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November 16, 2004

VIA HAND DELIVERY

Carole Washburn
Washington Utilities and Transportation Commission
1300 South Evergreen Park Drive SW
Olympia, WA 98504-7250

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STATE OF WASH.
UTIL. AND TRANSP.
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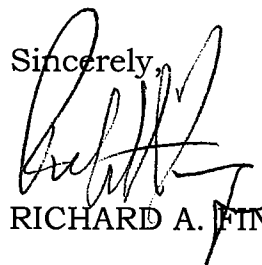
Re: American Water Resources, Inc. v. Washington Utilities and
Transportation Commission

Dear Ms. Washburn:

Enclosed are a copy of the Petition for Review and original Summons in
the above-referenced matter.

Thank you for your attention to this matter.

Sincerely,


RICHARD A. FINNIGAN

RAF/km
Enclosures

cc: Virgil Fox

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STATE OF WASH.
UTIL. AND TRANSP.
COMMISSION

**IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON
IN AND FOR THE COUNTY OF LEWIS**

AMERICAN WATER RESOURCES, INC.,

Petitioner,

v.

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Respondent.

CAUSE NO. 04-2-01618-3

SUMMONS

TO: THE RESPONDENT WASHINGTON UTILITIES AND TRANSPORTATION
COMMISSION.

AND TO: ATTORNEY GENERAL'S OFFICE.

A lawsuit has been started against you in the above-entitled Court by the Petitioner. The
Petitioner's claims are stated in the written Petition for Review, a copy of which is served upon you
with this Summons.

In order to defend against this lawsuit, you must respond to the Petition for Review by
stating your defense in writing, and by serving a copy upon the person signing this Summons within
twenty (20) days after service of this Summons, if service is made within the State of Washington,
or within sixty (60) days of service if service is made without the State of Washington, excluding

SUMMONS - 1

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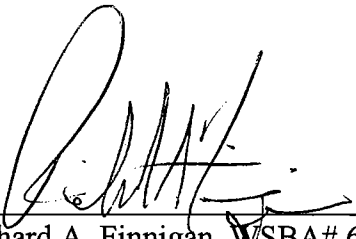
1 the day of service, or a default judgment may be entered against you without notice. A default
2 judgment is one where the Petitioners are entitled to what they are asking for because you have not
3 responded. If you serve a Notice of Appearance on the undersigned person, you are entitled to
4 notice before a default judgment may be entered.

5
6 You may demand that the Petitioners file this lawsuit with the Court. If you do so, the
7 demand must be in writing and must be served upon the person signing this Summons. Within
8 fourteen (14) days after you serve the demand, the Petitioners must file this lawsuit with the Court,
9 or the service on you of this Summons and Complaint will be void.

10 If you wish to seek the advice of an attorney in this matter, you should do so promptly so
11 that your written response, if any, may be served on time.

12 This Summons is issued pursuant to Rule 4 of the Superior Court Civil Rules of the State of
13 Washington.

14 Signed this 16th day of November, 2004.

15
16 
17 _____
18 Richard A. Finnigan, WSBA# 6443
19 Attorney for Petitioner

20 Richard A. Finnigan
21 2405 Evergreen Park Drive SW
22 Suite B-1
23 Olympia, WA 98502
24 Telephone: (360) 956-7001
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WSBA No. 6443

Attorney for Petitioners

SUMMONS - 2

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STATE OF WASH.
UTIL. AND TRANSP.
COMMISSION

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5 **IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON**
6 **IN AND FOR THE COUNTY OF LEWIS**

7 AMERICAN WATER RESOURCES, INC.,

8 Petitioner,

9 v.

10 WASHINGTON UTILITIES AND
11 TRANSPORTATION COMMISSION,

12 Respondent.

CAUSE NO. 04-2-01618-3

PETITION FOR REVIEW

13
14 COMES NOW THE PETITIONER, American Water Resources, Inc. ("AWRI" or
15 "Petitioner") and petitions for an order vacating and declaring invalid, and restraining the
16 enforcement of Order No. 8, the Final Order Dismissing Complaint Against Rates in Part,
17 Ordering Refund of "Docket Account" Set-Aside, and Denying Application for Mitigation of
18 Penalties in Docket Nos. UW-031284, UW-010961 and UW-031596 (consolidated) ("WUTC
19 Order") issued by the Washington Utilities and Transportation Commission (the "Commission" or
20 "WUTC").

21
22 The Commission issued its WUTC Order on November 1, 2004. A copy of the WUTC
23 Order is attached as Appendix A. This Petition is brought pursuant to RCW 34.05.570(3) and
24 RCW 34.05.514.

25
26 PETITION FOR REVIEW - 1

Law Office of
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Suite B-1
Olympia, WA 98502
(360) 956-7001

Pursuant to RCW 34.05.546, Petitioner states as follows:

1. The name and mailing address of the Petitioner:

American Water Resources, Inc.
921-B Middle Fork Road
Onalaska, WA 98570

2. The name and mailing address of the Petitioner's attorney:

Richard A. Finnigan
The Law Office of Richard A. Finnigan
2405 Evergreen Park Drive SW
Suite B-1
Olympia, WA 98502

3. The name and mailing address of the agency whose action is at issue:

Washington Utilities and Transportation Commission
1300 S. Evergreen Park Drive SW
P. O. Box 47250
Olympia, WA 98504-7250

4. Identification of the agency action at issue, together with a duplicate copy, summary or brief description of the agency action:

The agency action at issue is centered around the Commission's Final Order Dismissing Complaint Against Rates in Part, Ordering Refund of "Docket Account" Set-Aside, and Denying Application for Mitigation of Penalties in Docket Nos. UW-031284, UW-010961 and UW-031596 (consolidated). See, Appendix A.

5. Identification of persons who were parties to any adjudicative proceedings that led to the agency action:

The only party to the adjudication other than the Petitioner was the Staff of the agency. The address of the agency is set out under Paragraph 3, above.

1 6. Facts that demonstrate that the Petitioner is entitled to judicial review:

2 The Petitioner is a public service company, specifically a purveyor of water services and is
3 regulated by the Washington Utilities and Transportation Commission. Petitioner is aggrieved by
4 the WUTC Order set out on Appendix A. Petitioner was a party to the proceeding which resulted
5 in said WUTC Order and therefore is entitled to obtain judicial review of said WUTC Order.

6 7. The Petitioner's reasons for believing that relief should be granted:

7 Under RCW 34.05.570(3) relief from an agency order in an adjudicated proceeding is
8 appropriate if the order is in violation of constitutional provisions on its face or is applied, is
9 outside the authority or jurisdiction of the agency, the agency has erroneously interrupted or
10 applied the law, the order is not supported by evidence that is substantial when viewed in the light
11 of the whole record before the court, or the order is arbitrary or capricious, among other standards.
12 While not limiting the issues upon which Petitioner may seek review, at the very least, Petitioner
13 believes that the portions of the WUTC Order set out in Appendix A dealing with sharing of gain
14 on sale constitute an unconstitutional taking of Petitioner's property, are outside the statutory
15 authority or jurisdiction of the Commission to order such sharing of gain on sale with customers,
16 constitute an erroneous interpretation or application of the law, are not supported by evidence that
17 is substantial when viewed in light of the whole record, and is arbitrary or capricious.

18 8. Other matters in support of this claim:

19 This Court has jurisdiction over the parties and the subject matter of this proceeding
20 pursuant to RCW 34.05.514 and RCW 34.05.574. Pursuant to RCW 34.05.514 (1)(b), venue is
21 proper in Lewis County.

22 9. Request for relief:

23 Pursuant to RCW 34.05.574 and RCW 34.05.562, Petitioners request that the Court:
24
25
26

APPENDIX A

BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND)	
TRANSPORTATION COMMISSION,	)	DOCKET NO. UW-031284 &
	)	DOCKET NO. UW-010961
Complainant,	)	(consolidated)
)	
v.)	
)	
AMERICAN WATER RESOURCES,)	
INC.,)	
)	
Respondent.)	
.....)	
	)	DOCKET NO. UW-031596
In the Matter of the	)	(consolidated)
)	
Penalty Assessment Against Virgil R.	)	ORDER NO. 08
Fox, President, American Water)	
Resources, Inc., in the amount of	)	FINAL ORDER DISMISSING
\$3,700.00	)	COMPLAINT AGAINST RATES IN
	)	PART, ORDERING REFUND OF
	)	"DOCKET ACCOUNT" SET-ASIDE,
	)	AND DENYING APPLICATION
	)	FOR MITIGATION OF PENALTIES
.....)	

