the Wisconsin Public Service Commission have recognized that pass through entities, such as Subchapter S corporations, should be entitled to include income taxes as operating expenses.

16 Staff advocates that the income tax liability generated by the Company's regulated operations should be the shareholder's sole responsibility. According to Staff, the meaning of Subchapter S status to a corporation is that the company is a tax reporting entity, not a tax paying entity. The Subchapter S corporation reports the income to the Internal Revenue Service and to its shareholders, and the shareholders incur the tax liability. Staff explains:

> 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.

Staff Post-hearing Brief, p. 7.

Discussion and Decision:

17 All for-profit companies generate a tax liability through their operations, which must be paid either by the company or organization directly or through its owners. If they generate an income or return to the owners or stockholders for a taxable period, then

they generate a tax liability which is required to be paid to the IRS, either directly in the case of C Corporations or through the owners or investors in the case of S Corporations, LLCs, partnerships or sole proprietorships.

18 If a company is a C Corporation, the company records a tax expense during the taxable period, and when net income is closed to owner or stockholder's equity at the end of the accounting period, it serves to reduce owner or stockholder's equity by the amount of the income taxes. In the case of an S Corporation, LLC, partnership or sole proprietorship, income taxes are ordinarily paid by distributing an amount to the owners or stockholders out of owner's equity, to enable the owners to pay the tax liability generated by the company's operations for the taxable period, or the company will pay the IRS directly on behalf of the owners.

19 In all cases, payment of federal income taxes serves to reduce owner or stockholder's equity. Whether the amounts are first recorded as an operating expense or taken directly out of owner's equity, the payment has the same effect. In both cases, the owners or investors receive less money after taxes and the owner's equity in the Company is reduced by the same amount, or by a like amount, depending upon the effective tax rate the taxpayer must pay. In all cases, the owners or investors *are* the company, not something separate and apart from the company. It is the owners or investors' investment in the company that is put at risk. In all cases, the rate of return actually realized by the owners is the amount they receive after all taxes are paid, whether it is paid out of hand or out of their owner's equity in the company.

20 If the Commission set the fair rate of return at the same 10 percent for both a C Corporation and an S Corporation, and allowed the C Corporation but not the S Corporation to include federal income taxes in the cost of service the ratepayers had to pay, then the investors of the S Corporation would not have the opportunity to achieve that fair rate of return of 10% from their investment in the company. Certainly, the stockholders of an S corporation could pay their tax obligations out of their own personal savings, but this would not be paid from a return received from their investment in the company, and would reduce the amount of return they could achieve on their personal savings. Indeed, if federal income taxes were not recoverable through the rates paid by ratepayers of a regulated S corporation, then making an election to be an S Corporation would not be a rational decision.

21 This Initial Order proposes that Staff's position regarding Federal income taxes be rejected and that Federal income taxes be imputed and included in the cost of service the ratepayers must pay. **Appendix A** to this Order compares the Company and Staff's positions at brief, including the absence of Federal income taxes in Staff's revenue requirement calculations. **Appendix B** is identical to Appendix A, except that Federal income taxes are imputed on both the Company's and Staff's proposed adjustments. Any further comparisons of the Company and Staff's positions in this Order will refer to the amounts in Appendix B, unless specifically indicated.

2. The Appropriate Federal Income Tax Rate

22 In imputing Federal income taxes for ratemaking purposes, an appropriate Federal Income Tax ("FIT") rate must be established. The Company proposes that the Company be treated as if it were a C Corporation for Federal income tax purposes in this case and proposes an FIT rate of 34%. In Brief, page 11, the Staff argues that a flat rate of 34% should not be used because the ratepayers would not receive the benefit of the tax table that the RVW's stockholders will actually use to pay their FIT liability. This tax table contains lower tax brackets depending on the level of taxable income. (See Exhibit No. 1, Company's response to Bench Request No. 7 and Exhibit No.75, Schedule 3.)

23 In essence, for ratemaking purposes, taxable income is net operating income minus interest expense. No tax-timing differences have been measured on this record, but if they had been, current federal income taxes might be less, but that would be offset, in part or in total, by deferred income taxes, if a normalized accounting method is used. The Staff's case, as reflected in Exhibit No.75, reflects a taxable income of $388,884 at the pro forma level after Staff's proposed rate reduction. As reflected in Exhibit No. 75, Schedule 3, this level of taxable income would result in an effective tax rate of roughly 32.6%, which is 1.4 percentage points below the rate of 34% proposed by the Company. The Company's as recorded results of operations reflect a taxable income of $493,056, which would result in an effective tax rate of roughly 34.0% as reflected on Exhibit No. 75, Schedule 3, which is the same rate advocated by the Company. This means that the Company is either at or rapidly approaching the same effective tax rate as a C corporation and may soon be experiencing an effective FIT rate that is even higher than that of a C corporation.

Discussion and Decision:

24 The Company indicates that its proposal is that RVW should pay either the 34 percent corporate tax rate, or the individual tax rate, whichever is lower. Because there is no material difference between the two tax rates, in this case, this order will adopt and recommend an effective tax rate of 34%. In future cases, the Commission will need to review this issue on a case-by-case basis.

3. Flow-Through vs. Normalized Tax Methodology

25 At Brief page 12, Staff proposes that if Federal income taxes are imputed for ratemaking purposes, then a flow-through treatment of the tax-timing differences between book depreciation and tax depreciation should be used. Staff argues that since the Company is an S corporation, that RVW is not subject to Section 168 of the Internal Revenue Code, and therefore a flow-through tax treatment can be used.

Discussion and Decision:

26 Prior to the enactment of the Economic Recovery Tax Act of 1986 ("ERTA"), the Commission consistently employed a flow-through methodology. ERTA established Section 168 of the Internal Revenue Code that required that the tax-timing differences between book depreciation and tax depreciation must be normalized, or the regulated utility would lose its right to claim tax depreciation. Since that time, the Commission has adopted a normalized methodology.

27 Although Staff proposes to use a flow-through methodology, Staff did not include the information needed to make such a calculation in the record. Second, it is unclear whether the IRS would agree with Staff that Section 168 does not apply to RVW; if RVW should lose its right to claim tax depreciation, that would increase costs to the Company and its customers. Third, a flow-through treatment has not been previously in place for RVW. However, RVW has not been accumulating imputed deferred income taxes. If it had, there would be an amount of accumulated deferred income taxes available to be deducted from rate base under a normalized accounting treatment. If the Commission adopts the Company's request to be treated as a C corporation for ratemaking purposes, then RVW should be treated as a C corporation in all respects as related to Federal income taxes and the normalization of tax-timing differences.

28 This record does not include information on what the amount of imputed accumulated deferred income taxes should be. Although the Company asserts that such a calculation would be relatively simple to make, RVW does not favor the record with a measure of the amount. Hence, in this case, it is quite likely that the Company's rate base is overstated. As is discussed in the section on a working capital adjustment, this is one of the reasons this Order recommends that no working capital adjustment be adopted. This Order proposes that the Company be ordered to prepare a study of what the imputed accumulated deferred income tax balance would be, if the Company had been previously treated as a C corporation under a normalized tax accounting methodology. The Company should provide this study to Staff before the next rate case, and henceforth maintain an "off-book" or side-record calculation of imputed accumulated deferred income taxes that is well documented and available for Staff's audit.

D. Net-To-Gross Conversion Factor

29 The Net-To-Gross Conversion Factor ("NTGCF") is used to calculate the gross operating revenue excess or deficiency by dividing the net operating income excess or deficiency by the NTGCF. This calculation gives effect to all revenue sensitive expenses and taxes that change with a change in gross operating revenues. If there are no revenue sensitive or tax factors that affect gross operating revenues then the

net operating income excess or deficiency is also the gross operating revenue excess or deficiency.

30 In this case, the Company is proposing a NTGCF of 0.6188886. In its direct case and in brief, Staff proposes a NTGCF of 0.94771. Staff's factor used a B&O Tax factor of 4.3790 percent, which was derived by subtracting Staff's recommended Bad Debts factor of 0.65 percent from the B&O Tax factor of 5.029 percent. (TR 374-375) Implicit in this calculation is the assumption that the B&O tax is applied to gross operating revenues after the deduction of bad debts expense. However, in Staff's response to Bench Request No. 12[2], Staff abandoned the use of the factor of 4.370 percent, and used instead the B&O tax factor of 5.029 percent. This Initial Order will adopt Staff's response to Bench Request No. 12 as Staff's final position in this case. Therefore, the Staff's proposed NTGCF is 0.941210.

31 There are two remaining differences between the Company's and the Staff's NTGCFs of 0.6188886 and 0.9412100, respectively.

Discussion and Decision:

32 The Company proposes a bad debts factor of 1.0 percent and Staff proposes a factor of 0.65 percent. As is stated in item 1 of the Contested Net Operating Income Adjustments section of this Initial Order, this Order proposes the adoption of Staff's position regarding bad debts expense and adopts Staff's bad debts factor of 0.65 percent. The Company proposes a Federal income tax factor of 34 percent and Staff, in essence, proposes a Federal income tax factor of 0 percent. As discussed in paragraphs 9-24*,* this Order proposes the adoption of the Company's position regarding the Federal income tax issue, and adopts a Federal income tax factor of 34 percent. The above decisions yield a final Net-To-Gross Conversion Factor of 0.6211986, which is adopted in this Order.

E. Results of Operations and Rate Base

1. Results of Operations

33 The Company's results of operations for the test year form the basis of the analysis upon which the amount of revenue excess or deficiency is determined. This determination is made after all appropriate adjustments are made to the test period results of operations. These adjustments are for unusual events during the test period, and for known and measurable events that will occur prospectively, in order to reflect changes to the test year that will make it a better predictor of what the Company can expect its operations to cost. The primary objective of the historical test period approach is to identify the prospective percentage relationships of total pro formaed net operating income to total pro formaed average rate base that will exist during the

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[2] Bench Request 12 and the answers to Bench Request 12 are admitted into the record as Exhibit 75.

period in which the rates authorized at the conclusion of the rate case will be in effect. Both parties' results of operations statements portray restating and pro forma adjustments, which they propose be made to the Company's test period results of operations. *WAC 480-09-330(2*).

