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COMMISSION

November 6, 2003

Ms. Carole Washburn, Executive Secretary
Washington Utilities and Transportation Commission
1300 S. Evergreen Park Drive SW
Olympia, WA 98504-7250

Re: Docket No. UW-031596 – Virgil R. Fox, President, American Water Resources, Inc.

Dear Ms. Washburn:

Enclosed are the original and twelve copies of the Application for Mitigation of Penalties in the above-referenced matter. Thank you for your attention to this matter.

Sincerely,

RICHARD A. FINNIGAN

RAF/km
Enclosure

cc: Virgil Fox
Julia Parker

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

APPLICATION FOR MITIGATION OF PENALTIES

I have read and understand RCW 9A.72.030 and 080, which prescribe penalties for making false affidavits and hereby apply, under oath, for mitigation of Penalty Assessment Docket No. UW-031596, Order No. 01 for the following reasons:

1. I do admit that there were occasions when funds were not properly deposited into the Docket 010961 Account. As explained in Ms. Parker's Declaration, attached, it does not appear that there were as many violations as Commission Staff alleges. However, that does not change the fact that at least some violations occurred. I apologize to the Commission for those violations.

2. The money was not diverted away from Company uses. The money was used to meet operating expenses that were not covered by other revenues and to pay unanticipated federal taxes that simply could not be avoided or even delayed. That does not change the fact that there were occasions where the money was not deposited pursuant to the Commission's Order. I do not take the violation lightly, but wish to point out that I could see no other alternative. The money was used solely to pay Company obligations, not personal obligations.

3. Through our quarterly reports to the Commission and discussions with Commission Staff, we kept the Commission informed as to what was happening. We kept everything in the open and did not try to disguise anything.

4. I want to explain a little bit about what happened with the money used to pay income taxes. The income tax issue developed unexpectedly and came from two sources. One source is a gain on sale related to the sale of the View Royal Water System. With the sale of that system to an unregulated entity, I was able to generate revenue above what would be produced if I were to sell the system to another regulated entity. I made the decision, after a consultation with my accountant and attorney, to put every penny of the revenues received from that sale to use for the Company in reducing the Company's debt. The Commission had criticized the Company in earlier Commission orders as being too debt heavy and therefore unable to attract capital or new loans to address new capital needs. I thought by putting every penny to the reduction of debt, I was accomplishing one of the objectives that the Commission wanted. Both my accountant and myself thought there were sufficient losses from prior tax years that would be available on a carry over basis to address any gain on sale. Unfortunately, there was not.

In addition, with the Docket 010961 Account accumulating funds, that produced taxable income. The reason that the taxable income was produced is with the sale of the View Royal system, the additional employees contemplated in Docket 010961 were not needed. However, because of the loss of operating revenue with the sale of those customers, additional revenue was needed to maintain the current base of employees to address the ongoing needs of the remaining water systems. The Company approached Commission Staff in the summer of 2002 with a proposal that would allow the Docket Account funds to be used to pay for the existing operations of the Company in order to keep those operations above a deficit operating position. Commission Staff rejected that proposal. In retrospect, I suppose I should have instructed my consultants to proceed to bring the proposal to the Commissioners themselves. However, that costs quite a bit of money to do. Instead, I instructed my consultants to try to come up with alternative proposals. Of course, that took time and while that was pending, the tax liability related to the accrued funds arose. As a side note, a second proposal was brought to Commission Staff in the late spring or early summer of 2003 and Staff rejected that proposal as well. In any event, when the tax return was prepared, it became apparent that there was a significant tax liability. The Company had no monies from operating revenues to cover that cost. I had no money that I could infuse into the Company to cover that obligation. I was faced with trying to pay a tax bill without the funds to do so from any other source other than the Docket 010961 Account. I consulted with my outside accountant and my attorney, who went over the alternatives I had available to me. Based on the limited alternatives I had, I made the decision to pay the tax bills and try to replenish the Docket 010961 Account as best I could from the operations of the Company moving forward. Commission Staff was informed of what the Company was going to do on an informal basis. Of course, the results of the Company's actions were confirmed by the quarterly report presented to the Commission.