1 **Synopsis:** *The Commission finds that AWR failed to comply with the requirements related to the Docket Account and orders AWR to make a new tariff filing that refunds to customers the Docket Account balance of \$125,113 plus interest. The Commission determines that the portion of the complaint that alleges AWR's current rates and charges are excessive is not supported by the record and is dismissed. In addition, the Commission denies Mr. Fox's application for mitigation of penalties and orders payment of the \$3,700 penalty amount within 15 days of the entry of this order.*

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- 2 **Nature of the Proceeding:** Docket No. UW-031284, consolidated with reopened
Docket No. UW-010961, is a complaint filed on the Commission's own motion
against American Water Resources, Inc. The complaint alleges that AWR failed
to comply with the Order approving Settlement Agreement in Docket No. UW-
010961, and calls for an evaluation of AWR's rates.
- 3 Docket No. UW-031596, consolidated with Docket Nos. UW-031284 and UW-
010961, is a penalty assessment against Virgil R. Fox, President of AWR, for
failure to deposit required amounts in the "Docket 010961 Account" and for
unauthorized use of funds in the Docket 010961 Account. Mr. Fox filed an
application for mitigation of the penalty amount.
- 4 **Procedural history:** The matter was heard upon due and proper notice to all
interested parties before Administrative Law Judge (ALJ) Karen Caillé on April
26 and 27, 2004, in Olympia, Washington.
- 5 **Appearances:** The parties appeared as follows: Respondent, American Water
Resources, Inc. (AWR or Company), by Richard A. Finnigan, attorney, Olympia;
Commission Staff (Staff), by Lisa Watson, Assistant Attorney General.

I. MEMORANDUM

A. BACKGROUND

- 6 American Water Resources, Inc., is a public service company subject to the
jurisdiction of the Washington Utilities and Transportation Commission
(Commission). AWR originated in March of 1995 to focus on the management of
small water systems. AWR grew rapidly and reached 157 systems serving
approximately 2,000 residents in its first four years of operation. After

consolidating, AWR now serves 1,500 customers over 130 systems in several counties.

7 **Docket No. UW-010961.** AWR's most recent prior general rate case, Docket No. UW-010961 concluded on December 18, 2001, with the Commission's Order Approving Settlement Agreement (Order), which incorporated the terms of a settlement agreement between AWR and Commission Staff.

8 The Order required AWR to deposit \$4.40 per month from each payment received from a customer into a separate account named the "Docket 010961 Account" (Docket Account). The Order specified that AWR must use the money in the Docket 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 monthly average spent during the test period. The monthly averages were calculated as \$17,447.00 for Salary, \$2,727.00 for Transportation, \$4,662.00 for Payroll Tax and Benefits, and \$917.00 for Business Consulting.

9 In January 2002, shortly after the Order was entered, AWR sold View Royal. The Company applied the proceeds of the sale to reduce debt. The rates generated by the lower level of remaining customers were not adequate to fund the base-line seven employees required to trigger use of the money in the Docket Account. Thus, AWR could not use the funds from the Docket Account.

10 In the summer of 2002, AWR approached Staff with a proposal that would allow the Docket Account funds to be used to pay for the existing operations of the Company. Staff informed the Company it did not agree with AWR's proposal, and advised the Company that additional analysis was required before any changes could be made. On November 19, 2002, AWR filed a letter with the Commission requesting that the Commission remove the restrictions on the Docket Account to allow the Company to use the current billed revenue to pay

current operating expenses. On January 23, 2003, AWR withdrew its request. In the late spring or early summer of 2003, AWR brought a second proposal to Staff. Staff did not agree with that proposal, either. AWR never asked the Commission to cancel collection of the \$4.40 set-aside.

- 11 **Docket No. UW-031284.** On August 13, 2003, the Commission reopened Docket No. UW-010961 and issued a complaint against AWR, designated as Docket No. UW-031284, to determine whether AWR failed to comply with the Order's requirements related to the Docket 010961 Account. The complaint asks that the Commission evaluate whether AWR's current rates and charges provide the Company with an excessive return, determine whether the Order should be amended to impose a refund obligation upon AWR, determine whether the set-aside obligation imposed in Docket No. UW-010961 should be canceled, and determine whether AWR should be required to make a new tariff filing reducing rates. On August 22, 2003, the Commission entered an order that consolidated Docket Nos. UW-031284 and UW-010961.
- 12 On September 9, 2003, the Commission convened a prehearing conference before ALJ Karen Caillé. Among other things, the ALJ invoked the discovery rule, granted a request for a protective order, and established a procedural schedule. Commission Staff filed and discussed a Motion for Order Amending Commission Order Accepting Settlement Agreement dated December 18, 2001 (Motion). The Motion requested that the Commission amend its Order to require AWR to refund or credit its customers for funds collected and required to be deposited into the Docket 010961 Account, but not used for the purposes for which they were collected. In addition, Staff orally requested that the Order be amended to release AWR from the obligation to file a rate case by December 18, 2003, since Commission Staff would prefile its testimony in this complaint proceeding on December 16, 2003, and this proceeding will review the Company's rates.

- 13 On September 26, 2003, Commission Staff and AWR filed a proposed partial settlement agreement (Partial Settlement) for the Commission's approval as a partial resolution of the issues in the proceeding, and a full resolution of the issues raised in Staff's Motion. The Partial Settlement would discontinue the monthly set-aside amount of \$4.40 collected from customers, and would credit each customer \$7.10 for funds collected and inappropriately used between August 13, 2003, and October 1, 2003. Commission Staff and AWR agreed to waive an initial order, and present the matter directly to the Commission for final decision. On October 1, 2003, the Commission entered an order approving and adopting the Partial Settlement.
- 14 **Docket No. UW-031596.** At the Commission open meeting of October 8, 2003, Commission Staff recommended that the Commission issue a penalty assessment of \$4,100.00 against Virgil Fox, President of AWR. Staff's recommendation was based on eleven violations of the Commission's Order in Docket No. UW-010961, including AWR's failure to make required deposits to the Docket Account for the months of June –November 2002, and for unauthorized use of Docket Account funds for the months of June 2002 – September 2002 and June 2003. The Commission continued the matter to October 22, 2003, to allow Mr. Fox time to review Staff's recommendation.
- 15 On October 22, 2003, Commission Staff presented a revised penalty assessment recommendation of \$3,700 against Mr. Fox, based on seven violations relating to AWR's failure to deposit required amounts in the Docket Account for June 2002, July 2002, August 2002, September 2002, October, 2002, November 2002, and for unauthorized use of funds for June 2003. The Commission entered an order issuing a penalty assessment of \$3,700.
- 16 On November 6, 2003, Mr. Fox filed an application for mitigation of penalties. By order entered on February 2, 2004, the Commission consolidated Docket No. UW-031596 with Docket Nos. UW-031284 and UW-010964.

- 17 Evidentiary hearings on the issues in consolidated Docket Nos. UW-031284, UW-010961, and UW-031596 were conducted before ALJ Caillé on April 26 and 27, 2004. The testimony and exhibits of the following witnesses were admitted into the record: James Ward, WUTC Regulatory Analyst, Eugene Eckhardt, WUTC Assistant Director of Transportation and Water, and Denise Lahmann, Regional Manager for Southwest Drinking Water Operations for the Department of Health, on behalf of Commission Staff; Virgil Fox and Julia Parker, on behalf of AWR.
- 18 The record consists of 325 transcript pages and 126 exhibits, including prefiled direct and rebuttal testimony, and responses to Bench and Record Requests. AWR and Commission Staff filed Opening Briefs on June 18, 2004, and Response Briefs on July 9, 2004.

B. ISSUES

- 19 Issues in this proceeding include treatment of the Docket 010961 Account, treatment of gain from sales of the View Royal and Birchfield water systems, the appropriate level of employee expenses, officer salary, and rate case expense, and determination of whether the penalty assessment against Mr. Fox should be reduced.

C. POSITIONS OF THE PARTIES

- 20 Commission Staff recommends that the Commission order AWR to lower its current rates by \$100,555 annually, which would result in a decrease of AWR's average monthly residential rate from \$33.07 to \$27.38. Staff also recommends that the Commission deny Mr. Fox's application for mitigation and order that he pay the entire penalty amount.

21 AWR contends that Commission Staff has failed to carry its burden of proof in the complaint proceeding. Rather, the Company believes that it has demonstrated that for rates to be fair, just, reasonable, and sufficient an increase in rates is required. In addition, Mr. Fox asserts that the penalty assessment is miscalculated, and asks the Commission to take into account the totality of the circumstances and further mitigate the penalties assessed against him.

D. DISCUSSION AND DECISION

1. Principles of Utility Rate Setting

22 The ultimate determination to be made by the Commission in this matter is whether American Water's current rates and charges 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.

23 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.

2. Test Year

24 The parties have used the 12 months ending June 30, 2003, as the test period for investigation of the Company's operations for purposes of this proceeding. The use of the 12 months ending June 30, 2003, as the test year is appropriate and is adopted for this Order.