34 "Restating actual adjustments," is an accounting term, used to describe ratemaking adjustments employed to revise the booked operating results for any defects or infirmities that may exist in actual recorded results of operations, which can distort test period earnings. Restating actual adjustments are also used to adjust from an as-recorded basis to a basis that is acceptable for ratemaking purposes. Examples of restating actual adjustments are adjustments to remove amounts more appropriately attributable to a prior period, to eliminate below-the-line items that were recorded as operating revenues or expenses in error, to adjust from book estimates to actual amounts, and to eliminate or to normalize extraordinary items which have been recorded during the test period. *WAC 480-09-330(b)*.

35 "Pro forma adjustments," another accounting term, adjust actual test period results to give effect for all known and measurable changes that will occur prospectively that are not offset by other factors. Pro forma adjustments are used to adjust to prospective conditions. *Id*.

2. Rate Base

36 The appropriate rate base is derived from the balance sheets of the test period. This rate base is adjusted to reflect new additions and reductions to the Company's invested capital, including regulatory assets, which occurred during the test period. The rate base represents the net book value of assets provided by investors' funds that are used and useful in providing utility service to the public for the test period.

a. Uncontested Adjustments

37 This Order will first catalog the uncontested adjustments, then discuss and decide the contested adjustments. Table 1 provides the actual results of operations for the test year and the dollar impacts of the uncontested adjustments to net operating income and rate base.

38 Some of the proposed adjustments to the test year results of operations have been agreed on by RVW and Staff. The uncontested adjustments are shown in the following Table 1. With the exception of the working capital allowance (not shown in Table 1) the proposed uncontested adjustments have been reviewed and found reasonable for purposes of setting rates in this proceeding.

TABLE 1: RAINIER VIEW WATER CO., INC. ACTUAL RESULTS OF OPERATIONS & UNCONTESTED ADJUSTMENTS FOR THE 12 MONTHS ENDED DECEMBER 31, 2000					
		Per Staff		**Per Company**	
Ln #	**Description**	**Total Net Operating Income**	**Total Rate Base ***	**Total Net Operating Income**	**Total Rate Base ***
	(A)	(B)	(C)	(D)	(E)
1	Actual Results of Operations	$597,971	$5,064,468	$597,971	$5,069,911
2	Rate of Return – Per Books %		11.81%		11.79%
	Uncontested Adjustments				
3	Restate Surcharge Revenues	(119,220)	0	(119,220)	0
4	Building Rent	0	0	0	0
5	CIAC Adjustment	0	0	0	0
6	Medical & Dental Increases	(32,867)	0	(32,867)	0
7	Generator O&M (Mat.& Sup.)	(15,786)	0	(15,586)	0
8	Power Increases	(30,588)	0	(30,588)	0
9	Meter Jeeps/Billing Software	(6,098)	42,506	(6,098)	42,506
10	Total Uncontested Adjusts.	($204,558)	$42,506	($204,558)	$42,506

39 Table 1, lines 3 through 9 are Staff adjustments S-RA-1, S-RA-6, S-RA-10, S-PA-2, S-PA-4, S-PA-3 and S-PA-9, respectively. Table 1, lines 3 through 9 are also Company adjustments C-RA-1, None, None, C-PA-3, C-PA-6, C-PA-7 and C-PA-9A, respectively. Some of the above adjustments of Staff or the Company have been divided into their contested and uncontested parts. In such cases, the adjustments are identified as A or B.

40 *The amount of rate base in Table 1, line 1, columns (c) and (e) differs by a small amount. This results because, although Staff indicates in brief that they agree with the rate base amounts reflected in Company Exhibit No. 25, Staff did not change these amounts in its response to Bench Request No. 12 (Exhibit No. 75). Because Staff indicates that they agree with the Company, this Initial Order will adopt the amount of $5,069,911 as the amount of per-books rate base. Hence, the per-books actual rate of return on net operating income is 11.79%. It is unnecessary in this Order to reflect the return on net income, which includes below the line amounts.

b. Contested Net Operating Impact Adjustments

41 Contested adjustments are those adjustments to the test year results of operations sponsored by one of the parties to the proceeding, and contested by the other party.

42 Table 2 shows the contested ratemaking adjustments to Net Operating Income:

TABLE 2: CONTESTED NET OPERATING INCOME ADJUSTMENTS

Ln#	Contested Net Income Adjustments	Staff	Company	Difference
1	Bad Debts Expense	($12,005)	($33,674)	($21,669)
2	Depreciation Expense Adjustment	76,076	49,982	26,093
3	Ready-To-Serve Revenues	8,095	0	98,095
4	CoBank Refund	4,427	0	4,427
5	Salaries & Wages (Owner)	21,166	(4,336)	25,502
6	Legal Adjustment	1,028	0	1,028
7	Regulatory Expense	(606)	0	(606)
8	Interest Income Adjustment	24,512	0	24,512
9	Income Tax Adjustment	0	0	0
10	Salaries & Wages – Employees	(94,051)	(99,460)	5,409
11	Reduce Indian Springs Rates	0	(28,478)	(28,478)
12	Rate Case Expense	(4,180)	(14,894)	10,714
13	Insurance Adjustments	(32,160)	(31,784)	(376)
14	Developer Lawsuit	0	(4,186)	4,186
15	Interest Expense Adjustment	(46,444)	0	(46,444)
16	Depreciation Adj. Owner's Vehicle	3,458	0	3,458
17	Vehicle Insurance	376		376
18	Total Contested Adjustments – NOI	$39,692	(166,829)	$206,521

43 Table 2, lines 1 through 17 are Staff adjustments S-PA-8, S-RA-9, S-RA-2&11, S-RA-3, S-RA-4, S-RA-5, S-RA-8, S-RA-12, S-RA-13, S-PA-1A, None, S-PA-7, S-PA-5&6, None, S-PA-10, S-PA-9B, and S-RA-7, respectively. Table 1, lines 1 through 17 are also Company adjustments C-RA-2, C-RA-3B, None, None, C-PA-1B, None, None, None, None, C-PA-1A, C-PA-2, C-PA-4, C-PA-5, C-PA-10, None, C-PA-9B, and None, respectively. Some of the above adjustments of Staff or the Company have been divided into their contested and uncontested parts. In such cases, the adjustments are identified as A or B. As the above would suggest, there has been a great deal of unnecessary confusion created on this record because Staff did not adopt the Company's adjustment numbers for comparable adjustments and employ unused adjustment numbers for adjustments not sponsored by the Company.

1. Bad Debts Expense

44 As reflected in Exhibit No. 41 and as acknowledged in the Company's Brief at pages 43-44, the Company's booked bad debts expenses has varied widely from year to year for the last several years. The Company's booked bad debts expense for the test period was a negative $627. The Company proposes an adjustment of $53,723 to bring the bad debts expense to a pro forma level of $53,096. Although not booked, the Company asserts that its actual bad debts expense for the year 2000 test period was $53,096. In the alternative, the Company proposes that a five year average of bad debts expense be used, which would result in an adjustment of $33,556. Company Brief, page 43-45. The Company notes that it recently acquired Sound Water System, which caused the increase in its bad debts expense. However, in its analysis for each of the years 1996 through 2001, the Company provides no comparison of its bad debts expense with the Company's annual gross operating revenues which would substantiate this claim. Further, the Company holds its balance sheet account allowance for bad debts constant at $75,000 for the 1998 through 2001 period, which does not suggest a growth in the absolute dollars of bad debts expense. The Company proposes a level of bad debts expense that would be 1.76% of total pro forma operating revenues before rates and proposes a bad debts factor of 1.0% to be used in the conversion factor calculation. The Company has indicated that its bad debts expenses have increased because of an increase in a customer base that is a more transient population. However, this assertion is not documented by any definitive analysis that would allow measurement of this claimed effect.

45 By adjustment S-PA-8, Staff proposes a pro forma adjustment of $19,153, which brings test period bad debts expense to a pro forma level before rates of $18,526. The Staff indicates that it used an average approach, and argues that the use of the average write down of bad debts accounts should be used to compute the test year expense, rather than the accrued expense, because of the large disparity between the two figures. Staff proposes a level of bad debts expense that would be 0.57% of total pro forma operating revenues before rates, and proposes a bad debts factor of 0.65% to be used in the conversion factor calculation.

Discussion and Decision:

46 The Company makes a reasonable argument that the absolute dollar amount of bad debts should increase with a growth in operating revenues from an increased customer base. However, it did not provide an analysis of the relationship of bad debts expense to total gross operating revenues over time, which would have been the most useful analysis for the Commission to receive. In the historical test period approach, the percentage relationships are more important than the absolute dollar amounts. With normal growth, it can be expected that prospective levels of revenues and expenses will be higher than test period levels. However, the basic premise of the

historical test period approach is that if the percentage relationships of prospective conditions can be identified, then an appropriate revenue requirement can be calculated from an historical period. Averages of absolute dollar amounts of bad debt expense over a number of years would be more relevant if the Company was in a no-growth period during those years. However, the record shows that the Company's recorded bad debts expenses have varied widely over the last several years, and in such a case it is preferable and appropriate to normalize this expense for ratemaking purposes by use of an average. Staff proposes the use of an average and the Company proposes the use of an average as an alternative approach, but the amounts recommended by the parties from their proposed averages are significantly different.

47 An extrapolation from Exhibit No.73 indicates that for the year 1990, the ratio of bad debts expense to RVW's total pro forma operating revenues before rates was 1.11%. An extrapolation from Exhibit No.72 indicates that for the year 1991, the ratio of bad debts expense to RVW's total pro forma operating revenues before rates was 0.81%. An extrapolation from Exhibit No.48 and 71 indicates that for the year 1993, the ratio of bad debts expense to RVW's total pro forma operating revenues before rates was 0.38%. An extrapolation from Exhibit No. 19 and 70 indicates that for the year 1995, the ratio of bad debts expense to RVW's total pro forma operating revenues before rates was 0.50%. The average of the above four percentages for the four years is 0.70%. Staff's proposed ratio of 0.57% of total pro forma operating revenues, and its bad debts factor of 0.65% to be used in the conversion factor are reasonable.

48 The records indicate that the Company's proposed ratio of 1.76% for bad debts expense is excessive. This Order will therefore adopt the Staff's position and adjustment S-RA-2 in this case as reasonable.

