PORT LUDLOW VILLAGE COUNCIL
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November 15, 2010

Jefferey D. Goltz, Chairman
Washington Utilities and Transportation Commission
P.O. Box 47250
Olympia, WA 98504-7250

Subject: WUTC Docket Number 101543

Reference: Letter dated October 1, 2010 To: Jeffrey D. Goltz, Chairman, WUTC From: Anthony U. Simpson, President, Port Ludlow Village, Phillip C. Otness, Chairman, Port Ludlow Utilities Committee and Laurason T. Hunt, Director, Port Ludlow Village Council

Dear Commissioner Goltz,

The reference letter was sent to you and other WUTC members presenting some of the Port Ludlow Community concerns about the proposed water rate increase requested by Olympic Water and Sewer, Inc. (OWSI) in the subject docket. In that letter we indicated that we were conducting a more detailed analysis of the proposed rate increase and would present our analyses in a subsequent letter. This letter presents the results of that detailed analysis.

In summary, we did not find any basis for the increase in water rates requested by OWSI. In fact, we found that when the expenditures in the pro forma statement are corrected, OWSI currently has pre-tax income that exceeds that which is allowable by WUTC. We found that the OWSI pro forma statement submitted in their request contains errors, incorrectly allocates charges between the sewer business and the water business of OWSI and contains one time charges that should not be included as a part of the rate request. We found seven areas in the OWSI pro forma statement that we believe contain errors in expenditures. These include federal income taxes, interest expense, depreciation/amortization costs, repair costs, insurance, contractual management costs and contractual legal costs. We present the results of our analysis and the errors in each of these categories below.

OWSI is a Washington corporation consisting of a water supply business that is regulated by the WUTC and a sewer business that is private and not subject to regulation by the WUTC. Employees of OWSI work in both business areas so that allocation of charges between the two businesses is critical to proper accounting of the business. In addition, OWSI is a part of the parent company, Port Ludlow Associates (PLA). Senior management within PLA provide management functions to OWSI and these PLA management costs are allocated to the water and sewer sides of the business. Again, proper allocation of these management costs by PLA to the water and sewer business of OWSI is critical to the proper accounting of costs to the water business.

Maximum Allowable Income for Water Business of OWSI

In their application, OWSI indicated that their net rate base was $1,185,938 and that their weighted average cost of capital was 9.59%. We do not have the necessary accounting expertise to dispute these numbers and accept them for purposes of our analyses. **From these numbers, we calculate that the maximum allowable after-tax operating income for the water business portion of OWSI to be $113,731. From this after-tax operating income, we calculate the maximum allowable pre-tax income for OWSI to be $158,985.** These pre-tax and after-tax operating numbers form the basis for determining the revenue needed by OWSI to meeting these operating income numbers.

Below we present the seven categories of OWSI expenses where we believe that there are errors in the costs presented in the pro forma. After presenting the errors in each of these categories we will summarize what we believe are the true expenses that should be allowable by OWSI in consideration of their rate increase and the effect of the corrected expenses on OWSI Water operating income.

Federal Income Taxes

The maximum allowable pre-tax and after-tax operating income that OWSI may earn is summarized above as $158,985 and $113,731 respectively. Thus, the maximum federal income tax that OWSI should be required to pay is $45,254. In their pro forma statement OWSI claimed federal income taxes of $60,973 on pre-tax operating income of $83,824. That is obviously in error. We do not understand how OWSI s calculating federal income tax. We believe that it should be calculated based on the OWSI Water business pre-tax operating income and not calculated at the OWSI total business level and allocated between the water and sewer business units.

Insurance

Insurance for OWSI is purchased at the parent company level by PLA and is then allocated to each of their business units by the revenue of each of these organizations. The revenue of each of the OWSI business units in 2009 is contained in the Water Companies Annual Report submitted to OWSI. In their pro forma statement OWSI claimed that, based on revenue, 20.85% of the insurance costs should be allocated to OWSI. However, using the data in their annual report, the percentage of insurance costs allocated to OWSI should be 17.36%.