3. Treatment of Federal Income Tax

25 Federal Income Tax rates vary depending on the size of taxable income.¹ Both parties in this case use a Federal Income Tax Rate of 15%, which appears appropriate and will be adopted for this Order.

¹ Exhibit No. 202.

4. Rate Base and Results of Operations

a. Rate Base

26 The appropriate rate base is derived from the balance sheets of the test period. This rate base may require adjustment to reflect an appropriate rate base for ratemaking purposes. 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.

b. Results of Operations

27 The Company's results of its regulated operations during the test year form the basis for the analysis on which the Commission determines whether the Company needs additional revenues. This determination is made after all appropriate adjustments are made to the test period results of operations. These adjustments are for unusual events or conditions during the test period that are inappropriate to consider in ongoing rates (restating adjustments), and for known and measurable events that will occur prospectively (pro forma adjustments), to best estimate the relationship between the Company's costs and revenues and thus establish rates that are fair, just, and reasonable and allow the Company the opportunity to earn a fair rate of return. Both parties' statements of results of operations contain proposed restating and pro forma adjustments.

i. Uncontested Adjustments

28 The parties agreed to the actual results of operations for the test year and the dollar impacts of the uncontested adjustments to net operating income and rate base. Table 1 shows uncontested adjustments, which were not the subject of

contest by any party, and are accepted as reasonable for purposes of this proceeding.

TABLE 1: AMERICAN WATER RESOURCES, INC. ACTUAL RESULTS OF OPERATIONS & UNCONTESTED ADJUSTMENTS FOR THE 12 MONTHS ENDED JUNE 30, 2003					
Ln #	Description	Per Staff		Per Company	
		Total Net Operating Income	Total Rate Base	Total Net Operating Income	Total Rate Base
	(A)	(B)	(C)	(D)	(E)
1	Actual Results of Operations ²	\$84,761	\$841,448	\$84,759	\$920,616
2	RB-1 Adjust to BEOY Rate Base		78,487		
3	Actual Results w/BEOY Rate Base	84,761	919,935	84,759	\$920,616
4	Rate of Return w/BEOY Rate Base		9.21%		9.21%
	Uncontested Adjustments:				
5	RA-01 Remove Non-Oper. Income	(11,108)	0	(11,108)	0
6	RA-02 Remove IRS Penalty	2,597	0	2,597	0
7	RA-03 Remove Accounting Exp. ³	3,826	0	3,604	0
8	RA-04 Non-Recurring Legal Exp.	2,904	0	2,904	0
9	RA-05 Out of Period Adjust - VR	37,364	0	37,364	0
10	RA-07 Amort. Misc. Deferred Debit	0	6,467	0	6,467
11	RA-08 Dedicated Checking Adj.	0	36,367	0	36,367
12	RA-09 Adj. CIAC & Accum Amort.	0	(59,515)	0	(59,515)
13	RB-2/RA-10 Remaining Surcharge		(267,661)		(267,661)

² The amount of rate base in Table 1, line 1, columns (c) and (e) differs because Staff did not adjust to an average rate base until it made Adjustment RB-1, "Adjust to BEOY Rate Base" while the Company's presentation begins with an average rate base. After adding Staff's adjustment RB-1, the amounts on line 3 are comparable. The differences on line 3 are immaterial. This order will adopt the Company's per book amounts showing a 9.21% return on average rate base.

³ There is an immaterial difference between Staff and Company of \$222 for adjustment RA-3 at the net operating income level. Staff does not argue this difference in brief. The Company's adjustment will be adopted for this order.

14	RA-11 Adjust Acquisition Adjust.	(5,091)	176,974	(5,091)	176,974
15	P-01 Adj. for Over-Stated Revenue	(1,104)	0	(1,104)	0
16	P-02 Docket 010961 Decrease	(78,976)	0	(78,976)	0
17	P-07 Pierce County Permitting Fees	(2,090)	0	(2,090)	0
18	Total Uncontested Adjustments ⁴	<u>(\$51,678)</u>	<u>(\$28,881)</u>	<u>(\$51,900)</u>	<u>(\$107,368)</u>

ii. **Contested Rate Base Adjustments**

29 Four Staff-proposed ratemaking adjustments to Average Rate Base were contested at hearing. These include two adjustments, related to an asserted regulatory liability from Docket No.UW-010961: Restating Adjustment RA-6, which removes from rate base the amount of the regulatory liability totaling \$125,113, and Rate Base Adjustment RB-5, which amortizes the regulatory liability over two years. The other two proposed adjustments address alleged gains on sale of water systems: Rate Base Adjustment RB-3, which allocates gain from the sale of the View Royal water system, and Rate Base Adjustment RB-4, which allocates the apparent gain from the sale of the Birchfield water system. In combination, the four adjustments would reduce AWR's rate base to roughly half of that proposed by the Company.

1) Treatment of Docket 010961 Account set-aside for specific purpose, Pro Forma Adjustment, P-05, Restating Adjustment RA-06, Rate Base Adjustment, RB-5.

30 In Docket No. UW-010961, AWR requested rates to fund two additional employees needed for the Company's operations. The Commission approved and adopted a settlement agreement between Staff and AWR which resulted in a monthly rate increase of \$3.47. One of the settlement terms and conditions approved and adopted by the Commission required the Company to set aside

⁴ Totals include line 2 amounts. Without line 2, amounts in column (C) and (E) would both be \$107,368. See explanation in footnote 2.

\$4.40 from each monthly payment received, and to place this money in a separate bank account titled "Docket 010961 Account."⁵ The \$4.40 set-aside amount was earmarked for use to cover only those expenses for employees hired in addition to existing employee positions, and related benefits and expenses.⁶

31 AWR's sale of View Royal eliminated the need for the projected two additional employees for which the Commission established the Docket 010961 Account. Despite this change in circumstances, AWR continued collecting the \$4.40 set aside amount from each of its customers for approximately 21 months. As a result, money accumulated in the Docket Account.

32 Staff argues the Commission's Order in Docket No. UW-010961, specifying that the funds in the Docket Account be used only for expenses associated with the hire of two additional employees, created a regulatory liability obligation. Because AWR did not spend the set-aside money to hire the two additional employees, the regulatory liability obligation imposed by the Commission's Order remains. The Commission must decide how AWR will satisfy this regulatory liability obligation.

33 According to Staff, the total amount that should be in the Docket Account is \$125,113. Currently, the Docket Account has a balance of \$51,762. Staff reports that AWR improperly spent \$68,061, which included \$66,258 for taxes attributed to the gain on sale of View Royal, and income taxes associated with the Docket Account. In addition, AWR collected \$5,290 from customers that it never deposited.⁷

⁵ This resulted in a \$0.93 monthly rate decrease for AWR's then-current operations.

⁶ *WUTC v. American Water Resources, Inc., Order Approving Settlement Agreement*, at ¶19 (December 2001)

⁷ Staff Initial Br. pp. 8-9

- 34 AWR argues that it should be allowed to use the Docket Account funds to pay accounts payable and income tax resulting from the funds accumulating in the Docket Account. Staff opposes this approach because the funds were granted for a specific purpose (employee expenses) and had very specific restrictions to prevent AWR from using the funds for something other than employee expenses.
- 35 Staff argues that AWR likely does not owe tax on the accumulation of funds in the Docket Account. Staff contends that because the Commission restricted the use and the handling of the Docket Account funds, AWR does not have a claim of right to the money. According to Staff, the Docket Account funds are not taxable until AWR uses the funds for a Commission-sanctioned purpose.⁸ Alternatively, Staff argues that even if AWR owes tax on the Docket Account funds, the tax is a direct result of Mr. Fox's imprudent business decisions that resulted in AWR's inability to use the funds for the purpose intended.
- 36 Staff recommends that the Commission order AWR to use the funds for employee expenses because they were originally intended for this purpose.⁹ To offset AWR's current employee expenses with the Docket Account funds, Staff recommends that the funds should be normalized over two years. Staff asserts that two years is the appropriate time frame because AWR collected the funds over approximately two years.
- 37 Staff offers a series of adjustments through which this treatment is achieved. Staff normalizes the regulatory liability obligation over two years as reflected by Pro Forma Adjustment P-05, which offsets AWR's employee expenses by \$62,557, which is one-half of the regulatory liability obligation.¹⁰ Restating Adjustment RA-06 reduces AWR's rate base by the regulatory liability obligation

⁸ *Mutual Tel. Co. v. United States*, 204 F.2d 160, 161 (1953); Staff Initial Br. pp.10-11.