2. Depreciation Expense Adjustment

49 This adjustment relates to a depreciation "catch-up" entry booked by the Company during the test period. (Staff's Brief, page 32; Company Brief, page 45.) Mr. Kermode, in his direct testimony (Exhibit No. T-53, page 13) proposed adjustment S-RA-9, which removed $119,040 in depreciation expense. The amount he proposed to remove was related to a depreciation "catch-up" entry booked by the Company during the test period for "changes in accounting adjustments and prior period adjustments." In brief, Staff proposed an adjustment to remove $115,266, which removes the $119,040 originally proposed, but capitalizes the amount and amortizes the amount over 32.6 years at 3.17% each year. Staff Brief, page 32. It should be noted that an annual percentage of 3.17% suggests a life of 31.6 years, but a certain amount of assumed salvage or cost of removal may be the explanation. (100 divided by 3.17).

50 The Company made no comparable adjustment in its direct case, but in rebuttal, through the testimony of Mr. Frank Ault (Exhibit No. T-34, page 14, line 27), the Company proposes adjustment C-RA-3, which amortizes the amount at issue over

three years by removing $75,731, and adjusts to an average test period rate base. This Order divides the Company's adjustment into two parts: C-RA-3A is the adjustment to an average rate base and C-RA-3B is the adjustment to depreciation associated with the depreciation "catch-up" entry. The Company's adjustment C-RA-3B was derived by first deducting an amount of Contributions in Aid of Construction (CIAC) of $5,443 from the total amount of $119,040, and then removing two-thirds of this amount from test period results. ($119,040 - $5,443 = $113,597 X .66666 = $75,731.)

51 The Company's Exhibit No. 74, indicates that the Company's composite depreciation rate was 7.94% for the test period, and 4.84% for the following year 2001. Staff objects to the Company's calculations in Exhibit No. 74, and provides alternative calculations that, although different from the Company's, also show that the Company's composite depreciation rate went down after the test period. This means that the prospective percentage relationship of total depreciation expense to average rate base will be less. Hence, the amount of depreciation of $119,040 booked in the test period distorts test period earnings and must be adjusted.

52 Regarding the depreciation "catch-up" entry, the Company's Brief at pages 45-46, states in part:

> The Company analyzed the plant accounts and determined that a number of items were either misclassified (such as pumping equipment classified as transmission equipment) or assets had been used up prior to the expiration of its theoretical regulatory life.

Discussion and Decision.

53 Depreciation lives and rates are necessarily an estimate, and must be trued up when actual experience becomes available. The investors deserve to receive full capital recovery for their investment in assets providing service to the public plus a fair return on any unrecovered amount. The record indicates that no detail of the depreciation "catch-up" entry is available, hence a plant asset specific adjustment cannot be made. Since the prospective composite depreciation rate is declining, and since there is no detail of this adjustment, Mr. Kermode's approach to capitalize and amortize the amount over the average life of all plant in service is the most reasonable approach. This Initial Order therefore proposes that the Staff's adjustment S-PA-9 be adopted.

54 A problem exists, however, because Staff makes no adjustment to rate base. In the use of the historical test period approach with an original cost rate base, it is the practice of the Commission not to pro forma rate base. However, the adjustment proposed by Staff is a restating adjustment, not a pro forma adjustment. Historical amounts are being restated, and an adjustment to rate base should be made.

Therefore, this Order recommends that the average of the Staff's adjustment of $115,266 or $57,633 should be added to the Rate Base.

55 Further, an adjustment to book depreciation does not change current Federal income taxes because tax depreciation has not changed. However, the "spread" between book depreciation and tax depreciation has changed and, hence, there is a deferred tax effect which should be reflected in operating expenses and in rate base. This Initial Order does reflect those amounts in rate base using the customary end-of-period balances, which has been the Commission's long-standing position on accumulated deferred taxes.

3. Ready-To-Serve Revenues

56 By adjustment S-RA-2, the Staff proposes to include $154,066 in operating revenues related to receipts received by the Company during the test period that have been designated as Ready-To-Serve Fees. By adjustment S-RA-11, the Staff adjusts Taxes Other Than Income Taxes to include the amount of additional B&O taxes that would be paid above the amounts paid by the Company during the test period for these fees. The adjustment reflects the amount of taxes that would be paid if the fees at issue were taxed as ordinary operating revenues.

57 The Company argues that these fees should not be included in their regulated books of the Company. Much discussion is included on this record regarding this issue and many exhibits entered, including an exhibit of 1215 pages illustrating the contractual relationships through which the Company receives these fees.

58 Mr. Fischer testified in rebuttal, Exhibit No. T-15, page 13, lines 7 through 10, that:

> The ready to serve charge was calculated so that, on balance, using a five year amortization at a standard purchase price of $600 per connection and an interest rate of 6%, payments by the developer to RVW and the payments by RVW to the developer would be equal.

59 This testimony clearly states that the Ready-To-Serve Fees were designed and intended to be a direct offset to the cost of the plant purchased by the Company at $600 per connection.

Discussion and Decision:

60 Ready to Serve Charges are not operating revenues. They are not revenue received by an authorized tariff rate. Instead these charges effect a reduction in rate base. The principle underlying the historical test period approach with an original cost rate base is that the investors deserve to recover their net investment in plant is service. These Ready-To-Serve Fees reduce or completely offset the cost of the service

connection plant purchased by the Company. They should be recognized as a reduction to that plant in service and treated in a similar manner to CIAC. A review of the Company's balance sheets contained in Exhibit No. 1 indicates that the purchased service connections are included in the Company's rate base. It is therefore appropriate to deduct the average amount of Ready-To-Service Fees from rate base. This Order therefore proposes that the average amount of the $154,066, or $77,033, be included in CIAC. The Company may not recover these costs from developers and recover the same costs again from ratepayers.

61 Mr. Fischer indicated in testimony (TR 107-109) that the Company has been booking the Ready-To-Serve Fees as non-operating income. This is not appropriate. The fees are clearly an operating item that relates to the Company's purchased service connections. This means that the Company's rate base is overstated by the amounts, which have been previously recorded as non-operating income. This Initial Order therefore proposes that the Company be directed to examine its prior records and identify the amounts of Ready-To-Serve Fees which were recorded as non-operating income, and provide this analysis to the Staff in the next general rate case filed by the Company.

4. CoBank Refund

62 By adjustment S-RA-3, the Staff proposes to include $6,708 in operating revenues related to a cash distribution received from CoBank in the form of a patronage refund. Mr. Kermode testifies in direct testimony, Exhibit T-53, page 9, "CoBank annually distributes patronage refunds to its borrowers. The net result is a reduction to the stated interest rate paid by the Company."

63 The Company argues that generally accepted accounting principles (GAAP) allow it to either recognize the income as a direct reduction to interest expense, or, as the Company has done, recognize interest income. Exhibit T-53, p. 9, l. 10-19. RVW claims that it has already made an adjustment for the CoBank dividend by crediting the interest income in the calculation of interest expense, and that Staff's proposed adjustment would result in double counting this item. Exhibit T-15, p. 18, l. 7-21.

Discussion and Decision.

64 The $6,708 is directly related to a refund to borrowers, and is clearly a reduction in the effective interest rate paid by the Company. This item should therefore be treated as part of the cost of capital calculation that reduces the net imbedded cost of debt rate. This reduction will be made in the Cost of Capital section of this Order. In the case of the Company's proposed cost of debt rate of 6.93%, the adjustment for the $6,708 would reduce this rate to 6.75%. The adjustment is somewhat offset because it reduces the overall authorized return by a slight amount, but increases Federal

income taxes because pro forma interest would be less, and the deduction from taxable income would be less. If Federal income taxes increase, then net operating income decreases and the revenue requirement increases by a slight amount.

65 This Initial Order proposes that Staff's adjustment S-RA-3 not be made, and that the above amount at issue be included in the cost of capital calculation.

5. Salaries & Wages (Owner)

66 Mr. Neil H. Richardson and Mrs. Paula M. Richardson are the owners of the RVW Water Company. Mr. Richardson works for the company. Staff proposes adjustment S-RA-4, to reduce Mr. Richardson's salary from the amount included in the test period of $92,780 to $49,071. Ex. T-53, pp. 9-10.

67 Staff derived the $49,071 by identifying the amount of salary included for Mr. Richardson of $44,721 in a 1993 rate case, Docket No. UW-930190, *et al*. The $44,721 in salary was increased to a test period amount of $56,081 or by 25.4%, by the use of a Consumer Price Index ("CPI") for all urban consumers in Seattle. The $56,081 was calculated assuming that the 1993 salary amount reflected a salary for a full 8-hour workday. Staff's review of Mr. Richardson's work hours indicated that he works 60% of a 12-hour day or 90% of an 8-hour day, or 7.2 hours per day. TR 96. Staff apprently rounded to 7 hours and reduced the $56,081 to 87.5% of the amount, or to $49,071. In brief, Staff acknowledged that if the1993 amount of $44,721 had already been reduced to 60% of a workday, as argued by the Company, then Staff's adjustment needed to be recalculated. Hence, in Staff Exhibit No. 75, Schedule 1.2, the Staff does not reduce the $56,081 by 87.5%. Staff's original calculations appear in Exhibit No. 55.

68 The Staff originally proposed to capitalize $7,523 of Mr. Richardson's recommended salary. In brief this amount changed to $8,598, or 15.33% of $56,081. This results in a total test-period expense for Mr. Richardson's salary of $47,483. Staff made no adjustment to rate base related to the capitalized portion of the adjustment. Exhibit No. 75 also reflects a downward adjustment to payroll taxes related to Staff's adjustment to Mr. Richardson's salary. Staff made no pro forma adjustment to Mr. Richardson's salary, and opposes the Company's pro forma adjustment, which is a portion of adjustment C-PA-3.

69 The Company opposes the Staff's restating adjustment to Mr. Richardson's salary. The Company capitalized $16,340 of the total salary of $92,780 and included $76,440 for Mr. Richardson's salary in booked operating expenses for the test period. ($92,780 - $76,440 = $16,340.) The amount capitalized by Staff of $8,598 is less than the amount actually capitalized by the Company during the test period of $16,340. ($16,340 - $8598 = $7,742).

