BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Petitioners, v. RAINIER VIEW WATER CO. INC., Respondents.	DOCKET NO. UW-010877 COMMISSION STAFF'S PETITION FOR ADMINISTRATIVE REVIEW OF THIRD SUPPLEMENTAL ORDER, INITIAL ORDER REJECTING TARIFF FILING; ORDERING REFILING

The Initial Order in this docket rejects the tariff filing of Rainier View Water Company, Inc. (Rainier View or Company) and directs the Company to refile tariffs providing for a rate increase in the amount of $272,870 per year. The Initial Order shortens the time within which the parties may request administrative review to 19 days. Commission Staff submits this request for administrative review as set forth below.[1]

A. The Method Used to Calculate the Income Tax Expense to be Imputed to Subchapter S Corporations Should be Clarified.

In this case, Commission Staff took the position that the Company should not be allowed to include an imputed amount for income tax expense in its rates, as the Company is a subchapter S corporation and does not incur an income tax liability. The Initial Order allows the Company to include this expense in rates. Staff does not seek to challenge that determination, but requests guidance from the Commission on which tax schedule, individual or corporate, Staff should use

[1] The Initial Order contains several typographical errors. Those that are potentially significant are: Table 1, (¶38, in line 7, contains different numbers for the Staff and Company's Materials and Supplies Amounts, yet the totals for the two columns are the same. The correct number for both Staff and the Company is $15,786. Table 2, at ¶line 3, lists the Staff adjustment to Ready-to-Serve Revenues as $8,095. The number should be $98,095, as shown in the last column of the table. At ¶92, Staff believes the reference to S-RA-5 should be a reference to S-PA-5. Finally, ¶172 and ¶173 are identical.

to calculate the imputed tax. The Initial Order at ¶ 23 notes that Staff advocated an effective tax rate of 32.6% be used, if income taxes were to be imputed, thus allowing the ratepayers the benefit of the graduated levels of personal income tax (See Exhibit 75, Schedule 3). The Initial Order, at ¶24, reiterates the Company's proposal that the tax rate should be set at the lower of the corporate tax rate or the individual tax rate, then sets the effective tax rate at 34% "(b)ecause there is no material difference between the two tax rates, in this case," and notes that "(i)n future cases, the Commission will need to review this issue on a case-by-case basis." Because the Initial Order finds that the Company's "as recorded" income is at the 34% corporate tax rate, using Schedule 3 of Exhibit 75, the Initial Order sets the tax rate at the 34% level.

However, this leaves Commission Staff with no guidance about how to apply the imputation of income tax to water companies in which the corporate rate and individual tax rate would yield significantly different results, short of presenting it to the Commission on a case-by-case basis. This is contrary to the Commission's strong encouragement to parties (in the interests of reducing costs to companies and the costs of government) to resolve cases without adjudicative proceedings. If the individual tax rate is used, and there are several shareholders, there would be a need to average the rate.

Therefore, Staff requests that the Commission, on review, make a determination of the appropriate tax schedule, individual or corporate, to be used to determine the appropriate rate at which income tax should be imputed to subchapter S corporations. Staff recommends that the Commission direct the use of the *effective* corporate tax rate, taking into account the various tax brackets for levels of corporate income as included in the Internal Revenue Code in effect at the time of the calculation, not a flat corporate rate.

1. The Company Should be Directed to Prepare its Analysis of the Amount of Deferred Income Tax to Normalize Tax-Timing Differences Within 90 Days of the Final Order.

The Initial Order, at ¶ 27 and ¶28, finds that, with the imputation of income taxes, the Company is being treated as a C corporation for tax purposes. The Initial Order states "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." Staff agrees with the requirement in the Initial Order that the tax-timing differences be normalized, and that accumulated deferred income taxes should be deducted from rate base, under normalized accounting treatment. Despite the Company's insistence that it should be allowed to include imputed income tax expense in its rates (and that it has done so in the past), it has not been accumulating imputed deferred income taxes.

At ¶28, the Initial Order directs the Company to "prepare a study of what the imputed accumulated deferred income tax balance would be, if the Company had previously been treated as a C corporation under a normalized tax accounting methodology" and to provide the study to Staff "before the next rate case." Staff notes that the Company's last rate increase (prior to the 2001 filing that was withdrawn, UW-010683) was more than 6 years ago.