⁹ Staff Initial Br. 11

¹⁰ Staff, Exhibit No.. 206, Revised response to Bench Request No. 1 at column I, row 31.

amount, \$125,113.¹¹ To recognize the two-year amortization, Rate Base Adjustment RB-5 increases rate base by \$62,557.¹² Staff also reduced AWR's equity by \$125,113 to reflect the regulatory liability obligation.¹³

38 AWR argues that the practical effect of Staff's approach is to substantially reduce the revenues the Company has available to pay employees during the two-year normalization. AWR explains that the reason the cash-flow issue arises is that the money from the Docket Account was used to pay taxes associated with the sale of View Royal and from the creation of the Docket Account itself, i.e., that the revenues received were treated as income for federal income tax purposes.¹⁴ AWR acknowledges that the reason there was a tax bill associated with the View Royal sale is that Ms. Parker made an honest mistake. She believed there was sufficient net operating loss carry-forward to cover any tax on the gain from the sale of View Royal. Thus, instead of setting aside a portion of the proceeds to cover tax liability, all of the proceeds of View Royal were used to reduce the debt obligations of the Company.

39 AWR argues that given that a tax liability for the Company occurred, and that the funds from the View Royal sale were used to reduce debt pursuant to Commission direction, it is appropriate to allow the use of those funds from the Docket Account to satisfy the Company's tax obligation.¹⁵

40 AWR questions Staff's position that by treating the receipts in the Docket Account as a regulatory liability obligation, the tax consequences are avoided. AWR argues that Staff's position on the Docket Account is suspect in light of Mr. Ward's refusal to commit that, if the IRS determined an income tax is owed, Commission Staff would recommend that any penalties and interest be

¹¹ Staff, Exhibit No. 206, Revised response to Bench Request No. 1 at column E, row 54.

¹² Staff, Exhibit No. 206, Revised response to Bench Request No. 1 at column H, row 54.

¹³ Ward, Exhibit No. 41T at 51:10-13.

¹⁴ AWR Initial Br. pp. 22-23.

¹⁵ AWR Initial Br. p. 23.

considered a regulatory expense.¹⁶ AWR also argues that since the Docket Account is not stated separately, but is part of general rates, and the funds have already been collected, Staff's proposal applies a hindsight rather than a prospective analysis.¹⁷ According to AWR, Commission Staff's proposal for the Docket Account will place the Company in a position where it cannot operate in a way that allows it to provide service to the customers at an acceptable level.¹⁸

Commission Discussion and Decision

41 We agree with Staff's analysis that the \$4.40 set-aside constitutes a regulatory liability obligation. In our *Order Approving Settlement Agreement* we earmarked the \$4.40 for a specific purpose, to cover expenses for employees hired in addition to the existing employee positions. We ordered AWR to set aside \$4.40 from each monthly payment received, and to separate and maintain this money in a separate bank account titled "Docket 010961 Account." The sale of View Royal caused rates generated by the lower level of remaining customers to be inadequate to fund the base-line seven employees required to trigger use of the money in the Docket Account. Despite this change in circumstances, AWR continued to collect the monthly set-aside for approximately 21 months. Staff's analysis shows that the total amount that should be in the Docket Account is \$125,113. Since the purpose for which we created the set-aside no longer exists, we must determine how AWR will fulfill its regulatory liability obligation.

42 AWR suggests that it be allowed to use the Docket Account funds to pay accounts payable and federal taxes. We reject this proposal because the funds were collected from customers for a specific purpose, to fund employee expenses for newly hired employees.

¹⁶ Tr. 148, l.3-149, l. 19.

¹⁷ Tr. 149, l. 22-150, l. 1.; AWR Initial Br., p. 25.

¹⁸ AWR Initial Br., p. 12.

43 Staff recommends that we order AWR to use the Docket Account funds to offset current employee expenses because this is in keeping with the purpose for which the Docket Account was originally intended. While we acknowledge that Staff's proposal is a logical option, we believe that a fairer treatment to the customers calls for a refund of the Docket Account funds to the customers. Since the purpose for which the Docket Account was created no longer exists, the funds should be returned to the ratepayers.

44 Accordingly, we direct AWR to file a tariff five (5) days after the entry of this order that will refund to customers \$4.40 per customer per month until the Docket Account balance of \$125,113 plus interest is reduced to zero, at which time the Company should file to terminate the tariff schedule. Interest will be compounded monthly using the accepted debt rate from this proceeding of 7.53%.

45 In light of our treatment of the Docket Account funds, we do not accept Staff adjustments P-05, RA-06, and RB-5. Nor will we reduce equity by the amount of the regulatory liability obligation. Ratepayers are made whole with refunds of the amounts contributed plus interest as a result of our treatment of the Docket Account. Decreasing equity in addition to issuing refunds plus interest would result in a return plus, which we do not find fair or reasonable.

2) View Royal Gain on Sale, Rate Base Adjustment RB-3

46 Staff proposes an adjustment allocating gain from the sale of the View Royal water system between the shareholder and ratepayers. Staff recommends that the Commission reduce AWR's rate base by the amount of the gain on sale allocated to the ratepayers.¹⁹ AWR sold View Royal to Valley Water District in January 2002 for \$500,000, which exceeded rate base by \$335,550. According to

¹⁹ Staff Br. p. 39, Exhibit No. 40T at 24.

Staff, the net gain on sale is \$287,265, which incorporates Staff's recommendation regarding the acquisition adjustment discussed below.

- 47 Staff asserts that allocating the gain between the shareholder and ratepayers is appropriate because both the shareholder and ratepayers shared in the purchase cost and the cost of improvements. When AWR purchased it, View Royal's rate base was \$10,192. While View Royal was devoted to public service, its rate base increased to reflect items such as maintenance and capital upgrades. At the time of sale, View Royal's rate base was \$164,450.²⁰
- 48 Staff recommends that the Commission rely on the broad principle, as articulated in the *Centralia Case*,²¹ that reward should follow risk, and benefit should follow burden, and allocate the gain according to AWR's capital structure. Staff proposes the allocation be made using a four-year averaging of AWR's capital structure, the same method used to allocate the gain AWR was allowed from the sale and transfer of assets of 21 systems to Peninsula Light.²² According to Staff, the four-year average of AWR's capital structure results in 97.9 percent debt and 2.1 percent equity.²³ The amount of gain allocated to ratepayers would correspond with debt and totals \$281,232. The amount allocated to the shareholder would correspond with equity and totals \$6,033.²⁴
- 49 As an alternative to the use of capital structure to allocate gain, Staff recommends that the Commission use a symmetry-of-risk analysis. Symmetry of risk allocates the benefits and burdens of the transaction based on the proportion

²⁰ Ward, Exhibit No. 41T at 28.

²¹ *Centralia Case*, Docket Nos. UE-991255, UE-991262, and UE-991409 (Consolidated), Second Supplemental Order.

²² *In the Matter of the Application for the Sale and Transfer of Assets from AWR to Peninsula Light Company*, Docket UW-010417, Order Granting Application for Sale and Transfer of Assets and Tariff Adoption; Ward, Exhibit No. 41T at 27:7-9.

²³ Ward, Exhibit No. 71.

²⁴ Staff Initial Br. p. 41.

of cost for which the shareholder and ratepayers were responsible.²⁵ Under symmetry of risk, the ratepayers' burden equals the amount included in rate base. The shareholder's burden equals the amount excluded from rate base. In this case, at the time of the sale, the amount included in rate base for View Royal was \$164,450, and the amount not included in rate base was \$164,808. Thus, the total cost for View Royal was \$329,258; the ratepayers carried 49.95 percent of the burden, and the shareholder carried 50.05 percent.²⁶ Staff's symmetry-of-risk analysis removes the acquisition adjustment from the calculation and arrives at a net gain of \$287,265. Thus the allocation of gain to ratepayers is \$143,489, while the shareholder's allocation is \$143,776.

- 50 Staff cautions that the Commission's decision regarding the allocation of gain affects AWR's acquisition adjustment, Restating Adjustment R-11, discussed below. View Royal was purchased at a premium. Accordingly, AWR's shareholder should be rewarded through either the acquisition adjustment or gain on sale, but not both.
- 51 If the Commission accepts Staff's primary recommendation to allocate gain using capital structure, Staff suggests that AWR be allowed the acquisition adjustment, since under Staff's primary recommendation, the shareholder will receive the benefit from the balancing achieved through the acquisition adjustment, but not from gain on sale.
- 52 If the Commission adopts Staff's alternative recommendation, Staff suggests that the acquisition adjustment be rejected, since under the symmetry-of-risk analysis, the shareholder receives the benefit from gain on sale, and no balancing through the acquisition adjustment is needed.

²⁵ Ward, Exhibit No. 41T at 29:9-12.

²⁶ Staff Initial B. p.42.