70 The Company proposed adjustment C-PA-3, which gave pro forma effect to both employee wages and salaries and Mr. Richardson's salary. This Order will identify the portion of the Company's adjustment related to employee salaries as adjustment C-PA-3A, and that portion of the adjustment related to Mr. Richardson's salary as C-PA-3B. Employee salaries will be addressed in a separate section of this Order. In adjustment C-PA-3B, the Company originally proposed to increase Mr. Richardson's booked test period salary by $6,818, but in brief reduced the amount to $5,800, which capitalized 14.93% of the proposed increase or $1,018. Staff's Brief at page 5, indicates that the capitalized amount should be $1,045, using a capitalization factor of 15.33%. The Company's Brief, at page 6, indicates that the Company used a capitalization factor of 15.33% for salary and payroll increases occurring within the year 2000 test period, and a capitalization factor of 14.24% for increases occurring in the year 2001. However, the capitalization factor of 14.24% does not appear to be included in the record. Therefore, this Order will use a factor of 15.33% as the capitalization factor for all pro forma salary increases.

Discussion and Decision:

71 The Staff's adjustment proposes to lift the 1993 salary amount for Mr. Richardson to a year 2000 level by use of a CPI or inflation factor. This same methodology was proposed by the Company in the Bremerton-Kitsap Airporter case and was opposed by Staff. *See,* Initial Order in Docket No. TC-001846 (April, 2002). Consistent with the Initial Order proposed in the Bremerton-Kitsap case, this Order recommends that the inflation factor methodology proposed by the Staff in adjustment S-RA-3 be rejected.

72 The Company offers extensive testimony regarding the level of Mr. Richardson's salary. RVW's analysis includes analysis of growth in the size of the Company, the complexity of the industry, a comparison of salaries paid to executives in the Pacific Northwest, a Millman and Robertson survey of Northwest companies, Census Bureau data, a Wall Street Journal survey, and a Northshore survey. The information provides a basis for comparison of Mr. Richardson's salary to managers of companies of similar size and complexity.

73 Because of the variety of approaches one could take, it is important to establish and maintain a ratemaking standard the Commission can use to determine a fair compensation for an owner/operator. The standard ratemaking treatment in establishing an owner/operator allowance has been to authorize an owner/operator a salary that is comparable to a competitive or prevailing salary level for the type or types of services the owner-operator performs. Ratepayers should not have to pay a higher level of salary simply because Mr. Richardson is also the owner. The owner is compensated for his investment and risk in the business through the authorized fair rate of return.

74 The appropriate salary level for Mr. Richardson is the amount the Company would have to pay in the competitive labor market to attract a competent non-owner CEO to run a business of the size and complexity of RVW. This Order proposes that the Commission reject the assumption of Staff that such a non-owner CEO could be hired for an annual salary of $56,081.

75 This Initial Order recommends that the Commission find Mr. Richardson's salary for the test period reasonable and adopt the Company's proposed pro forma adjustment C-PA-1A to increase Mr. Richardson's salary by $6,818. In doing so, this Order places some weight on the representations by the Company that Mr. Richardson has never received a salary increase greater than that given to the rank and file employees of RVW (Company Brief, page 22) and that Mr. Richardson's compensation "is on the low end, if not the absolute lowest, of compensation as a percentage of revenue and percentage of rate base allowed owners of other water companies." Company Brief, page 24. Further, all parties agree that RVW is efficiently run and the level of customer complaints is very low.

76 The record also indicates that Mr. Richardson works on average 7.2 hours per day for RVW. TR 96 This Initial Order does not adopt Staff's position that Mr. Richardson's salary, for regulatory purposes, should be set at 60 percent of his total salary. Based upon the capitalization ratio of 15.33%, $1,045 of the pro forma increase in Mr. Richardson's salary of $6,818 should be capitalized. As Mr. Fischer of RVW acknowledged in cross-examination, it is the practice of the Commission not to pro form rate base. TR 77, lines 14-16. Therefore, the $1,045 should not be added to rate base now. The capitalized portion of salary actually relates to a future rate base and not to the historical rate base under consideration in this proceeding.

6. Legal Adjustment

77 The analysis of this adjustment is included as a part of the discussion of Rate Case Expense in Section 12, paragraphs 89 to 92 below. This Initial Order recommends that Staff's adjustment S-RA-5 be adopted.

7. Regulatory Expense

78 By adjustment S-RA-8, the Staff proposes an adjustment to true-up regulatory expense to the level of restated revenues. Exhibit T-53, page 12, lines 23-26. The Company acknowledges that this type of "flow-through" adjustment needs to be made, but did not make any comparable adjustment. The net operating income effect is a negative $606. This Initial Order recommends adoption of the Staff's proposed adjustment S-RA-8.

8. Interest Income Adjustment

79 By adjustment S-RA-12, Staff proposes to remove $72,094 of interest income as non-operating income. The interest income itself was not included in operating revenues or expenses, but the Company's imputed operating Federal income tax was affected by this amount. Therefore, the only effect this adjustment has is on operating Federal income taxes. By removing the interest income for the test period, Federal income taxes are reduced and net operating income is increased. The Company makes no comparable adjustment. This is a standard restating adjustment often sponsored by Staff, and is appropriate. This Initial Order, therefore, recommends adoption of Staff adjustment S-RA-12.

9. Income Tax Adjustment

80 This adjustment is discussed and decided in paragraphs 9 through 28 above. This Initial Order recommends rejection of Staff adjustment S-RA-13.

10. Salaries & Wages – Employees

81 By adjustment S-PA-1A and C-PA-1A, the Staff and Company, respectively, propose a pro forma adjustment to give effect to employee wage and salary increases. In brief the parties agree that this expense should be pro formed to give effect to increases that occurred through the end of the year 2001. Both parties agree as to the amount of the pro forma increase. The only differences between Staff and Company relate to the amount of the adjustment that should be capitalized, and to whether the capitalized amounts should be added to rate base. It appears that the difference between the Staff and Company, as to the amount to be capitalized relates to the difference in the capitalization factors used by the parties for the year 2001 portion of the adjustment. The Staff used a capitalization factor of 15.33%, and it appears the Company used a capitalization factor of 14.24%. Company Brief, page 6, line 8. The capitalization factor of 14.24% does not appear in the record. Further, it is the Commission's standard position that rate base should not be pro formed. Therefore, this Initial Order recommends the adoption of Staff's adjustment S-PA-1A.

11. Reduce Indian Springs Rates

82 By adjustment C-PA-2, the Company proposes to bring its Indian Springs system into rate parity with Rainier View's overall system rates, which reduces the Indian Springs rates. Exhibit No. T-4, page 16 and Company Brief, page 47-48. The Company's adjustment reduces operating revenues by $45,433, and net operating income by $28,478. The Staff opposes the adjustment, asserting that the adjustment understates the Company's operating revenues because the adjustment is made before the Commission has approved the rate changes proposed for Indian Springs. Staff Brief, pages 33-34.

Discussion and Decision:

83 The record indicates that the rates for the Indian Springs system are higher than RVW's overall system rates. If the Commission approves the reduction of Indian Springs' rates to achieve rate parity, then an adjustment to reflect this impact in the revenue requirement calculation is appropriate. This is true because the higher revenues previously received from the Indian Springs system would not be received prospectively and, therefore, the higher amount is nonrecurring. The information on the record regarding this adjustment is not detailed. If the Company's adjustment reduces operating revenues to the level proposed by the Company, and if the Commission authorizes a rate increase that is less than that proposed by the Company, then the Company's adjustment will not reduce operating revenues enough to reflect the Commission's decision. If this is the case, then the Staff has appropriately opposed the method used by the Company in this adjustment. The adjustment should have been made to reduce the Indian Springs' revenues to the current RVW overall system rate levels. The revenue requirement should be calculated on this basis. The Company should then be ordered to refile rate changes to its non-Indian Springs rates by the percent increase or decrease authorized in this Order. The Indian Springs rates should then be refiled to reflect the new non-Indian Springs rate levels. If the Company has miscalculated their adjustment, Staff has not provided the record with what the appropriate adjustment should be.

84 This Initial Order recommends approval of the Company's proposal to reduce the Indian Spring's rates to achieve rate parity. With some reservation, this Initial Order proposes that the Company's adjustment C-PA-2 be adopted.

12. Rate Case Expense

a. Recovery of the Company's Costs in This Proceeding

85 The Company seeks recovery of $67,700 in rate case costs for the current proceeding in its adjustment C-PA-4. It seeks to have these costs amortized over a period of three years and, thus, to include $22,567 in rates. See, Exhibit No. T-4, page 19, T-15, pages 31-34, Exhibit No. 25, page 5, and Company Brief, pages 30-31. In direct testimony, Exhibit No. T-53, page 23, Staff proposes that $29,500 in rate case costs be allowed, to be amortized over three years and, thus, to include $9,833 in rates. Staff argues that an earlier estimate of rate case costs should be used. The Company argues that their actual costs exceed their last estimate as reflected in Exhibit No. 25, page 5. Staff, on brief, appears to abandon its challenge to the Company's costs for this proceeding.

Discussion and Decision.

86 This proceeding has included many contested issues, and has been burdened by difficulties in determining accurate accounting numbers and positions. The rate case costs sought by RVW appear to be reasonable, given the scope of the work that the Company has had to perform. This Initial Order recommends that the Commission should approve Company adjustment C-PA-4, but for the amount addressed in the following paragraphs 87 and 88.

b. Recovery of 1999 Rate Case Mailing Costs

87 In adjustment S-PA-7, Staff proposes that $3,500 in costs associated with mailings related to a prior rate case be removed from recorded expenses for the test period. Staff addresses rate case expense issues in its Brief at pages 20-22 and includes Mr. Kermode's proposed adjustment S-PA-7 in its Exhibit No. 75.

Discussion and Decision:

88 The Commission should adopt the Company's proposed adjustment C-PA-4, but should adopt that portion of Staff's adjustment S-PA-7 that removes the $3,500 in mailing costs. The test period should not reflect the costs of two mailings for rate cases. The net result of approval of the Company's $22,567 in rate case cost, less the $3,500 in mailing costs is $19,067. After giving effect to Federal income taxes, the result is an adjustment recommended by this Initial Order that reduces net operating income by$12,584.

c. Recovery of Other 1999 Rate Case Costs

89 By adjustment S-RA-5, Staff proposes to remove $1,558 in legal expenses related to a prior rate case, which the Company withdrew in the year 2000. Staff's position is that it would be unfair to require the ratepayers to pay for a case that the Company, on its own motion, withdrew. See*,* Exhibit T-53, page 10, lines 12-17 and Staff's Brief, pages 20-22. Staff's Brief includes information that does not appear to be part of the record.