Please note that I am not trying to suggest that Commission Staff did anything wrong or that Commission Staff somehow approved of my actions. That is not the purpose of my describing what has happened. All that I am trying to do is to tell you the efforts the Company has made to try to address this situation.

5. I have tried to control expenses to the best I can in order to get money into those accounts on a makeup basis. We have been partially successful in getting those funds back into the account, but still have a ways to go. We are continuing to try to meet that objective.

6. As explained in Ms. Parker's Declaration, we are trying to run AWRI as close to the bone as we can. This means that almost any little event can throw us off course.

I respectfully request that the Commission mitigate as much of the penalty as possible.

I swear that the foregoing, along with the materials stated in Ms. Parker's Declaration, which accompanies this Application, is a true and complete statement of the basis for mitigation.

VIRGIL A. FOX

STATE OF Washington)
: ss.
County of Lewis)

On this day personally appeared before me VIRGIL A. FOX, to me known to be the individual described in and who executed the within and foregoing instrument, and acknowledged that he signed the same as his free and voluntary act and deed, for the uses and purposes therein mentioned.

GIVEN under my hand and official seal this 5 day of November, 2003.

Christine E. Perry
Christine E. Perry
[Printed Name]
Notary Public in and for the State of Washington, residing at Ethel.
My commission expires 4-29-07.

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

NOTICE OF PENALTIES INCURRED AND DUE FOR VIOLATIONS OF COMMISSION ORDER

VIRGIL R. FOX, President, American Water Resources, Inc.	PENALTY ASSESSMENT NO. UW-031596 DECLARATION OF JULIA M PARKER

I, Julia Parker, hereby declare under penalty of perjury under the laws of the state of Washington that the following statements are true and correct:

1. I am over the age of eighteen and competent to testify.

2. I am the accountant/regulatory consultant for American Water Resources, Inc.

3. I have reviewed the proposal by staff to impose penalties on the officer of American Water Resources Inc. for violations of the Commission Order in Docket 010961. I believe there are some inconsistencies in this proposal.

4. First I'd like to point out that the proposed penalties for failure to deposit are miscalculated each time by one month. For example, the first failure to deposit for June 2002 has penalties calculated for 4 months. The June revenue is not billed until approximately the 27th of the month, and not due until July. The earliest the company can expect to deposit into this account is July 13th. In this example as the deposit was not deposited until October 23, the deposit is overdue by August, September and October or three months, therefore $300 not

$400 is the appropriate penalty. Each of the penalty calculations for failure to deposit are made in the same manner and each are overstated by $100.

5. Second, I would like to address the appropriate use of the Docket 010961 funds. The notice of penalties states:

> "The Company's expenses for the items set out in the order did not raise to levels that would authorize the Company to expend funds from the Docket 010961 Account. However, Staff's review of AWR's books and records shows that the Company improperly used funds from the Docket 010961 Account as follows:"

6. At this point in the notice of penalties a table is presented in the notice of penalties for the months April through September 2002. I believe that the use of this period is highly misleading and that the criteria for the imposition of penalties is using only a portion of that which was stated in the order not the entire intent of the order.

7. The Order Approving Settlement Agreement in Docket UW-010961 had specific criteria as to when the funds in the Docket 010961 Account could be utilized. To be precise, the order states:

> "(c) Use the money in this account to cover only those expenses for employees hired in addition to existing employee positions, the related benefits, payroll tax, and transportation expense, and outside business consulting that exceed the average monthly amount spent during the test period calculated as follows:

	Monthly Average	
Salary	$	17,477
Transportation	$	2,487
Payroll Tax & Benefits	$	4,662
Business Consulting	$	917

> (d) Not pay expenses for any change in position or increase in expenses for

existing employee positions from the separate account.

(e) Obtain the vehicles to be used by the two additional field employees from an independent company, i.e., one with no ties to the Company or to Mr. Fox, by purchase or lease."

8. My interpretation of the above statement in the order as it relates to the hiring of employees has been that: 1) no expenditure could be made from the account without hiring a new employee; and 2) expenditure could only be made once salaries exceeded $17,477. It sounds pretty straightforward on the surface. However, in application this isn't so easy.