The Company's rebuttal testimony asserts that the calculation of the deferred tax is "not a very difficult process" (Exhibit T-50, page 12, lines 18-27). In fact, Bench Request No. 5, issued to the Company before the hearing, requested the Company perform this calculation, and the Company declined to do so. *See* Exhibit 1, Company Response to WUTC Bench Request 5. Staff advocates that the Commission require the Company to prepare the study outlined in the

Initial Order and provide it to Staff within 90 days of the date the final order in this case is entered, or to include it in the Company's next rate filing, whichever is sooner.

B. Accounting For Rainier View's Ready to Serve Charges.

1. Staff Requests Clarification of the Initial Order's Statement About the Nature of Ready-to-Serve Revenues.

In its direct testimony, Commission Staff advocated that the Company be required to account for the revenue it collects from developers as "Ready to Serve" charges as operating revenue. The Initial Order does not require the Company to do so, but does require the Company to treat the Ready to Serve revenue as Contributions in Aid of Construction (CIAC). In doing so, the Initial Order makes the statement at paragraph 60 that "Ready to Serve Charges are not operating revenues."

Staff believes this statement is overly broad and could have consequences beyond this case. Many regulated water companies have a cost-based Ready to Serve (RTS) charge in their tariffs and collect RTS revenues as operating revenues to cover operating costs. Such RTS revenues are properly classified as operating revenues. Rainer View, by contrast, uses Ready to Serve charges in a very different way as set forth in the contracts entered into this case as Exhibit 17 and discussed on the record. *See, e.g.,* Exhibit T-15, page 39. Rather than making the broad statement included in the Initial Order at ¶ 60, Staff requests that the statement be modified as follows:

> "The Ready to Serve Charges ~~are not operating revenues.~~ as included in the contracts that Rainier View has entered into with developers which are included in Exhibit 17 in this case, are not operating revenues."

Limiting the conclusion about the nature of Ready to Serve charges to the manner in which Rainier View has used these charges is necessary to avoid confusion about the treatment of RTS revenues in different circumstances.

2. Rainier View Should be Directed to Prepare and File its Analysis of the Ready to Serve Fees Within 90 Days.

The effect of treating the Company's RTS revenues collected over the past several years as CIAC as the Initial Order recommends will likely have a major impact on the Company's rate base, level of equity, and possibly on its authorized rate of return. This is because the Company has recorded the RTS revenue as non-operating revenue, and used it to increase the owner's equity. When the RTS revenue is treated as CIAC, the conversion of the test year RTS revenue to CIAC will reduce the Company's rate base and the level of the owner's equity. The effect of the RTS revenues collected in the test year can be calculated and included in the Company's compliance filing in this case. Rainier View has used its RTS method since 1994. Staff believes the cumulative effect on the Company's rate base, equity, and rate of return should be examined as quickly as possible, rather than waiting for the Company to file a rate case.

As with the accumulated deferred tax, the Initial Order at ¶61 directs the Company to examine its prior records and identify the amount of RTS fees that were recorded as non-operating income and provide the analysis to Staff before the next rate case. The Company has the contracts compiled and available to it, as a result of this case, as they were submitted as Exhibit 17. The Company should be directed to prepare the study and to file it with Staff within 90 days of the date of the final order or to include it in the Company's next rate filing, whichever is sooner.

C. Staff Does not Contest the Initial Order's Decision to not Allow Working Capital

Staff has extensively reviewed and analyzed the determination in the Initial Order to deny the Company Working Capital, as there is no showing the Company has any Investor Supplied Working Capital. The working capital amount provided by Staff is derived from applying

formulas to the expenses in the income statement representing assumed net lags of expenses over associated revenues. As a consequence, as the pro forma income statement results change, the amount of working capital will change, under the formula approach. At ¶110 of the Initial Order, Staff is chastised for changing the amount of its recommended working capital allowance in its response to Bench Request No. 12 (Exhibit 75) without explanation. The number included in Exhibit 75 changed because the number is a result of a formula in a linked spreadsheet. Bench Request No. 12 asked Staff to provide certain calculations, including in its response the result of Staff's agreement with the Company on certain adjustments, such as the amount of Building Rent Expense. When those changes were made, the revised amounts flowed through to the calculations of other items (such as working capital) which also changed.

D. The Company's Cost of Equity Should be Set by Using the Debt Service Coverage Ratio, Not Simply by Accepting the Rate Used by the Company in its 1996 Rate Case.