90 In support of its requests to include the prior year's rate case costs in rates, RVW argues that the majority of the costs in that case were incurred in the Company's work and research on the income tax and Ready-to-Serve charge issues that are major issues in this case. It claims that if the costs were not incurred last year, then it would have had to incur those expenses this year in prosecuting the rate proposal now considered. Since Staff raised these two issues and proposed adjustments, RVW would like to add these amounts to the rate case costs directly incurrred in this docket. Company Brief, pages 30-31.

Discussion and Decision.

91 The rate case costs from the 1999 filing should not be included in this proceeding. The amount approved for recovery includes sufficient recovery of costs related to the income tax, Ready-to-Serve charge and owner's salary issues. The purpose of including and amortized portion of rate case costs in rates is to allow the Company to earn an amount that approximates an annual amount of costs related to rate cases before the Commission. The amount included in rate case costs for this docket, as amortized, does an adequate job of including a reasonable amount for this cost.

92 The amount at issue is only 0.48% of total gross operating revenues and therefore does not materially effect the outcome of this proceeding. The amount does appear to be prior period in nature, in that it relates to a previous filing. This Initial Order will therefore recommend that Staff's adjustment S-RA-5 be adopted.

13. Insurance Adjustments

93 By adjusment C-PA-5, the Company proposes to decrease Vehicle Insurance by $6,911 and increase Liability Insurance by $55,069. Staff's comparable adjustments are S-PA-5 and S-PA-6. By adjustment S-PA-5, Staff proposes to reduce Vehicle Insurance by $6,342, and by adjustment S-PA-6, proposes to increase Liability Insurance by $55,069. Hence, the Company and Staff agree to the pro forma increase in Liability Insurance.

The difference between Staff and Company regarding Vehicle Insurance is $569, which has a net operating income effect of a negative $376. This difference has the reverse effect of Staff adjustment S-RA-5, which increased net operating income by $376. This appears to be a double counting or something of the like. In any case, the difference is immaterial and this Initial Order will recommend that the Company's adjustment C-PA-5 be adopted.

14. Developer Lawsuit

94 The Company seeks, in adjustment C-PA-10, to recover the legal costs it incurred in 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. Staff opposes this proposal.

95 RVW acknowledges that this is an out-of-period adjustment. It argues, however, that this is the kind of expense for which there are no offsetting revenues, and that it meets the definition of a pro forma adjustment in WAC 480-09-330(2)(b)(ii). The Company also argues that its customers benefit from the outcome of the proceeding, in which the Company was able to protect limited water resources for their use.

96 Staff opposes recovery of the litigation costs for two reasons. First, the expenses fall outside the test period. Second, Staff argues that it is expected that the Company will incur legal costs in a normal year, and that these costs are not so extraordinary that they should be embedded in rates.

Discussion and Decision.

97 The Company is expected to incur legal expenses in the course of operating its business, and a test-year level of these costs is included in calculating net operating income. No analysis was provided to the record of legal costs over time to establish what a normal level might be, and how greatly these costs might exceed that norm. As previously noted, the purpose of including legal costs in rates is to set a normal level of legal costs that might be expected in the rate year. Including these costs in addition to the test year, legal expenses would embed them in rates for future periods, even though such expenses would not be expected in those years. Pro forma adjustment C-PA-10 should not be made.

15. Interest Expense Adjustment

98 By adjustment S-PA-10, Staff proposes an interest synchronization adjustment. TR 374. This adjustment is frequently called the Pro Forma Debt adjustment by the Washington Staff. The Pro Forma Debt adjustment synchronizes Federal income taxes to relate to the final cost of capital determination in a rate case. Hence, this adjustment must be recalculated to the cost of capital recommendation in this Initial Order. The recalculation of this adjustment appears in **Appendix C**, page 15. The effect of the adjustment reduces Net Operating Income by $46,984.

16. Depreciation Adjustment – Owner's Vehicle

99 The Company has included in its assets (and thus rate base and depreciation expense) the cost of a Lincoln Navigator used by Mr. Richardso on Company business and for personal use. Staff has proposed adjustments to remove the cost of this vehicle from rate base, depreciation expense and vehicle insurance expense, replacing those costs with the costs of a Chevy C-35 truch listed in the Company's depreciation schedule. S-PA-5, 9. Staff chose the Chevy C-35 truck as a proxy because it is the most expensive vehicle on the Company's books (except for the Navigator) and substituted this cost for that of the Navigator. TR 330, lines 1-3. Staff did not choose the truck for the function it performs, but rather considered its cost as a reasonable substitute for a vehicle that could be purchased and used to perform the functions currently performed by the Navigator.

100 RVW argues that the Navigator is used more as a company vehicle, than as a personal vehicle. It argues that the Navigator is used to transport Company staff to meetings on a regular basis, and is used by both Mr. Blackman and Mr. Fisher, in addition to

Mr. Richardson, on official company business on a regular basis, citing Exhibit T-15, p. 30, l. 25-28; TR 85, l. 15-18, TR 133, l. 2 - 134, l. 2 and TR 131, l. 2 – 132, l. The Company also argues that Commission Staff's surrogate vehicle has no real rationale, that Mr. Kermode simply took this vehicle off the Company's depreciation list and that in reality, the surrogate is a flatbed pickup truck that could hardly be used for the same purposes that Mr. Richardson's vehicle is used, to transport multiple Company representatives to meetings on a regular basis.

Discussion and Decision:

101 If it is established that the Navigator is more expensive than is reasonable or prudent for a company owned vehicle, then it would be appropriate to choose a proxy vehicle as a surrogate for its cost. It is clear that Staff's proposal is that the company use the *cost* of the pick-up as a substitute, rather than its *functions*. It is not clear, however, that the cost of the depreciated Navigator is excessive. The Company is seeking to add the Navigator at its current value to rate base; i.e., it seeks the value of the used vehicle. Exhibit No. 75, Schedule 2.3, page 1 of 4, indicates that the purchase date of the Lincoln Navigator was December 1, 1998, hence, the vehicle is now 3 ½ years old, and would have been two years old at the end of the year 2000 test period. The depreciated cost of the used Navigator is not materially different from the new value of the proxy vehicle. This initial order recommends that Staff adjustment S--PA-9B should not be approved.

17. Vehicle Insurance

102 Staff recommends a vehicle insurance adjustment to remove $569 from the Company's insurance costs, based on the costs of insuring the Lincoln Navigator discussed in paragraphs 99 through 101. The adjustment increases net operating income by only $376. Consistent with the decision on depreciation of the owner's vehicle, this Order recommends that vehicle insurance adjustment S-RA-7, proposed by Staff should not be approved.

103 Table 3 reflects the decision in this Initial Order for the contested ratemaking adjustments to Net Operating Income:

TABLE 3: CONTESTED NET OPERATING INCOME ADJUSTMENTS				
Ln#	Contested Net Income Adjustments	Staff	Company	Decision
1	Bad Debts Expense	($12,005)	($33,674)	($12,005)
2	Depreciation Expense Adjustment	76,076	49,982	76,076
3	Ready-To-Serve Revenues	98,095	0	0
4	CoBank Refund	4,427	0	0
5	Salaries & Wages (Owner)	21,166	(4,336)	(4,318)
6	Legal Adjustment	1,028	0	1,028
7	Regulatory Expense	(606)	0	(606)
8	Interest Income Adjustment	24,512	0	24,512
9	Income Tax Adjustment	0	0	0
10	Salaries & Wages – Employees	(94,051)	(99,460)	(94,051)
11	Reduce Indian Springs Rates	0	(28,478)	(28,478)
12	Rate Case Expense	(4,180)	(14,894)	(12,584)
13	Insurance Adjustments	(32,160)	(31,784)	(31,784)
14	Developer Lawsuit	0	(4,186)	0
15	Interest Expense Adjustment	(46,444)	0	(46,948)
16	Depreciation Adj. Owner's Vehicle	3,458	0	0
17	Vehicle Insurance	376	0	0
18	Total Contested Adjustments – NOI	$39,692	($166,829)	($129,194)

c. Contested Rate Base Adjustments

104 Table 4 shows the contested ratemaking adjustments to Average Rate Base:

TABLE 4: CONTESTED RATE BASE ADJUSTMENTS				
Ln#	Contested Adjustments To Rate Base	Staff	Company	Difference
1	Adjust to Average Rate Base	($99,882)	($102,603)	$2,721
2	Working Capital Allowance	240,945	231,387	9,558
3	Depreciation Adj. Owner's Vehicle	(25,409)	24,499	(49,908)
4	Total Uncontested Adjs. – Rate Base	$115,654	$153,283	($37,629)

105 Table 3, lines 1 through 3 are Staff adjustments S-RA-14&15, S-RA-16, and S-PA-9B, respectively. Table 3, lines 1 through 3 are also Company adjustments C-PA-3A, C-PA-16, and C-PA-9B, respectively. Some of the above adjustments of Staff or the Company have been divided into their contested and uncontested parts. In such cases, the adjustments are identified as A or B.

1. Adjust to Average Rate Base

106 Regarding rate base, the Company tells us at page six of its brief:

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

107 Under the heading "The Company and Commission Staff Agree on the Amount of Rate Base" the Commission Staff tells us at page six of its brief:

> 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.

108 The numbers provided in Exhibit 75, however, indicate that Staff uses a figure of ($99,882) while the Company provides a number of ($102,603). The difference between these figures is $2,721.

109 In the Staff's response to Bench Request No. 12 (Exhibit No. 75), on its supporting restating adjustments schedule, Staff makes the same adjustment to rate base as the Company, but does not carry the amounts forward to the summary pro forma sheet. This Order will assume this was an error, and will propose that the Company's adjustment C-PA-3A be adopted.

2. Working Capital Allowance.

110 By adjustment S-RA-16, the Staff initially proposed a working capital allowance of $231,387, which Mr. Kermode calculated using a "Formula Method." By adjustment C-RA-16, the Company adopts the Staff's adjustment. In its response to Bench Request No. 12 (Exhibit No. 75), the Staff, without explanation, changed the amount to $240,945. The Staff's approach is a so-called "rule-of-thumb" calculation rather than an investor-supplied working capital calculation. Such an approach has often been challenged by Staff in prior cases. Mr. Kermode rejects both the Lead-Lag method and the standard Staff Balance-Sheet Approach. Further, Mr. Kermode's description of the balance sheet approach often advocated by Staff does not compare with previous Staff testimony in other proceedings regarding the subject.