9. The company's payroll is calculated on a bi-weekly basis. There are approximately 4.2 weeks in each month. This means that the total salary expense for most months will be below the average with two or three months having salary expense that are far above the average. Below is a monthly breakdown of the expense and a comparison to the order:

Month 2002	Total Salary Expense	Amount Exceeding $17,477
January	$ 16,352	$ 0
February	$ 16,601	$ 0
March	$ 24,953	$ 7,506
April	$ 16,556	$ 0
May	$ 16,693	$ 0
June	$ 17,148	$ 0
July	$ 18,140	$ 606
August	$ 27,286	$ 9,839
September	$ 18,366	$ 919
October	$ 16,929	$ 0
November	$ 16,909	$ 0
December	$ 19,994	$ 2,547
Total 2002	$ 225,921	$21,504

10. Using just the second criteria of the order "that exceed the average monthly amount spent during the test period," the company would have been properly authorized to withdraw $21,504 from the Docket 010961 Account. However, the first part of the criteria states, "expenses for employees hired in addition to existing employee positions." AWRI was fully staffed with the 7 original employees all year, and hired an additional employee during the months of June, July, August, and September. A total of $5,350 was spent on his salary, $957.27 on related payroll taxes, with an additional $53.96 in mileage reimbursement; making total costs related to this additional employee $6,361.23.

11. Calculated from the table above the average payroll cost for the year is $18,827, which for the entire year exceeds $17,447. The company clearly met both criteria for using the Docket 010961 funds to pay the cost of the new employee. From the Docket 010961 account $5,707.23 was actually withdrawn to pay these costs, the rest was funded from the general operating fund. Each withdrawal made from the Docket 010961 Account was for the purpose stated in the order, thus the penalty for unauthorized withdrawal is unwarranted.

12. Similar analysis was done by the company on the other expenses specifically noted by the order for use of the funds. For example the payroll tax and benefits expenses are presented below:

Month 2002	Total Payroll Tax & Benefits Expense	Amount Exceeding $4,662
January	$ 4,976	$ 314
February	$ 5,253	$ 591
March	$ 6,183	$ 1,521
April	$ 5.192	$ 530

May	$ 5,261	$ 599
June	$ 5,708	$ 1,046
July	$ 5,005	$ 343
August	$ 7,901	$ 3,239
September	$ 5,403	$ 741
October	$ 4,896	$ 234
November	$ 4,817	$ 155
December	$ 4,878	$ 216
Total 2002	$ 65,472	$ 9,528

13. Again, using just the second criteria of the order "that exceed the average monthly amount spent during the test period," the company would have been properly authorized to withdraw $9,528 from the Docket 010961 Account. However, the company, concerned with the first criteria, only withdrew a portion of those costs as stated before. The overages above were paid with funds from the general operating fund. The analysis from the Transportation Expense and the Business Consulting Expense showed the monthly costs exceeded the amounts set forth in the order by $4,699 and $15,437 respectively. Again these overages were paid through the general operating fund.

14. To address the issue of failure to deposit, I would like to offer explanation in that the company has been struggling to meet the operating expenses of the company with the remaining funds after the Docket Account deposit is made. In January 2002, after the Docket Account was funded, the revenue remaining to pay expenses for the company was $57,757 while expenses were $64,292, leaving a deficit of <$6,535>. In February 2002, the deficit was <$1,936> and in March the deficit was <$15,186>. In each of these months the

required deposit to the Docket Account was made in a timely manner within 30 days of billing, while operating funds decreased by a total of $23,657.

15. In April the deficit between revenue remaining to pay operating expenses and the operating expenses was <$4,531>, and the company was still recovering from the higher Salary Expense it experienced in March, further compounding its cash flow to pay operations. In order to continue to be able to pay salaries the company deferred it's April deposit into the Docket Account from its May due date to a later date.

16. In May the deficit between revenue remaining to pay operating expenses and the operating expenses was <$2,326>. Feeling the increasing pressure on cash flow, the company began searching for ways to cut operating expenses to continue to survive on the net revenue remaining to pay operating expenses after the Docket Account was funded. In order to continue to pay the operating expenses of the company, the May deposit due in June was also deferred to a later date.