53 AWR does not believe any gain on sale adjustment is appropriate based on the circumstances of this case, specifically, that the shareholder did not retain any of the gain. AWR applied all the proceeds from the sale to retire Company debt. According to AWR, the theory for gain-on-sale adjustment is that the ratepayers, through paying for depreciation in rates have helped pay for the asset and therefore should be entitled to some portion of the gain.²⁷ AWR suggests that that theory holds less viability when, as here, the asset is held for only a short period of time,²⁸ and the Company is attempting to respond in a way that it reasonably perceives is the direction the Commission desires the Company to move.²⁹

54 AWR notes that over the five years from purchase of View Royal with a rate base of \$10,192, to its sale with a rate base of \$164,450, Mr. Fox invested approximately \$155,000 in new facilities in the system. AWR observes that the average rate base over the five years was \$77,129. AWR argues that, assuming the plant has an average life of thirty years, the customers paid approximately \$13,000 in depreciation associated with the plant. According to AWR, that amount, if anything, is the customers' share.³⁰

55 AWR argues that because it applied all the proceeds from the sale of View Royal to retire Company debt, the customers benefited from the safer capital structure that the Commission ordered AWR to obtain, and Mr. Fox benefited from the higher return on equity.

²⁷ AWR Initial Br. at 17.

²⁸ AWR's predecessor company purchased View Royal in February 1997. Ward, Exhibit No. 40T at 21.

²⁹ In the Sixth Supplemental Order in Docket Nos. UW-980072, UW-980258, and UW-980265 (consolidated) and Docket No. UW-980076 (Sixth Supplemental Order) the Commission severely criticized AWR about its capital structure and the fact that Mr. Fox was the primary debt holder.

³⁰ AWR Initial Br. at 21

- 56 Staff disagrees with AWR's contention that the theory behind the allocation of gain between ratepayers and shareholders rests on ratepayers' payment for assets through paying depreciation in rates. Rather, Staff asserts that the allocation of gain rests essentially on equitable considerations.³¹ Staff argues that investors do not have an absolute right to the appreciation of value accruing while the utility property is devoted to service. According to Staff, an investor who has shielded himself from the risk of loss or has already been rewarded for taking the risk does not have a strong claim to the gain.³²
- 57 Staff argues that Mr. Fox has shielded himself from risk. AWR purchased View Royal in 1996 or 1997 for a premium.³³ Staff suggests that it is likely that the funds used to purchase View Royal were from loans made by Mr. Fox to AWR.³⁴ Staff explains that by holding debt, Mr. Fox shielded himself from the risk of loss.³⁵ In addition, AWR's capital structure was almost exclusively debt, placing very little risk on Mr. Fox, and further shielding him from the risk of loss because he had such a small amount of equity. In contrast, the ratepayers bore the burden of the debt, because the Commission did not allow the premium amount in rate base, and thus AWR carried more debt than rate base for View Royal.³⁶
- 58 Likewise, Staff challenges AWR's argument that the gain should not be allocated because the sales proceeds were used to retire Company debt held by Mr. Fox, leaving only bank debt. Staff argues that retiring debt held by Mr. Fox allowed Mr. Fox to receive the substantial \$287,265 gain as equity. Staff notes that the

³¹ Staff Reply Br., p. 20; *Democratic Central Committee v. Washington Metropolitan Area Transit Commission*, 485 F. 2d 786, 821 (1973), *reh. denied, cert. denied*, 415 US 935 (1973).

³² Staff Reply Br., p. 20, *Democratic Central*, 485 F.2d at 800-802, 806.

³³ Fox, Tr. 280:18-21.

³⁴ Fox, Exhibit No. 120T at 14, Parker, Exhibit No. 100T at 24.

³⁵ *Consolidated 1998 Dockets*, Sixth Supplemental Order at 9.

³⁶ Staff Reply Br., pp. 20-21.

proceeds were insufficient to pay off the entire amount owed to Mr. Fox, and that Mr. Fox drew on AWR's line of credit to pay the balance.³⁷

59 Finally, Staff responds that AWR's customers have not benefited from the View Royal sale. Staff argues that Mr. Fox sold AWR's best, most profitable system, and he did so knowing the Company's cash flow would be adversely affected. According to Staff, AWR experienced a \$12,000 to \$13,000 net average monthly revenue reduction as a result of the sale.³⁸

Commission Discussion and Decision

60 We agree with Staff that the allocation between the shareholder and customers of the gain on sale of in-service utility assets rests essentially on equitable considerations. The allocation process necessitates a sensitive balancing of the interests of the shareholder and ratepayers in view of the particular circumstances of the case.

61 In the circumstances of the sale of View Royal, we adopt Staff's symmetry-of-risk analysis to arrive at the appropriate allocation of the gain between the shareholder and ratepayers. Our review of the record brings us to the same conclusion as that of Staff - that the shareholder has shielded himself from the risk of loss and therefore does not have a strong claim to the gain.

62 Our calculation of the symmetry of risk parallels Staff's in the use of the \$164,450 book value of rate base at the time of sale as the ratepayers burden. Unlike Staff, however, we attribute the book value of the acquisition adjustment at the time of sale of \$66,256³⁹ to the shareholder as his burden. We note that since the total debt from the original purchase was being funded by the Company, including

³⁷ Staff Reply Br., pp. 21-22.

³⁸ Staff Reply Br., pp. 23-24.

³⁹ Exhibit No. 71, 1.27.

the acquisition adjustment, the shareholder was under virtually no risk unless the Company was not able to meet the loan obligations. Our calculation results in a customer allocation of gain of 71.28 percent of the net gain of \$221,010 or \$157,539, and the shareholder portion equals 28.72 percent or \$63,471. We note that our use of the symmetry-of-risk analysis to allocate gain between the ratepayers and the shareholder is based on the circumstances of this particular case, and is not meant to establish a preferred methodology for use in future cases.

3) Birchfield Gain on Sale, Rate Base Adjustment RB-4

63 Staff proposes an adjustment to rate base to allocate the gain from the sale of the Birchfield water system. The Lewis County Utility Corporation (LCUC), owned by Mr. Fox, originally devoted Birchfield to public service in July 1996.⁴⁰ That same year, Mr. Fox changed LCUC to AWR, and he received common stock and a note payable when Birchfield was incorporated into AWR.⁴¹ During the period between 1997 and 1999, Mr. Fox began to construct the water system infrastructure for Birchfield Master Planned Community.⁴²

64 In September 2003, Lewis County Water and Sewer District No. 5 purchased Birchfield for \$325,000.⁴³ Rate base for Birchfield was \$57,500. A promissory note was issued to AWR in the amount of \$57,500 and the buyer assumed a debt obligation of \$11,500.⁴⁴ A second note was issued to Mr. Fox and his wife for \$256,500.⁴⁵ The Bill of Sale to AWR describes and values the facilities as those associated with the Birchfield Mobile Home Park, and the Fox residence, cottage,

⁴⁰ Fox, Exhibit No. 120T at 37:2-4.

⁴¹ Parker, Exhibit No. 100T at 26:1-2;Tr. 204-205.

⁴² Fox, Exhibit No. 120T at 37.

⁴³ Mr. Fox signed the sales contract on behalf of AWR as sole owner and President of AWR, on behalf of the LCWSD#5 as President of LCWSD#5, and as an individual. Ward, Exhibit No. 40T at 27.

⁴⁴ Exhibit No. 57 at 14-15.

barn, and shop.⁴⁶ The Bill of Sale to Mr. and Mrs. Fox describes and values the facilities as three wells and associated water rights, and all piping, valves, hydrants and equipment necessary for the operation of the system installed in Birchfield Parkway and Birchfield Division II.⁴⁷

65 Staff argues, based on documents submitted by AWR to three different state agencies (the Commission, the Department of Ecology, and Department of Health) that Birchfield is one water system consisting of three wells and associated water rights owned by AWR.⁴⁸ Based on its understanding that AWR owned Birchfield as a single water system consisting of three wells and the associated infrastructure, Staff argues that the amount of the purchase price exceeding rate base is gain to be allocated between the shareholder and ratepayers.⁴⁹

66 Staff accounts for an investment of \$78,428 by Mr. Fox in Birchfield⁵⁰ and arrives at a net gain from the sale of Birchfield of \$139,597.⁵¹ The gain is calculated by subtracting from \$256,500 (the amount over rate base) the tax and escrow costs totaling \$38,475, and the additional investment totaling \$78,428. Staff proposes that the gain be allocated between the shareholder and ratepayers in the proportion of equity and debt, respectively, according to a four-year averaging of AWR's capital structure, the method used to allocate the gain AWR was allowed from the sale of systems to Peninsula Light.⁵² According to Staff, the four-year averaging of AWR's capital structure results in 94.5 percent debt and 5.5 percent equity. The proportional amount allocated to ratepayers totals \$131,945. The

⁴⁵ Exhibit No. 57 at 16-17

⁴⁶ Exhibit No. 57 at 18.

⁴⁷ Exhibit No. 57 at 21-22.

⁴⁸ Staff Initial Br. p. 35; Exhibit Nos. 73-77 (Ward), Exhibit No. 17(Lahmann).

⁴⁹ Staff Initial Br. p. 35.

⁵⁰ Ward, Tr. 167-173; Exhibit Nos. 142 and 143.