Discussion and Decision:

111 Staff has advocated and the Commission has adopted in innumerable rate proceedings an investor-supplied working capital analysis, which employs an analysis of the regulated companies' average balance sheet balances for the test period[3]. The

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[3] *See, for example, WUTC v. Cascade Natual Gas Corporation,* Cause No. U-71-34 (June 1972) "It has been the practice of this Commission to recognize an investment in working

premise of the approach is that if it can be demonstrated that there are test period investor-supplied amounts in excess of the amounts included in net rate base, then these amounts should be added to rate base as investor-supplied working capital. To the extent that amounts are demonstrated to be investor-supplied and providing service to the public, the regulated utility deserves to earn a fair return on these amounts.

112 The Commission should consider any reasonable approach, but when Staff abandons a long-standing methodology, Staff should offer testimony explaining why it has done so. The only explanation Mr. Kermode offers is that water companies do not ordinarily book monthly amounts in a timely manner, and therefore the balance-sheet method is not reliable. Implicit in this testimony is the assumption that the balance sheet approach must be based upon monthly averages. However, the Commission has adopted a beginning-end-of-year average balance sheet approach in past cases. For example, *See*, *WUTC v. Pacific Power & Light Company,* Second Supplemental Order, Cause No. U-81-17 (December, 1981) p. 5. In that case, Staff advocated a beginning-end-of-year average investor-supplied working capital analysis because the company's constructed rate base was based upon beginning-end-of-year averages. Staff argued that it was appropriate to do so, to avoid mixing averages and thereby increasing or decreasing the amount of rate base simply because of adding a beginning-end-of-year average to an average-of-monthly averages amount.

113 Rainier View Water Company also uses a beginning-end-of-year average in constructing their rate base in this present case, and this approach has been adopted by Staff. It would seem that if the balance sheet is reliable enough to measure the larger portions of rate base, it should be adequate to measure the amount of investor-supplied working capital.

114 The Company and Staff have agreed upon the same beginning-end-of-year average rate base before adjustments, which is as follows:

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capital by making an appropriate allowance if it is shown that funds are in fact supplied by the investor." p. 19; *WUTC v. Continental Telephone Company of the Northwest, Inc.,* Cause No. U-75-46 (April 1976) p. 6; *WUTC v. Continental Telephone Company of the Northwest, Inc.,* Cause No. U-76-37 (May 1977) pp. 6-7; *WUTC v. Continental Telephone Company of the Northwest, Inc.,* Cause No. U-80-32 (December 1980) p. 5; *WUTC v. Cascade Natural Gas Corporation,* Cause No. U-83-35 (July 1983) p. 5; *WUTC v. Continental Telephone Company of the Northwest, Inc.,* (August 1983) p. 17; *WUTC v. Puget Sound Power & Light Company,* Docket Nos. U-89-2688-T and U-89-2955-T (January 1990); *WUTC v. Puget Sound Power & Light Company,* Docket Nos. UE-920433, UE-920499 and UE-921262 (September 1993) p.83; *WUTC v. U. S. West Communications, Inc.,* Docket No. 950200 (April 1996) pp. 50-52.

1	Utility Plant in Service	$12,638,575
2	Accumulated Depreciation	(2,373,914)
3	Net Utility Plant in Service (Line 1-2)	10,260,660
4	Less: CIAC	(5,292,352)
5	Net Average Rate Base	$ 4,967,309

115 The beginning-end-of-year average test period capitalization can be extrapolated from the balance sheets in Exhibit No. 1, as follows:

	Average Capitalization	Amount	Percentage Distribution
6	Average Stockholder's Equity	$1,876,106	33.39%
7	Average Long Term Debt	3,742,278	66.61%
8	Total Average Capitalization	$5,618,384	100.00%

116 Mr. Fischer testified that the amounts appearing on the balance sheet as Other Assets were all related to the acquisition of bank loans. See TR 100-102. There are three accounts listed under Other Assets. They are Debt Service Reserves, Loan Fees and Investments. The beginning-end-of-year average balances for the test period for these Other Asset accounts can be extrapolated from the Company balance sheets in Exhibit No. 1, as follows:

9	Debt Service Reserves	$352,208
10	Loan Fees	26,511
11	Investments – In CoBank Stock	36,366
12	Total Other Assets	$415,085

117 Mr. Kermode testified as follows at TR 379, lines 7-12:

Q. (Judge Schaer) If the Company incurred certain costs of financing, or has certain debt discounts or premiums, would those factors change the amount of net proceeds that would be made available to the Company if it took out a long-term debt loan?

A. (Mr. Kermode) Normally, yes.

118 Exhibit No. 33, page 9, item (L) also discusses these amounts, and in Exhibit No. 49, page 10, Note 4, states, in part:

> The CoBank agreements require that certain debt service reserves be maintained. As of December 31, 2000 and 1999, the debt service reserves totaled $361,284 and $343,131, respectively. Additionally, the Company is

required to maintain stock in CoBank. At December 31, 2000 and 1999, the fair market value of the CoBank stock totaled $44,193 and $28,540, respectively.

119 CoBank is the Company's principal lender. The above lines 9 and 11 are the averages from the Company's year 2000 Financial Report. Since the balances in Other Assets are amounts incurred to establish and maintain bank loans, these amounts would reduce the amount of funds available to the Company to buy or construct rate base assets or to otherwise be available for the day-to-day needs for working capital. Hence, in measuring a working capital calculation, these amounts would logically be considered, as follows:

13	Total Average Capitalization	$5,618,384
14	Total Average Other Assets	(415,085)
15	Adjusted Average Capitalization	$5,203,299

120 The above adjusted average capitalization of $5,203,299 compares with a test period average net rate base of $4,967,309.

121 However, Mr. Fischer testified regarding the balance sheets in Exhibit No. 1, testified that the amounts in an account, Deposits for Advances for Construction, are amounts that will ultimately be credited to CIAC, TR 102. If the amounts are ultimately destined to be credited to the CIAC account, then logically they are not investor-supplied amounts. The beginning-end-of-test year average balances in the account Deposits for Advances for Construction were $380,306 for the test period.

122 The above review of the record does not propose an alternative adjustment in this case. The review is simply made to test the theory that there was an amount of investor-supplied working capital for the test period. The review indicates that the Company did not have investor-supplied working capital in the test year.

123 In addition to the above, RVW wishes to be treated as a C Corporation for ratemaking purposes in determining Federal Income Taxes and the Company's ultimate revenue requirement. This order recommends approval of the Company's position. As discussed in paragraph 27 of the Income tax adjustment, if RVW had been keeping its books in a manner consistent with a C corporation, then there would be a balance of Accumulated Deferred Income Taxes (ADIT) that would be used to reduce rate base. ADIT is calculated to account for the tax-timing differences between book depreciation and tax depreciation. The Company has not kept a "side-record" or "off-book" record of what the imputed ADIT balance should be for the test period. The Company asserts that such amounts would be immaterial, but provides no numeric analysis to support its assertion. In addition, as observed in the discussion of the

Ready-To-Serve Fees ("RTSF"), the position of this Initial Order is that test period rate base has been overstated because the amounts of these Ready-To-Serve Fees in previous years were not treated in a manner similar to CIAC.

124 In summary, the record in this case does not demonstrate that there was any investor-supplied working capital during the test period. Further, rate base is most likely overstated because of the lack of an ADIT balance to include in rate base, and because of the treatment of RTSF in prior years. Adding working capital to the rate base would further overstate it. This Initial Order, therefore, recommends that Staff's adjustment S-RA-16 and the Company's comparable adjustment C-RA-16 both be rejected.

3. Depreciation Adjustment Owner's Vehicle

125 This is the rate base complement to Net Operating Income contested adjustment 16. (S-PA-9B & C-PA-9B). As discussed paragraphs 99 through 101, this order recommends that the owner's vehicle, at its presently depreciated value, be allowed as Company expense. The recommendation regarding the proposed rate base adjustments is the same.

126 The Company included its proposed adjustment or alternative adjustment in adjustment C-PA-9. This Order has designated adjustment C-PA-9B as that portion of the adjustment related to the Owner's Vehicle. In its rebuttal Exhibit No. 25, the Company includes an amount of $20,979 in rate base related to this adjustment. In Brief, the Company increased the rate base adjustment by $46,026, without any clear explanation as to how the amount was calculated. Since this Initial Order proposes that the booked amounts related to the Owner's Vehicle be allowed for ratemaking, the question regarding the Company's adjustment should be moot; i.e., no adjustment should be needed. This Initial order proposes the rejection of both Staff adjustment S-PA-9B and the Company's comparable adjustment C-PA-9B.

127 Two additional rate base adjustments must be made in order to reflect the rate base portion of adjustments approved in the net operating income section. The first is an addition to rate base of $18,243 as a result of the decision on the Depreciation Expense Adjustment. This adjustment is shown in **Appendix C.** The second is a reduction in rate base of $77,073 as a result of the decision on Ready-to-Serve Fees. This adjustment is discussed and decided in paragraphs 56 through 61 above.

128 Table 5 reflects the decision in this Initial Order for the contested ratemaking adjustments to Average Rate Base:

TABLE 5: CONTESTED RATE BASE ADJUSTMENTS DECISION				
Ln#	Contested Adjustments To Rate Base	Staff	Company	Decision
1	Depreciation Expense Adjustment	0	0	$18,423
2	Ready To Serve Fees	0	0	($77,033)
3	Adjust to Average Rate Base	($99,882)	($102,603)	($102,603)
4	Working Capital Allowance	240,945	231,387	0
5	Depreciation Adj. Owner's Vehicle	(25,409)	24,499	0
6	Total Contested Adjs. – Rate Base	$115,654	$153,283	($161,213)

D. Rate of Return

129 The stockholders deserve a fair rate of return on capital they have invested in the Company that is used to provide service to ratepayers. The overall rate of return is the weighted average cost of the utility's various sources of capital, and is the amount of money it must spend annually to obtain the capital it uses to provide regulated products.