Further, the OWSI insurance costs contains a onetime expense of $5,997 for two insurance claims against OWSI water. We do not understand why these claims were not paid as a part of the OWSI insurance but in any case, one time charges should not be a part of the OWSI expense base for the purpose of determining a requested rate increase. To do so would allow OWSI to collect one time costs in perpetuity.

When the percentage of insurance costs allocated to OWSI is corrected and the one time expense of $5997 is deleted, the allowable insurance costs should be $9,106. **Thus, the insurance costs are overstated by $7,309.**

It is noteworthy that in 2008 the OWSI insurance costs were $7,374, in 2007 it was $4,058, in 2006 it was $6,044, and in 2005 it was $4,208. Therefore, an insurance expense of $9,106 is certainly more in line with prior expenses in this area.

Depreciation/Amortization Expense

In the WUTC Data Request 3 to OWSI, the question is asked "On the CIAC amortization schedule provided the company calculates $10,833.33. Why is this not used to offset asset depreciation of $86,250.31?" OWSI answered that the current year depreciation should be offset by the current year CIAC amortization and that they agreed with the WUTC calculation. **Thus, the OWSI depreciation/amortization expense is overstated by $10,833.**

Interest Expense

OWSI claimed an interest expense of $24,904 in their pro forma statement. In WUTC Data Request 1 the question is asked "Please provide a copy of all outstanding loan documents the water company currently has for the test period. This should include the loan balance, interest rate, payment and principle reduction for the test period. Additionally, please list what the loan proceeds were used for (capital project, operating funds, etc.)." The OWSI answer to this question stated that the OWSI has no outstanding loans. They indicated that money was advanced to the "Water" side of the company from the "Sewer" side but that there were no official documents substantiating this action, nor was there any interest being charged since it's inside the same company. **Therefore, the "Water" side should not be allowed to claim an interest expense and the $24,904 interest expense should be eliminated.** If the IRS should require that an interest expense be imputed, then OWSI must declare such interest income and the income would cancel out the Water side interest expense.

Repair Expense

The pro forma contains an adjustment to Repair Costs of $18,400 for costs associated with fuel contamination cleanup and re-drilling of well 17 which was being drilled when fuel contamination was discovered. Fuel contamination cleanup costs should not be an allowable expense for three reasons. First, as discussed in our reference letter of

October 1, 2010, OWSI and/or PLA have the power to pursue recovery of remediation costs under RCW 70.105D.080 and RCW 70.105D.040. These statues provide a fair process for proper determination of cleanup costs and re-drilling costs, and for the allocation of costs between multiple corporate entities

Second, the fuel contamination costs are a one-time expense and should not be considered as a part of continued expenses by the water side of OWSI. Again, to do so would allow OWSI to collect a one-time cost reimbursement on a yearly basis into perpetuity.

Third, the WUTC should not be rewarding OWSI for a serious management error in the drilling of a new water well in the middle of a fuel storage area. **The repair expense is overstated by $18,400.**

The repair costs in the OWSI Water expense statement for 2009 most likely also contains fuel contamination related costs since drilling was done during 2009 to determine the extent of fuel contamination around well 17. We cannot determine what portion of 2009 repair costs may be related to the fuel contamination effort. Thus, we have made no further reduction in repair costs but WUTC may have access to cost information that will allow them to determine if additional fuel contamination costs should be removed from allowable expenses in this category.

Contractual Legal Expense

The OWSI pro forma contains legal costs of $9,250 that are totally associated with the fuel contamination found when drilling well 17. As stated above, any costs associated with the fuel contamination should not be allowed. In 2005, 2006 and 2007 the legal costs for the water side of OWSI were zero. **Thus, the contractual legal costs are overstated by $9,250.**

Contractual Management Expense

Contractual management expenses are PLA management costs allocated to the water side of OWSI. Interestingly, these costs were stated as being $196,787 in 2009. In 2006, these costs were $97,191 so that in three years the costs have doubled in this cost category. Since the water side of OWSI water sales have been flat for the past several years there does not appear to be any reasonable explanation for this doubling of PLA management costs.