17. In June there was a small surplus between revenue remaining to pay operating expenses and the operating expenses of $2,953. Aware that the deposit had not been made for April, the company deposited the set-aside funds for the April billing, but did not have the cash flow after expenses to make its required deposit from the May billings.

18. In July there was again a small surplus between revenue remaining to pay operating expenses and the operating expenses this time of $2,445. The required deposit for May was done, but anticipating large operating expenses for August, the company did not make any further deposits to the Docket Account, leaving the June funds not deposited.

19. In August the company again saw a deficit between revenue remaining to pay operating expenses and the operating expenses this time of <$11,903>. The cause of this shortfall was the higher payroll cost associated with the bi-weekly cash flow as well as higher costs of increased consumption and an emergency repair made on one of the systems the company operates. All of these circumstances made it extremely difficult to meet the Company's operating expenses. While withdrawals were made from the Docket Account to help with the increased payroll costs attributable to the additional employee, it was not enough to cover all increased expenses. Thus the Company decided it was best to defer the required deposit from July leaving both June and July deposits unfunded.

20. In September, there was a surplus between the revenue remaining to pay operating expenses and the operating expenses this time of $11,000. Anticipating continuing high expenses no funds were deposited into the Docket Account making the June, July and August deposits unfunded.

21. In October, the difference between revenue remaining to pay operating expenses and the operating expenses resulted in a deficit of <$3,506>. Realizing that the docket account was behind, the company took all available cash and funded the Docket Account for the required June and July deposits, leaving the required August and September deposits still unfunded.

22. In November, the difference between revenue remaining to pay operating expenses and the operating expenses resulted in a deficit of <$3,816>. Unable to make a full deposit for any of the outstanding months no deposit was made, leaving August September and October unfunded.

23. In December, the difference between revenue remaining to pay operating expenses and the operating expenses resulted in a deficit of <$6,336>. Much of this deficit is again due to the higher payroll cost associated with the bi-weekly cash flow. Even with this deficit, the company managed to make a deposit into the Docket Account to cover all of August and part of September, leaving half of September and all of October and November unfunded

24. To reiterate, the Company's operating cash flow throughout the year was decreasing each month just to pay the normal and necessary operating costs of the company. The company's operations had changed from the test period such that instead of adding two additional employees to the existing staff of seven, management was planning reductions across the board to meet the lower revenue expected from the reduction in customers from approximately 1820 customers to 1410 as well as the reduced consumption in the winter months. Revenue was expected to be $209,241 short from the pro forma results of operations approved in the last rate increase filing. As most of the expenses of the Company are fixed, management determined that 9 full time employees as allowed with the last rate increase were not needed. With the lower customer numbers, the Company would make due with the 7 full time employees they currently had. In 2002 the Company made every cut it could to reduce expenses without reducing the current level of employees, and in doing so did not utilize the funds from the Docket 010961 Account beyond the hiring of a part time summer employee.

25. The result of not using the funds that were set-aside in the Docket Account created taxable income to the company over which the company had no control. The total of the income tax attributable to operations was $18,494. This expense amount was not considered in the last

rate case filing. The Commission has always allowed rates to include the cost of income tax, however failed to provide for this expense in the prior rate filing. Upon realizing the tax liability the Company looked to the reason for this income tax and found it was due to the deposit requirement of the Docket 010961 Account. Thus when the Company had no funds available for the payment of this federal liability, and used the only other source it had, the Docket 010961 Account.

26. In addition the estimated quarterly taxes for 2003 were calculated at $5,200 per quarter. This liability is also a direct result of the deposit requirement and as such the Company used the Docket 010961 to pay the quarterly estimated taxes due for the first and second quarters of 2003.

27. Again to summarize, I believe that there are circumstances that were not considered in the assessment of this penalty. The company did, in all months it could, deposit the required funds into the Docket 010961 Account. In those months where deposits were not made, the funds were spent on operations, and not used in any other way.

RESPECTFULLY SUBMITTED this 20th day of October, 2003.

Julia M Parker