130 A utility is entitled to the opportunity to earn a rate of return sufficient to maintain its financial integrity, attract capital on reasonable terms, and receive a return comparable to other enterprises of corresponding risk. *Duquesne Light Company v. Barasch*, *488 U.S. 299, 310, 312, 109 S.Ct. 609, 102 l. Ed. 2d 646, 98 P.U.R. 4th 253 (1989); Federal Power Commission v. Hope Natural Gas Co.I, 320 U.S. 591 (1944); Bluefield Water Works Improvement Co. v. PSC of West Virginia*, *262 U.S. 679 (19)*

1. Cost of Equity

131 The cost of common equity capital, stated as a rate of return on common equity, is primarily an attempt to quantify a rate of return required by investors for that particular investment. Discounted Cash Flow (DCF) studies compare the utility whose cost of equity is the focus of the study (RVW) to the return found appropriate for a group of companies that are of comparable risk to RVW's regulated utility operations.

132 RVW proposes to continue to use what it has historically been allowed as a return on equity. Ex. 24 ; TR 93, ll. 2-4. The Commission Staff performed a DCF analysis of RVW's cost of equity. Staff also prepared a study of using an interest coverage ratio

approach based on covenants that RVW must meet under its loan with CoBank. Staff's recommendation is based on its interest coverage ratio approach.

Discussion and Decision

133 This Initial Order recommends a return on equity of 12.00 percent, as proposed by the Company. In brief, the Staff proposes a cost of equity capital of 16.05%, which had to be extrapolated from the Staff's Exhibit No. 75. Staff's overall rate of return in Exhibit No. 75 of 8.62% does not appear anywhere else in the record. Although Staff performs a DCF calculation, Staff does not advocate the use of the analysis, and under cross-examination, Mr. Kermode conceded that a number of the companies included in his analysis should not have been included. TR 343-347. Further, it is unclear why Mr. Kermode deducts cash and other short-term assets from the Company's equity capital structure as non-rate base items. Exhibit No.T-53, page 34, lines 11-25. Exhibit T-53, page 34, lines 11-25. Cash, materials and supplies are a common rate base component in the form of working capital, if it can be demonstrated that the amounts are investor-supplied. Further, it is unclear how Mr. Kermode determined that the cash and short-term investments were all equity related since it is difficult, if not impossible, to trace every dollar of capitalization on the Liability and Equity side of the balance sheet to a specific dollar spent on a specific asset on the Assets side of the balance sheet. Generally, it is held that all assets are assumed to be financed by the overall mix of total capitalization or by accounts receivables. It is not clear why Mr. Kermode adjusts capitalization to equal the total absolute dollars of rate base. It is true, in a pure theoretical sense, that if there are no non-operating operations, construction work in progress or other assets excluded from in rate base, then total capitalization should equal total rate base. However, in more cases than not, a regulated company has a certain amount of non-regulated assets or has assets providing service in another jurisdiction, which are also financed by the total capitalization of the company. The position generally held is that the mix of total capitalization has financed both regulated and non-regulated operations. The capital structure and cost of capital rates are developed as percentages or ratios and applied to average rate base to determine the net operating income requirement. With the use of such ratios, it is unnecessary to adjust capitalization to equal the absolute dollars in rate base. Further, it is unclear why the proposed authorized return would change depending on whether the return is applied to an average or end-of-period rate base. TR 372-374.

134 Staff uses a debt coverage ratio methodology to determine cost of capital. Exhibit T-53, pp. 33-34. As discussed below, by adopting the Company's proposed cost rates of debt and equity and using the latest available capital structure at September 30, 2001, the resulting overall recommended fair rate of return is 8.76%, which is only slightly above the overall return recommended by Staff in brief of 8.62%. Hence, it can be assumed that the fair rate of return proposed in this Initial Order will provide adequate interest coverage.

2. Cost of Debt

135 RVW proposes use of the average interest rate charged by CoBank during 2001 as the Company's cost of debt, noting that CoBank charges it a variable interest rate. It seeks a cost of debt of seven percent. Ex. T-15, p. 36, l. 8. The Company argues that the rate proposed by Staff is a "snapshot" rate that coincides with an historical low in interest rates, and that is estimate of debt cost is a far more prudent estimate of where rates will be. The company asks the Commission to take official notice under WAC 480-09-950 of certain publications, including: *The Beige Book, Summary of Commentary on Current Economic Conditions* by Federal Reserve District available at http://www.federalreserve.gov/FOMC/beigebook/2002/20020306/fullreport.htm; the University of Michigan's respected annual economic forecast, found at www.umich.edu/~newsinfo/releases; the U.S. Department of Labor's Producer Price Index, found at www.bls.gov/news.release; and the Federal Reserve Statistical Summary www.bls.gov/news.release under WAC 480-09-750. RVW argues that the Beige Book reports that economic activity is trending upward, and that the other three reports point to increasing interest rates in the near future. The Company includes copies of these documents in Appendix A to its brief.

136 Staff, in its filing, proposes use of the interest rate charged by CoBank in November 2001 as the cost of debt, because this is the most recent cost of debt available, and the best predictor of what debt rates will be during the rate year. This rate was 5.55 percent. Staff notes on brief that since November the prime rate has in fact dropped an additional 25 basis points (.25%) lowering Rainier View's interest cost even further. Staff argues that if the Company is uncomfortable with the effects of increasing interest rates, it could consider converting the variable rate notes to fixed rate notes, especially in the current low rate market.

Discussion and Decision:

137 The cost of debt, particularly variable debt, should be based on an average of rates over a period of time. A one-time, so called "snap-shot" rate is not as reliable a predictor of the range of rates that may be expected during the rate year. The seven percent figure sought by RVW is the appropriate starting point for setting the cost of debt. As discussed in paragraph 63 a refund received from CoBank should be applied to reduce the Company's cost of debt to what it cost during the test period. When that effect is included, it produces an embedded cost of debt of 6.75 percent. This initial order recommends using 6.75 percent for the cost of debt.

138 This Initial Order recommends that the Commission should not take official notice of the documents the Company has provided in its Appendix A. Official Notice may have been an appropriate basis for their admission in the record while the record was open in this case. Now, however, no Company witness is available to answer questions about the documents, nor is Staff able to respond in its Brief. The two

general statements extracted by the Company in its brief, "economic activity is trending upward" and "these three reports point to increasing interest rates in the near future" do not add any useful facts to the decision whether averaged rates from 200o, or a November 2001 interest rate will be better predictors of interest costs during the rate year. The company has not applied any information to be found in these documents to its analysis of these issues.

3. Capital Structure

139 The Company proposes use of a hypothetical capital structure of 50 percent debt and 50 percent equity. The Company indicates that it had first proposed to use its actual capital structure, but that in light of the differences between the Company and Staff as to how to identify the Company's actual capital structure, it changed its proposal to the 50/50 hypothetical capital structure.

140 Staff calculates the Company's capital structure as consisting of 70.76% debt and 29.24% debt. Staff disagrees with the Company's proposed hypothetical capital structure, arguing that the usual purpose of a hypothetical capital structure is to correct the effect of an equity rich capital structure. Staff notes that the cost of equity usually exceeds the cost of a company's debt, and that 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. Staff argues that the problem of a company that has more debt than may be considered desirable is better addressed by use of the Debt Service Coverage Ratio, as Staff has proposed.

Discussion and Decision:

141 The latest available capital structure on this record can be extrapolated from the balance sheet in Exhibit No. 1 at September 30, 2001, which indicated the Company's actual capital structure is 61.76 percent Debt and 38.24 percent Equity. This capital structure is the most accurate view of what the Company's capital structure will be in the rate year The Company's actual capital structure will provide an appropriate balance between two long-standing principles of sound ratemaking: 1) that a utility is entitled to earn a return on capital sufficent to preserve its creditworthiness; and 2) that the rate of return on capital mist not burden ratepayers unnecessarily i.e., it must be economical. This Initialk Order recommends a capital structure for RVW of 61.76 percent debt and 38.24 percent equity.

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TABLE 6: Capital Structure, Cost Rates & Fair Rate of Return Decision				
Ln #	Item	Capital Structure	Embedded Cost	Rate of Return
1	Equity	38.24%	12.00%	4.59%
2	Debt	61.76%	6.75%	4.17%
3	Total Capital	100.00%		**8.76%**

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143 A return of 8.76 percent will provide RVW Water with the opportunity to earn a rate of return sufficient to maintain its financial integrity, attract capital on reasonable terms, and receive a return comparable to other enterprises of corresponding risk

G. ACTUAL RESULTS OF OPERATION AND RATE OF RETURN

144 Table 7 below, summarizes the Company's results of operations for the 12 months ended December 31, 2000, and incorporates the recommendations made to the Commission regarding all contested issues having a revenue requirement impact, and the decisions recommended in this Order.

TABLE 7: RAINIER VIEW WATER CO., INC. ACTUAL RESULTS OF OPERATIONS FOR THE 12 MONTHS ENDED DECEMBER 31, 2000 DECISION				
Ln#	**Description**	**Total Net Operating Income**	**Total Average Rate Base**	**Rate of Return - %**
	(A)	(B)	(C)	(D)
1	Actual Results of Operations	$597,971	$5,069,911	11.79%
2	Total Uncontested Adjustments	($204,558)	$42,506	
3	Total Contested Adjustments	($129,194)	($161,213)	
4	Results Before Rate Changes	$264,219	$4,951,204	5.33%
5	NOI (Excess) / Deficiency	$169,506	$0	
6	Results at Commission Decision	$433,725	$4,951,204	8.76%

145 Table 8 below reflects the revenue requirement calculation for the adjusted results of operations of RVW for the test period based upon the decisions recommended in this proposed Order.

TABLE 8: REVENUE REQUIREMENT CALUCATION DECISION		
Ln #	**Description**	**Amount $**
	(A)	(B)
1	Total Pro Forma Average Rate Base	$4,951,204
2	Overall Authorized Rate of Return - %	8.76%
3	Net Operating Income Requirement (Ln 1 x (Ln 2/100)	$433,725
4	Pro Forma Net Operating Income	$264,219
5	Net Operating Income (Excess) or Deficiency (Ln 3 – Ln 4)	$169,506
6	Net-To-Gross Conversion Factor	0.6211986
7	Gross Revenue (Excess) or Deficiency (Ln 5/Ln 6)	**$272,870**
8	Percentage Increase (Decrease) in Overall Operating Revenues	**9.02%**

146 The recommended revenue requirement calculation reflects a revenue deficiency of $272,870. The indicated overall recommended increase in operating revenues is 9.02%

F. Rate Design

147 The Company proposes to lower the rates charged to customers on its Indian Springs and system to bring those rates to parity with the customers on its other systems. The Staff does not object.