Staff witness Danny Kermode, in his prefiled testimony, described the Discounted Cash Flow (DCF) analysis that he performed to determine the Company's cost of equity. Contrary to the conclusion of the Initial Order at ¶133, Mr. Kermode, on cross-examination, did not concede that "a number of companies" should not have been included in his DCF analysis. He did acknowledge that two of the companies, American Water Works, and E'town, would be excluded from such an analysis in the future, because they had been sold and are no longer publicly traded. In response to the question regarding American Water Works he responded "Now that it's out of the market, *any current one that I would try to run*, it would not be in there…" Tr. p. 344, lines 8-9 (emphasis added). In response to the question regarding E'town, Mr. Kermode states ".. if it's not publicly traded, you can't get information on it at all" again referring to the lack of future data. Tr. p.346, lines 9-10. The responses do not address in

anyway the validity of the filed DCF analysis, they clearly only refer to any *future* DCF analysis that Staff may prepare. Mr. Kermode did not acknowledge that it was inappropriate to include these companies in the DCF analysis at the time it was performed.

The Initial Order sets the Company's rate of return on equity at 12% based upon the Company's testimony, which was limited to a statement that "this is the number we used in the last rate case." (Tr. p. 92-93, Testimony of Doug Fisher). The last rate case this Company filed that resulted in a Commission order setting its rates was in 1996. That case was not an adjudicated case, but was the result of settlement. Staff does not believe the Commission should use the cost of equity from a 1996 rate case without any analysis of whether or not it is appropriate for this rate case.

Staff advocated, and continues to advocate, that the revenue requirement be set at a level sufficient to meet the Company's Debt Service Coverage Ratio (DSCR).[2] If the return on equity calculated in Mr. Kermode's DCF analysis provides adequate net operating income to meet the Company's required DSCR, the Company is entitled to that return on equity. That is, the Company should not receive *less* than the DCF calculated return of 10.81% shown in Exhibit 60.[3] However, setting the rate of return on equity at 10.81% produces a revenue requirement that does not provide the net operating income the Company needs to meet the DSCR. In this

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[2] The Initial Order confesses confusion as to why the Staff-proposed authorized return would change depending on whether the return is applied to an average or end-of-period rate base. Staff's proposal is based on DSCR, which requires a minimum net income in order to provide the needed coverage ratio. The DSCR approach is only necessary if the normal allowed cost of equity fails to provide the needed coverage. In other words, the minimum net income must remain constant regardless of the size of the rate base. Therefore, the return required on end-of-period rate base will be less than the return required on the smaller average rate base in order to produce the same net income amount.

[3] The Initial Order, at ¶133, states that "In brief, the Staff proposes a cost of equity capital of 16.05%, which had to be extrapolated from the Staff's Exhibit 75." The reason the number had to be extrapolated is that Staff did not, and does not, recommend a 16.05% return on equity. Staff recommended the Company's Revenue Requirement be set at a level sufficient to allow it to meet its DSCR.

circumstance, the Commission should use the Company's DSCR to determine the appropriate revenue requirement, as Staff recommended.

Normally, Staff uses a company's capital structure, cost of debt, and cost of equity to calculate the company's return. That is then used to calculate the company's revenue requirement. In this case, we *start* with the net operating income needed to meet the DSCR and use that to calculate the revenue requirement. Staff did not calculate a return on equity component because Staff did not need the return on equity to calculate the revenue requirement and rates. The return on equity is a result of the DSCR.

E. Staff Requests Clarification of How to Determine the Appropriate Cost of Debt When the Company's Debt has a Variable Rate of Interest.

The Initial Order sets the cost of debt using the average interest rate for the most recent 12 months (*See* Exhibit T-15, page 36) less the CoBank patronage refund amount. The language of the Initial Order at ¶137 states: "The cost of debt, particularly variable debt, should be based on an average of rates over a period of time." No time period is specified. Staff believes this potentially creates a win-win situation for companies that issue variable interest rate notes. If the average interest rate is lower than the current interest rate the company is actually paying, the company can apply for relief and should be granted recovery of interest expense at the current interest rate. If the average interest rate, imbedded in rates, is above the current interest rate that the company is paying, the company receives the higher rate of interest. If RVW does not care to bear the risk that interest rates will rise above the most current rate, then it should consider converting its variable-rate debt to fixed-rate debt. Staff requests clarification of whether it is the intent of the Commission that interest on variable-rate debt be based on the higher of the average rate over the most recent 12 month period, or the actual rate in effect at the time the company's rates are set.