⁵¹ See updated calculation of the gain from the sale of Birchfield supplied as Attachment 5 to Staff's Initial brief.

⁵² See fn. 44.

proportional amount allocated to the shareholder totals \$7,651. Staff recommends the Commission reclassify \$131,945 of equity to Contributions In Aid of Construction (CIAC).⁵³

67 AWR argues that the compensation to AWR for the transfer of the Birchfield system was its rate base, and that is the appropriate compensation.⁵⁴ The value received by V. R. Fox Company from the Birchfield sale was for the expenditures for the improvements for future use: the many thousands of feet of additional main; the thirteen fire hydrants; the engineering for the improvements; and the labor for the improvements.⁵⁵

68 In support of its argument, AWR references Exhibit 27 at page 5, and asserts that it shows that the Birchfield system includes 6,000 feet of eight-inch main and 2,300 feet of twelve-inch main for future use. AWR contends that those assets were never part of the assets transferred to AWR.⁵⁶ AWR points out that Staff admits that those assets were never used for any prior ratemaking for AWR and never appeared on the books of AWR.⁵⁷ AWR notes that Mr. Ward admitted that Exhibit 88 contains a complete list of the assets for the Birchfield system that are on the AWR books.⁵⁸ AWR further notes that Mr. Ward admits that there was no evidence that AWR paid for the improvements for future use (mains, etc.).⁵⁹ Finally, AWR contends Mr. Ward acknowledged that there are no records that show that the three Birchfield wells are included in AWR's rate base.⁶⁰

⁵³ Ward, Exhibit No. 41T, 35:5-12.

⁵⁴ AWR Reply Br. p. 6

⁵⁵ Id.

⁵⁶ AWR Initial Br. at 16

⁵⁷ Tr. 123-128.

⁵⁸ Tr. 118-119.

⁵⁹ Tr. 123 -124.

⁶⁰ Tr. 128.

69 In further support of its position, AWR references Exhibit 142, which shows invoice after invoice where V.R. Fox, Inc., paid for the construction of those parts of the water system above and beyond what were on the books of AWR. AWR references Exhibit 85, the Declaration of Ms. Woods, confirming those expenditures by V.R. Fox, Inc.

70 According to AWR, Staff has no basis to characterize the sums spent for future needs as an investment by Mr. Fox in AWR. AWR argues that the record shows that V.R. Fox Company made expenditures for the water system improvements where it would be the developer of homes at a later date. AWR suggests that Staff's position amounts to a confiscation of private assets for a public benefit.⁶¹

71 In reply, Staff argues that the fact that Mr. Fox paid for improvements to Birchfield does not translate into separate ownership. Rather, the investment, a capital investment in AWR, affects how much of the gain is allocated to Mr. Fox as shareholder of AWR.⁶² Staff notes that AWR had difficulty producing records to quantify the additional investment. Staff points out that its analysis of the invoices in Exhibit 142 takes into account Mr. Fox's investment in water-related facilities, and informs Staff's recommendation for the allocation of gain.⁶³

72 In response to AWR's contention that Mr. Ward admitted that Exhibit No. 88 contains the complete list of assets associated with Birchfield, Staff observes that Mr. Ward neither created the exhibit, nor possessed actual knowledge of what it represented. Staff points out that Exhibit No. 88 contains the same list of assets found in the sales agreement that is Exhibit No. 57, and Mr. Fox acknowledged that the list of assets in the sales agreement is inaccurate. Specifically, the list of

⁶¹ AWR Reply Br. p. 5.

⁶² Staff Reply Br. at 16-17.

⁶³ *Id.*

assets includes the transfer of water rights from Mr. Fox to LCWSD#5, when those water rights had previously been transferred from Mr. Fox to AWR.⁶⁴

73 Finally, in response to the Company's argument that AWR never paid for the wells associated with Birchfield, Staff argues that the record establishes that the three wells were serving the Birchfield water system prior to the sale of the water system to LCWSC#5.⁶⁵

Commission Discussion and Decision

74 Our review of the record, including the exhibits from the Department of Health and the Department of Ecology, affirms Staff's characterization of Birchfield as a single water system owned by AWR, consisting of three wells and associated infrastructure. We note that Staff accounts for Mr. Fox's off-book investment in the infrastructure of Birchfield. Because the owner's investment is off-book, we do not find the allocation of the gain based on a debt-to-equity ratio compelling. Rather, based on the circumstances of this sale, we adopt a symmetry-of-risk analysis for the gain on sale of Birchfield.

75 Our calculation of the symmetry-of-risk attributes the rate base of \$57,500 as the ratepayers' investment in Birchfield. We attribute Mr. Fox's off-book investment of \$78,428 as the shareholder's investment. Our calculation results in a customer allocation of gain of 42.3 percent of the gain of \$139,597 or \$59,052. The shareholder portion equates to 57.7 percent or \$80,545. Again, as we stated above, our use of the symmetry-of-risk analysis to allocate gain between the ratepayers and the shareholder is based on the circumstances of this particular case, and is not meant to establish a preferred methodology for use in future cases.

⁶⁴ Staff Reply Br. at 18, Fox, Tr. 291:1-11, Ward, Exhibit No. 77 at 10-12.

⁶⁵ Lahmann, Exhibit No. 17 at 16.

76 While we are not in the position to review whether the sale of Birchfield to LCWSD#5 resulted from an arms-length or equivalently fair transaction, we are troubled by the circumstances of the sale: Mr. Fox signed the sales contract on behalf of both the buyer and the seller. Accordingly, we highlight this circumstance as a possible conflict of interest for review by appropriate governmental authorities.

4) Acquisition Adjustment, Restating Adjustment RA-11

77 Staff and AWR agree that an acquisition adjustment of \$176,974 may be appropriate in this case. Staff explains that the acquisition adjustment, Adjustment RA-11, adds back to rate base the amount of AWR's acquisition adjustment account.⁶⁶ If no adjustment were made, AWR's rate base would be reduced by the net acquisition adjustment account amount (\$176,974). Adjustment RA-11 prevents this by adding a positive \$176,974, causing the effect on rate base to be zero.⁶⁷ Staff conditions its agreement to the acquisition adjustment on the Commission's allocating the gain on sale of View Royal using AWR's capital structure.⁶⁸

78 The Commission views this adjustment as an uncontested adjustment. The sale of View Royal is not linked to the acquisition adjustment. Rather, it reflects the systems, other than View Royal, where AWR purchased those systems for less than historical cost adjusted for accumulated depreciation. The Commission's treatment of the gain on the View Royal sale is consistent with the treatment of the acquisition adjustment in this case.

79 Table 2 reflects the Commission's determination of Average Rate Base.

⁶⁶ Staff Initial Br. at 43

⁶⁷ Staff, Ex. 206 at ¶¶4-5 and Attachment A (Staff's Response to Bench Request No. 1 (Revised)).

⁶⁸ Ward, Ex. 41T at 21:15-17.

TABLE 2: RATE BASE				
Ln#	Contested Adjustments To Rate Base	Staff	Company	Decision
1	RA-06 Regulatory Liability - 010961	(\$125,113)	\$0	\$0
2	RB-3 GOS View Royal	(216,350)	0	(157,539)
3	RB-4 GOS Birchfield	(131,945)	0	(59,052)
4	RB-5 Regulatory Liability Amort.	62,557	0	0
5	Total Contested Adjs. - Rate Base	<u>(\$410,851)</u>	<u>\$0</u>	<u>(\$216,591)</u>

iii. Contested Net Operating Income Adjustments

80 Table 3 shows the contested ratemaking adjustments to Net Operating Income.

TABLE 3: CONTESTED NET OPERATING INCOME ADJUSTMENTS				
Ln#	Contested Net Income Adjustments	Staff	Company	Difference
	(A)	(B)	(C)	(D) = B-C
1	P-03 Adjust Salaries & Payroll Taxes	\$28,560	(\$47,832)	\$76,392
2	P-04 Pro Forma Debt Adjustment	(2,561)	7,673	(10,234)
3	P-05 Payroll Offset Adj. Acct 010961	62,557	0	62,557
4	P-06 Manager's Salary	0	(38,924)	38,924
5	P-08 Site Assessment Compensation	0	(6,344)	6,344
6	P-09 Increase Rate Case Expense	0	(14,017)	14,017
7	P-10 Employee COLA	0	(10,830)	10,830
8	Total Contested Adjustments - NOI	<u>\$88,556</u>	<u>(\$110,274)</u>	<u>\$198,830</u>

**1) Employee Salaries & Payroll Expenses, *Pro Forma Adjustment P-03,*
*Site Assessment Compensation, Pro Forma Adjustment P-08***

81 Staff proposes that the Commission set the amount for salaries and wages using historical cost data, an accepted method of setting rates.⁶⁹ Staff argues that AWR's employees received less than full-time compensation during the test year. According to Staff, AWR's test-year cost for six employees, consisting of one manager, two office employees, and three field personnel, was \$23,842 in manager salary, \$89,070 in field personnel salary, \$56,924 in office staff salary, \$26,859 in benefits, and \$22,006 in payroll tax.⁷⁰

82 Staff offers an alternative proposal if the Commission believes an upward adjustment is warranted. Staff recommends that the Commission include only the equivalent of full-time compensation amounts for the six positions currently filled. Staff reports the full-time compensation levels for AWR as \$24,000 in manager salary, \$98,703 in field personnel salary, \$64,002 in office staff salary, \$26,859 in benefits, and \$24,169 in payroll tax.⁷¹

83 AWR explains that Staff's Adjustment P-03 reflects that the Company personnel worked at reduced hour levels during a portion of the test period while the Company attempted to live within its means. AWR asserts that those hours were reinstated in July 2003 and have continued at the full amount since that time.⁷² AWR agrees with the principle of Staff's alternative recommendation for Pro Forma Adjustment P-03, which allows in rates the equivalent of full-time compensation for the six employees AWR currently employs.