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

149 Staff's recommendation is that rates should be reduced. In order to implement a rate reduction, 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.

Discussion and Decision.

150 The outcome of this order is a rate increase of roughly 9.02 percent. The rate changes in this order should be implemented by first refiling rates to adjust the rate levels of the non-Indian Springs system based upon the overall percentage increase granted in this proceeding. The Indian Springs rates should then be adjusted to the new non-Indian Springs rates. The allocation of the rate increase in this manner will be fair and equitable to the Company's ratepayers.

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G. Appendices to the Order

152 The following appendices have been attached to this proposed Order to provide more detail of the numeric calculations of the proposed decisions.

153 **Appendix A** compares the positions of Staff and Company at brief, in which Staff does not impute Federal income taxes..

154 **Appendix B** is the same as Appendix A except Federal income taxes have been imputed on Staff's proposed adjustments.

155 **Appendix C** is a full pro forma statement reflecting the decisions proposed in this Initial Order.

156 These appendices are a part of this Order, and are incorporated into the memorandum portion of the order by this reference.

I. FINDINGS OF FACT

157 Having discussed in detail both the oral and documentary evidence concerning all material matters inquired into, and having previously stated findings and conclusions based thereon, the following summary of the facts is now made. The portions of the proceeding detailing findings and discussion pertaining to the ultimate facts are incorporated herein by this reference.

158 (1) The Washington Utilities and Transportation Commission (the Commission) is an agency of the state of Washington vested by statute with the authority to regulate rates, rules, regulations, practices, accounts, securities, and transfers of public service companies, including water companies that have reached the appropriate jurisdictional threshold.

159 (2) Rainier View Water Company, Inc. (RVW or the Company) is a public service company subject to the jurisdiction of the Commission.

160 (3) RVW, is a water company engaged in the business of furnishing potable water to the public within Washington State.

161 (4) RVW provides domestic water service to over 11,000 homes and businesses, serving largely residential customers, through 31 water systems located primarily in Pierce County.

162 (5) On June 15, 2001, RVW Water Company, Inc (Rainier) filed with the Commission revisions to its currently effective Tariff WN U-2, designated as:
Eighth Revised Sheet No. 21. Canceling Seventh Revised Sheet No. 21
First Revised Sheet No. 21.1 Canceling Original Sheet No. 21.1

Seventh Revised Sheet No. 32 Canceling Sixth Revised Sheet No. 32.

163 The Company's original proposal would increase its annual revenues by $453,157 or 13.6 percent. In Exhibit 3 to its Post hearing brief, calculates the requested increase at $444,244 per year for a total revenue requirement of $3,438,557.

164 (6) The 12-month period ending December 31, 2000 is an appropriate test year to examine for ratemaking purposes in these proceedings.

165 (7) Federal income tax expense should not be removed from RVW's results of operations for ratemaking purposes. RVW has been allowed to recover federal income tax expense both from its general customer base and from individual developers, depending upon the circumstance, for the last ten years or more. The federal income tax expense is generated by the regulated operations of the Company. Federal income tax at an effective tax rate of 34 percent should be imputed. A comparison of Appendices A and B show the effect of imputing income tax on Staff's proposed adjustments.

166 (8) Normally, there should be an adjustment to rate base for the deferred tax component related to the timing differences for tax depreciation in excess of book depreciation. The Company should be ordered to prepare a study of what the accumulated deferred income tax balance would be, if the Company had been previously treated as a C c orporation under a normalized tax accounting methodology. The Company should provide this study to the regulatory staff of the Commmission (Staff) before the next rate case, and maintain an "off-book" or side-record calculation of accumulated deferred income taxes that is well documented and available for Staff's audit.

167 (9) The appropriate Net-To-Gross Conversion Factor to be used in setting rates for RVW is 0.6211986.

168 (10) The parties agreed to several adjustments to the per books numbers from the test year. These adjustments are listed in Table 1. These adjustments result in a $204,558 decrease in net operating income and a $42,506 increase in rate base. These adjustments are consistent with generally acceptetd ratemaking principles and should be adopted.

169 (11) There are seventeen contested net operating income adjustments to the per books numbers f rom the test year. These adjustments are listed in Tables 2 and 3, and the resolutions this Order finds correct are listed in Table 3. these adjustments are consistent with generally accepted ratemaking principles and should be adopted.

170 (12) The Company should be directed to examine its prior records and identify the amounts of Ready-To-Serve Fees which were r ecorded as non-operating income, and provid this analysis to Staff in RVW's next geneeral rate case.

171 (13) There are three contested rate base adjustments to the per book numbers for the test year. These adjustments are listed in Tables 4 and 5, and the resolutions this Order finds correct are listed in Table 5. These adjustments are consistent with generally accepted ratemaking principles and should be adopted.

172 (14) The appropriate capital structure to be used in setting rates for RVW is 61.76 percent debt and 38.24 percent equity.

173 (15) The appropriate capital structure to be used in setting rates for RVW is 61.76 percent debt and 38.24 percent equity.

174 (16) The appropriate cost of equity to be used in setting rates for RVW is 12.00 percent..

(17) The appropriate overall return for the Company is 8.76 percent.

175 (18) The calculation of the return on investment as set forth in Table 6 is reasonable, is supported by substantial evidence in the re cord of this case and should be approved.

176 (19) The results of operations set forth in Table 7 are reasonable, are supported by substantial evidence in the record of this case and should be approved.

177 (20) The revenue requirement calculation for the adjusted results of operations of RVW for the test period based upon the decisions recommended in this proposed Order set forth in Table 8 is reasonable, is supported by substantial evidence in the record of this case and should be approved.

178 (21) Additional revenues in the amount of $272,870 are appropriate and should be allowed. This is based upon a need to recover an additional $169,506 in Net Operating Income.

179 (22) The revenues from the Indian Springs system should be restated as if they are the same as all other system rates. The rate increase percentage should then be calculated and applied to the non-Indian Springs rates. The Indian Springs rates should then be r efiled and set at parity with those adjusted non-Indian Springs rates.

180 (23) The rates that result from this Order together are just, reasonable, and compensatory.

181 (24) The rates that result from this Order are neither unduly preferential nor discriminatory.

II. CONCLUSIONS OF LAW

182 Having discussed above in detail all matters material to this decision, and having stated general findings and conclusions, the following provides summary conclusions of law. Those portions of the preceding detailed discussion that state conclusions pertaining to the ultimate decisions of the Order are incorporated by this reference.

183 (1) The Washington Utilities and Transportation Commission has jurisdiction over the parties to, and subject matter of, this proceeding. RCW 80.01.040; Chapter 80.04 RCW; Chapter 80.28 RCW.

184 (2) The rates and charges included in, or made effective by, RVW's tariff WN U-2, Seventh Revised Sheet No. 21, Original Sheet No. 21.1 and Sixth Revised Sheet No. 32, do not produce rates that are just, fair, reasonable and sufficient and fail to yield reasonable compensation for the services rendered, and are rejected.

185 (3) A rate increase of 9.02 will result in rates that are fair, just, reasonable, and sufficient.

186 (4) Rates, term and practices determined in accordance with the findings and conclusions of this Order, including separately stating Findings of Fact and Conclusions of Law, and the forgoing analysis and discussion of the record, support Commission determined rates, charges and practices that should be fixed by order as the just, reasonable, and sufficient rates, charges and practices that RVW should observe and put in force in accordance with the terms of this Order.

187 (5) The Commission should retain jurisdiction over the subject matter and the parties to effectuate the provisions of this Order. *Title 80 RCW.*

III. ORDER

188 (1) The Commission has jurisdiction over the subject matter and the Parties to these proceedings.

189 (2) Rainier View Water Company, Inc., is authorized and required to make appropriate compliance filings and such other filings as are necessary to

effectuate the terms of this Order. Staff shall examine the compliance filing, and shall provide its analysis of whether the compliance filing meets the requirements of this Order no later than ten business days after the Company's compliance filing is filed with the Commission.

190 (3) The Company must prepare a study of what its accumulated deferred income tax balance should be, if the Company had been previously treated as a C corporation under a normalized tax accounting methodology. The Company should provide this study to Staff before its next rate case, and henceforth maintain an "off-book" or side-record calculation of accumulated deferred income taxes, which is well documented and available for Staff's audit.

191 (4) The Commission must examine its prior records and identify the amounts of Ready-To-Serve Fees which were recorded as non-operating income, and provide this analysis to the Staff in RVW's next general rate case.

DATED at Olympia, Washington, and effective this_________day of May, 2002.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

MARJORIE R. SCHAER
Administrative Law Judge

NOTICE TO THE PARTIES

This is an Initial Order. The action proposed in this Initial Order is not effective until entry of a final order by the Utilities and Transportation Commission. If you disagree with this Initial Order and want the Commission to consider your comments, you must take specific action within the time limits outlined below.

WAC 480-09-135 allows the Commission to shorten time in its discretion. The times for filing of Petitions for Administrative Review and Answers are shortened for this Order, so that the Commission may have adequate time to

complete its review before the end of the suspension period. WAC 480-09-780(2) provides that any party to this proceeding has twenty (20) days after the entry of this Initial Order to file a *Petition for Administrative Review*. **This order shortens that time to nineteen (19) days; petitions for administrative review must be filed no later than May 22, 2002.** What must be included in any Petition and other requirements for a Petition are stated in WAC 480-09-780(3). WAC 480-09-780(4) states that any *Answer* to any Petition for review may be filed by any party within (10) days after service of the Petition. **This order shortens that time to nine (9) days; Anwers to Petitions for review must be filed no later than May 31, 2002.**

WAC 480-09-820(2) provides that before entry of a Final Order any party may file a *Petition to Reopen* a contested proceeding to permit receipt of evidence essential to a decision, but unavailable and not reasonably discoverable at the time of hearing, or for other good and sufficient cause. No Answer to a Petition to Reopen will be accepted for filing absent express notice by the Commission calling for such answer.

One copy of any Petition or Answer filed must be served on each party of record, with proof of service as required by WAC 480-09-120(2). An Original and nineteen copies of any Petition or Answer must be filed by mail delivery to:

Attn: Carole J. Washburn, Secretary
Washington Utilities and Transportation Commission
P.O. Box 47250
Olympia Washington 98504-7250.