F. The Initial Order Fails to Adjust the Company's Capital Structure for the Amount of RTS Revenues Converted to CIAC.

The Initial Order determined that the Ready to Serve revenues collected in the test year by the Company pursuant to its contracts with developers should be properly recorded as CIAC. The amount of CIAC that should be recorded in the test year is $154,066. Despite the determination that the (BEOY) average amount of $77,033 should be included in CIAC (Initial Order, ¶60), the calculations that accompany the Initial Order's determination of the Company's capital structure do not take this amount of CIAC, which reduces the Company's rate base, and the owners' equity, into account. Rather, the Initial Order, at ¶141, states that the Company's capital structure was extrapolated from the balance sheet in Exhibit 1, at September 30, 2001. This extrapolated capital structure does not include the BEOY average of Ready to Serve revenues the Company collected in the test year that the Order at ¶60 says should be included in CIAC. Including the $77,033 in the capital structure would change the capital structure used in the order of 61.76% debt and 38.24% equity changes to 62.55% debt and 37.45% equity. *See* Appendix 1, page 9.

G. Treatment of Rates for the Indian Springs Systems

Staff continues to have concerns that the reduction of the rates for the Indian Springs systems, as proposed by the Company and as proposed by the Initial Order, misstates the test year revenue received by the Company from customers on these systems. The Initial Order ("with some reservation" *See* ¶84) recommends approval of the Company's proposal to use a Proforma Adjustment (C-PA-2) to reduce its current operating revenues by $45,433 and net operating income by $28,478. However, at ¶83, the Initial Order states:

> 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**."

(Emphasis added). The Initial Order *does* recommend that the Commission authorize "a rate increase that is less than that proposed by the Company." In that case, using the logic of the next sentence of the Initial Order, perhaps Staff's analysis should be adopted by the Commission. However, Staff is confident that these issues can be sorted out with the Company in the determination of the design of the final rates.

H. Rate Case Expense

In Staff's prefiled testimony and Exhibits, Staff recommended that the Company should be allowed the amount of $29,550 for rate case costs, amortized over three years, as filed by the Company, instead of the $55,000 that the Company requested when it filed the Direct Testimony of Mr. Fisher. Staff included the amount of $9,833 for rate case expense in its proforma income statement. The Initial Order, at ¶85, states "Staff, on brief, appears to abandon its challenge to the Company's costs for this proceeding." The Initial Order allows the Company to collect $67,700 in rate case expense, a figure the Company provided with its rebuttal testimony.

Simply because Staff did not devote a separate section of its Posthearing brief to justifying its recommendation that its adjustment S-PA-7 be used, in preference to the Company's C-PA-4, does not mean that Staff abandoned the challenges raised in its testimony and exhibits. In those instances where Staff did change its position on an adjustment or an expense item, Staff specifically detailed its change of position, and its reasons for doing so. *See, e.g.,* Staff Posthearing Brief at page 17 (Building Rental Expense). Staff should not be regarded as having abandoned its opposition to these costs. If the Commission determines the requested

costs are reasonable, the order should reflect that determination, but not because Staff is mistakenly regarded as concurring in the Company's request.

I. The Value at Which Owner's Vehicle is Included in Rates is Miscalculated

The Initial Order, at ¶101, mischaracterizes the effect of the Company's proposal in Mr. Fisher's rebuttal testimony (Exhibit T-15, p.31, and Exhibit 22) to substitute the cost of a Ford Expedition as the vehicle used by the company owner. At ¶101, the Initial Order states that the Company is seeking to add the Navigator *at its current value* to rate base. This statement is incorrect. The Lincoln Navigator is a water company asset, included on its books already, and is already included in the Company's rate base. The Navigator is included in rate base *at original cost*, of $50,884, not at its value as a *used* vehicle as the Initial Order states.

The depreciation the Company has taken on the vehicle is based on that cost, not the *current depreciated* value. Therefore in stating at ¶101 that "The depreciated cost of the used Navigator is not materially different from the new value of the proxy vehicle," the Initial Order makes an invalid comparison. Allowing the Company to include the Navigator in rate base at the level it proposes adds the amount of $12,223 to rate base and includes approximately $3,300 annually in depreciation expense. If the Commission determines that there should be no adjustment to rate base and accumulated depreciation relating to the inclusion of the Navigator in rate base, then the final order should reflect that. However, the rationale used by the Initial Order to justify the level of expense should be modified.

Finally, Staff requests the Commission provide guidance to assist Staff in evaluating the prudence and reasonableness of company decisions to purchase "luxury" vehicles and including those costs in rates.

J. Summary and Conclusion

Commission Staff appreciates the careful review of the arguments and exhibits presented in this case, but requests that the Commission consider the areas raised above in order to insure that there is clear direction to Staff and regulated water companies about how such matters should be treated in future cases. Staff has included as Appendix 1 revised schedules to reflect the recommendations contained herein.

Respectfully submitted this 24th day of May, 2002.

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