⁶⁹ *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310, 109 S.Ct. 609, 102 L.Ed.2d 646 (1989).

⁷⁰ Staff Brief, p. 16.

⁷¹ Staff Brief, pp. 17-18.

⁷² Company Initial Brief, pp. 11-12.

Commission Discussion and Decision

84 The Commission accepts Staff's alternative recommendation for Pro Forma Adjustment P-03, which allows in rates the equivalent of full-time compensation for six employees. The record shows that AWR reduced the hours of its six employees for a portion of the test period in order to mitigate its cash flow problems. The record establishes that those hours were reinstated in July of 2003 and have remained at that level ever since. Accordingly, the Commission finds it appropriate to allow in rates the equivalent of full-time compensation amounts for the six positions currently filled.

85 Additionally, our review of the record shows that Staff's incorporation of six employees at full-time allows for additional time beyond the end of the test period levels. As such, recognition is given for any additional costs that may arise with DOH's site assessment program for certain Group B water systems. Therefore, the Company's proposed adjustment P-08 is not accepted.

2) Manager's Salary, Pro Forma adjustment, P-06

86 AWR proposes Pro Forma Adjustment P-06 that would increase Mr. Fox's salary from \$24,000 to \$60,000. The record shows that \$23,842 was actually booked during the test period for Mr. Fox's salary. AWR's proposed adjustment would increase test period expenses by \$36,158, plus the increases in related payroll taxes ($\$23,842 + \$36,158 = \$60,000$). AWR explains that Mr. Fox's salary was reduced to \$24,000 at a time when he had a manager in place who was receiving \$60,000. In February 2001, Mr. Fox terminated the manager and took over the duties of operations manager. In Docket No. UW-010961, all costs associated with the operations manager were removed.⁷³ AWR requests that the Commission recognize the function that Mr. Fox performs as manager and provide him with compensation appropriate for that level. AWR references

Exhibit No. 94 in support of its argument that the \$60,000 salary is reasonable as compared to other regulated water companies.

87 Staff argues that Mr. Fox's salary should remain at \$24,000 "due to ongoing concerns about management quality."⁷⁴ In support of its argument, Staff references the Staff Open Meeting Memo and the Order Approving Tariff Revisions in Docket No. UW-991392, dated November 15, 1999, stating that there "Staff proposed that manager compensation be reduced to \$24,000 due to poor service quality, poor water quality, and poor management."⁷⁵ Staff lists several examples of purported mismanagement, and argues that these demonstrate a pattern of continued mismanagement.⁷⁶ Staff maintains that "although certain service and water quality issues seem to have been positively resolved, customers should not have to pay higher rates for ineffective management."⁷⁷

Commission Discussion and Decision

88 Our review of the November 15, 1999, Staff Open Meeting Memo and the Commission's Order Approving Tariffs in Docket No. UW-991392 does not provide us with the basis for the reduction in officer salary to \$24,000 per year. Contrary to Staff's assertion, there is no reference in the Memo or the Order that the \$24,000 reduction was due to poor service quality, poor water quality, and poor management. Rather, it appears that Staff and the Company reached an agreement to reduce officer compensation, and the basis for that agreement is not revealed. Nonetheless, the record before us shows that service has improved dramatically. Exhibit No. 32 shows that the total number of complaints fell from a high of 49 in 2000 to three in 2003. Regarding Staff's litany of Mr. Fox's purported imprudent management decisions, we find it preferable to address the

⁷³ Exhibit No. 100T, p. 15.

⁷⁴ Staff Initial Br. p. 18.

⁷⁵ *Id.*

⁷⁶ Staff Initial Br. pp. 18-23.

⁷⁷ Staff Initial Br., p. 23; Eckhardt, Exhibit No. 30T, p. 29.

prudence of those decisions and any associated adjustments directly, not through an adjustment to owner's salary allowance, which is likely to be arbitrary in its measurement.

- 89 The record indicates that \$60,000 was previously used for a non-owner salary.⁷⁸ The test for establishing an owner's allowances is generally based on what a company would have to pay a manager in an arm's length arrangement. The record shows that the proposed manager's salary of \$60,000 for Mr. Fox is not out of line with other water utilities regulated by the Commission, and in fact, it appears to be below the average, based on several different views of the question.⁷⁹
- 90 AWR did not fill a vacancy for a manager's position and Mr. Fox assumed this role. The manager was paid \$60,000 per year before he left. At that time Mr. Fox was paid an annual salary of \$24,000. The Company's request to eliminate Mr. Fox's previous salary and pay Mr. Fox \$60,000 per year therefore reduces the Company's expenses by \$24,000 from previous levels. If the Company again hires a separate manager, then only the \$60,000 would be included in rates.
- 91 Finally, we believe it appropriate to recognize the responsibility associated with the position of operations manager. We find \$24,000 inadequate compensation for the amount of responsibility associated with running a business of this size. Accordingly, the Commission allows AWR's Pro forma Adjustment P-06 that would increase Mr. Fox's salary from \$24,000 to \$60,000.

⁷⁸ Exhibit No. 100T, p.15.

⁷⁹ Exhibit No. 32.

3) Rate Case Expense, Pro Forma Adjustment, P-09

- 92 Staff did not propose an adjustment to rate case expenses, choosing instead to leave rate case expenses at the level previously set, \$11,000 annually.⁸⁰ Mr. Ward testified that in the *Consolidated 1998 Dockets*,⁸¹ rate case costs were set at \$36,000 normalized over three years, resulting in \$12,000 being included in rates annually. He testified that rate case costs were set at \$11,000 per year as part of the settlement in Docket No. UW-010961. Mr. Ward states that the conditions under which rate case costs were established in both the *Consolidated 1998 Dockets* and Docket No. UW-010961 are similar to the conditions present in this case.⁸²
- 93 Staff notes that the rate case expenses proposed by AWR have evolved over the course of this proceeding. Originally, AWR proposed estimated rate case expenses of \$41,000 normalized over two years.⁸³ During cross-examination of Mr. Ward, AWR presented exhibits consisting of two declarations and an invoice that contained actual billings and estimates to arrive at rate case expenses of \$50,000.⁸⁴
- 94 Staff argues that the estimates for May 2004 and beyond should be rejected because they are unreliable. Staff suggests that the Commission could determine that AWR's rate case expenses totaled \$32,884 by totaling the actual billed amounts and the April 2004 estimates. Normalizing \$32,884 over three years would result in a normalized amount of \$10,961.⁸⁵

⁸⁰ Ward, Exhibit No. 41T at 16:13-17; Staff Initial Br. at 27.

⁸¹ *WUTC v. AWR, Docket Nos. UW-980072, UW-980258, and UW-980265, (Consolidated 1998 Dockets)*, Fifth Supplemental Order at 29-30.

⁸² Ward, Exhibit No. 41T at 16:13-17.

⁸³ Parker, Exhibit No.100T at 17:5-11.

⁸⁴ Ward, Tr. 144:21 to 145:18; Exhibit Nos. 91, 92, and 96. Staff did not object to the admission of Exhibit Nos. 91, 92, and 96.

⁸⁵ Staff Initial Br. pp. 28-29.

95 Staff argues that even if AWR can substantiate legitimate rate case expenses occurring after April 2004,⁸⁶ \$11,000 annually remains appropriate for ratemaking purposes. Staff contends that the total amount of fees attributed to this consolidated docket include fees for the penalty assessment and the Docket Account issue.⁸⁷ Staff argues that litigation related to these items should not be included in rates. According to Staff, ratepayers should not be required to pay for fees associated with defending Mr. Fox against the penalty assessment, nor should they be required to pay for litigation to determine how AWR will fulfill its regulatory liability obligation as a result of poor management decisions. Staff contends that 25 percent of the costs should be allocated to the penalty assessment, and 15 percent of the costs should be allocated to the Docket Account.