A review of the OWSI 2009 federal income tax statement reveals that the total management costs charged to OWSI (both water side and sewer side) was $200,055. Thus, we conclude that the water side of OWSI is being allocated 98.4% of the total management fees charged by PLA. Since, the water side of OWSI has revenue of $728,193 and the sewer side has revenue of $771,200 there can be no basis that the water side should be paying 98.4% of the total PLA management fees allocated to OWSI.

We believe that a reasonable approach is to allocate PLA management fees within OWSI according to the revenue generated by the water side and the sewer side. Taking such an approach results in a PLA management fee allocation of $97,158. This is very consistent with that charged to the water side in 2006. **We therefore, believe that the water PLA management fees are overstated by $99,629.**

WUTC will note that there is a direct correlation with the drop in total revenue for PLA and the *increase* in PLA management costs that are allocated to the water side of OWSI. This is shown in the table below. It appears that as the residential construction side of the PLA business has been seriously reduced due to the recession, they are simply charging more of their time to the water side of OWSI. Since, the total water sales have been essentially flat during this period shown in table 1 below, we see no reason why the contractual management fees are increasing. We believe that PLA should be doing a better job of managing their expenses and not putting that burden on the residents of Port Ludlow.

Table 1- Comparison of PLA Revenue and OWSI Water Contractual Management Costs

Calendar Year	PLA Revenue	Water Side Contractual Management Costs
2009	$8,638,608	$196,787
2008	$9,997,408	$147,090
2007	$11,451,939	$110,468
2006	$12,672,000	$97,491
2005	$18,947,076	$89,896

Summary

We believe the OWSI pro forma expenses are overstated by a total of$145,491, the federal income tax should be calculated based on actual corporate rates for OWSI Water profits only (maximum of $45,254 if OWSI Water earns maximum allowable operating income), and the interest expense of $24,904 should not be allowed.

Based on our analysis of OWSI expenses, we have revised the Pro Forma results to state what we believe is a true picture of their current financial condition. Those results are shown in table 2 below. In the table the operating expenses of OWSI Water have been reduced by what we believe are unallowable annual operating costs totaling $145,254. With this correction we note that OWSI Water currently receives a return on capital of 11.89% (without a rate adjustment) exceeding the target return established by WUTC. **We therefore conclude that no adjustment to the water rates is justified.**

Table 2- OWSI Water Revised Pro Forma Corrected for Allowable Expenses

Revised Pro Forma Item	Value
Operating Revenue	$728,193
Operating Expenses	$524,453
Operating Income Before Taxes	$203,740
Interest Expense	$0
Federal Income Taxes	$62,708
Total Expenses	$587,161
Net Operating Income	$141,031
Return on Capital	11.89%

We can also examine what revenue is necessary for OWSI Water to meet the target net operating revenue established by WUTC. We do this in table 3 below. As noted in the table, a water sales revenue of $683,438 is necessary to meet the net operating profit goals of OWSI Water. Since their current revenue is $728,193 one could argue that the rates should be modified to reduce revenue by $44,755. In any case, again, no water rate increase is justified.

Table 3- Calculation of Revenue Required to Meet Target Return on Capital

Pro Forma Item	Value
Return on Capital	9.59%
Net Operating Income	$113,731
Federal Income Taxes	$45,254
Interest Expense	$0
Operating Income Before Taxes	$158,985
Operating Expenses	$525,453
Revenue Required to Meet Net Operating Income Target	$683,438

We appreciate the opportunity to provide our analysis of the OWSI request for a water rate increase. We trust that the WUTC staff analyzing the request will take into consideration the results of our analysis when finalizing their recommendations to be made to the WUTC Commissioners on the rate increase request. We do intend to provide public testimony at the public meeting of the WUTC commissioners on December 16, 2010 and request that we be put on a list of those who will provide testimony. We would also appreciate that you provide us in advance any potential questions that you may have for us to answer at the public meeting.

Yours truly,

Thomas E. Stone
President, Port Ludlow Village Council

cc: Patrick J. Oshie, WUTC Commissioner
Philip B. Jones, WUTC Commissioner
Jim Ward, WUTC Regulatory Analyst
Dennis Shutler,WUTC Consumer Complaints
Diana Smeland, PLA President and CEO, and OWSI Vice President
Larry Smith, OWSI President
Troy Crosby, OWSI Treasurer