96 Accompanying its post-hearing reply brief, AWR submits Supplemental Declarations of Mr. Finnigan and Ms. Parker as late-filed exhibits that show actual billings through June, work in process through July 8, 2004, and estimates to complete AWR's reply brief, review Staff's reply brief, and review the Commission Order. The revised estimate reflects AWR's decision to forego the Initial Order, and thus removes the potential for two further rounds of comments and briefs in this proceeding. AWR's total rate case expense is now estimated at \$41,946.91.⁸⁸

97 In response to Staff's concerns about the reliability of estimates of rate case expenses for May 2004 and beyond, AWR states that the Declarations of Mr.

⁸⁶ Staff concedes that AWR has experienced additional legal fees since the conclusion of the April 26 and 27, 2004, hearing, since both parties will submit two rounds of post-hearing briefs. Staff Initial Br. at 29, fn 145.

⁸⁷ Staff Initial Br. at 29.

⁸⁸ AWR Reply Br. p. 2-3. AWR asks that Mr. Finnigan's Supplemental Declaration, and Ms. Parker's Supplemental Declaration be admitted into the record as late filed exhibits. Staff did not object to the admission of these late-filed exhibits. Accordingly, the Supplemental Declarations are admitted into the record as Exhibit No. 301 (Mr. Finnigan's) and Exhibit No. 302 (Ms. Parker's).

Finnigan and Ms. Parker,⁸⁹ submitted under oath, represent good-faith estimates of the amounts it would take to finish the case. AWR observes that given the nature of a rate case expense, declarations such as those have been used by the Commission in the past to support a rate case expense adjustment.⁹⁰ AWR contrasts this evidence with Staff's unsupported proposal to disallow 25% of the rate case cost based on the faulty assumption that costs associated with the penalty assessment were included in rates. AWR refers to its Opening Brief where AWR noted that the Company did not include any of the costs associated with the penalty assessment in its rate case expense adjustment.⁹¹ AWR also notes the Declarations set out as Exhibits 91 and 92 did not include the penalty case docket number in the caption, and confirms that the omission was intentional.⁹²

98 AWR argues that Staff's 15% reduction to rate case costs for work done on the Docket Account adjustment is also unsupported by the record. AWR notes that the Docket Account is an adjustment raised by Staff in the course of this proceeding. AWR asserts that it has a right to reply to that adjustment.⁹³

99 Finally, AWR argues that the normalization period should be no more than two years, given the history of the Company coming before the Commission for seven rate cases and four surcharge filings in eight years.⁹⁴

⁸⁹ Exhibit Nos. 91 and 92.

⁹⁰ *WUTC v. Rainier View Water Company, Inc.*, Docket No. UW-010877, Sixth Supplemental Order (July 12, 2002) at ¶¶ 63-70.

⁹¹ AWR Initial Br. p. 13, fn. 70.

⁹² AWR Reply Br. p. 3, fn. 6; Exhibit Nos. 91 and 92.

⁹³ AWR Reply Br. pp. 3-4.

⁹⁴ Eckhardt, Exhibit No. 30T at pp. 6, l. 12-15.

Commission Discussion and Decision.

100 Based on our review of the record in this proceeding and the sworn affidavits of Mr. Finnigan and Ms. Parker, we find the rate case expenses proposed by AWR in the amount of \$41,946.91 to be reasonable and justified for a case with this degree of complexity. Accordingly, we will allow the Company's proposed adjustment for rate case expenses; however, we find the appropriate period for normalizing the rate case expenses to be three years, rather than the two years proposed by AWR. We base this decision on the similarity of conditions under which the normalization period was established in AWR's most recent fully-litigated rate case, the *Consolidated 1998 Dockets*.

4) Employee COLA, Pro Forma Adjustment, P-10

101 AWR proposes Adjustment P-10 to reflect an increase in cost of living for all employees. In support of its proposal, AWR observes that the employees have not had a cost-of-living increase in at least two years. In addition, AWR references the testimony of Ms. Lahmann, who recognized the difficulty of operating a water system with many small systems spread across several counties.⁹⁵

102 Staff opposes AWR's Adjustment P-10. Staff notes that AWR did not file Adjustment P-10 with its testimony; rather, AWR introduced it in response to the Bench Requests on April 23, 2004. Staff argues that AWR provided no evidence that Adjustment P-10 corresponds with the rate of inflation during the test period. In addition, Staff maintains that AWR has not established that appropriate economic conditions warrant a COLA.⁹⁶

⁹⁵ AWR Initial Br., p. 12.

⁹⁶ Staff Br., p. 32.

Commission Discussion and Decision

103 One week prior to hearings in this proceeding, the Commission issued Bench Requests 1-8. Bench Request No. 3 references Staff's Exhibit No. JAW-25 and Company Exhibit No. JMP-2 and asks the parties to provide tables that show the revenue, expense, taxes, net operating income and rate base effect of each adjustment in a separate column format. Additionally, Bench Request No. 3 requests that if the amounts in testimony do not agree with the amounts appearing in the results of operations statement, the parties should explain why.

104 In its response to Bench Request No. 3, AWR identifies adjustment PA-10 as one that does not agree with the amounts referenced in testimony. AWR explains the disparity as follows: "PA-10 was added to reflect a cost of living allowance for all employees."⁹⁷

105 AWR's proposed adjustment is not supported by Company testimony or any analysis that would demonstrate that the adjustment is appropriate. Accordingly, the Commission disallows AWR's Pro Forma Adjustment P-10.

5) Interest Synchronization, Pro Forma adjustment, P-04

106 Pro Forma debt adjustment P-04, Interest Synchronization, synchronizes Federal income taxes to relate to the final cost of capital determination in a rate case. This adjustment also adjusts the level of Federal Income Tax to the Commission adjusted results of operation. Both Commission Staff and AWR use the tax rate of 15% for \$0-50,000.⁹⁸

107 Adjusted rate base is \$596,656. The weighted cost of debt is 2.66%. Therefore, the pro forma level of deductible interest is \$15,871. The Net Operating Income

⁹⁷ Exhibit No. 201, Request No. 3.

⁹⁸ Exhibit No. 203, Staff's Response to Bench Request No. 11; Tr. 221; Exhibit No. 202.

(NOI) after Commission adopted adjustments is \$479. After adding back the Per Books FIT of \$16,652, the taxable NOI before interest and taxes is \$17,131. After subtracting pro forma interest of \$15,871, the taxable income is \$1,260. FIT is \$189 (\$1,260 X 15%). The NOI impact of Interest Synchronization adjustment is an increase of \$16,463 (FIT expense is reduced by \$16,463 (\$189 - \$16,652)).

108 Table 4 reflects the Commission's decisions on contested adjustments to Net Operating Income.

TABLE 4: CONTESTED NET OPERATING INCOME ADJUSTMENTS - DECISION				
Ln#	Contested Net Income Adjustments	Staff	Company	Decision
	(A)	(B)	(C)	(D)
1	P-03 Adjust Salaries & Payroll Taxes	\$28,560	(\$47,832)	\$9,528
2	P-04 Pro Forma Debt Adjustment	(2,561)	7,673	16,463
3	P-05 Payroll Offset Adj. Acct 010961	62,557	0	0
4	P-06 Manager's Salary	0	(38,924)	(38,924)
5	P-08 Site Assessment Compensation	0	(6,344)	0
6	P-09 Increase Rate Case Expense	0	(14,017)	(2,982)
7	P-10 Employee COLA	0	(10,830)	0
8	Total Contested Adjustments – NOI	<u>\$88,556</u>	<u>(\$110,274)</u>	<u>(\$15,915)</u>

5. Rate of Return

109 The shareholders deserve a fair rate of return on capital they have invested in a 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 cost to obtain the capital it uses to provide regulated products.

110 A utility has the right under the United States Constitution 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. Borsch*, 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 (1923)

a. Cost of Equity/Cost of Debt

111 The cost of common equity capital, stated as the rate of return on common equity, measures the rate of return reasonably required by investors to invest funds into ownership of the utility. Staff and Company propose a return on equity of 12%, which has historically been allowed as a return on equity. The Commission accepts 12% return on equity for the purposes of this proceeding.

112 Staff and the Company propose a cost of debt of 7.53%. The Commission accepts 7.53% as the cost of debt for the purposes of this order.

b. Capital Structure

113 Staff and the Company disagree on the proposed capital structure. Staff recommends an overall recommended return on rate base of 10.11%.⁹⁹ The Company recommends 10.41%.¹⁰⁰ The difference in these two proposed returns is only 0.3 of a percentage point.

⁹⁹ Ward, Ex. 41T at 52, Ex. 201, Staff Response to Bench Request No. 8, Attachment F.

¹⁰⁰ AWR Response to Bench Request No. 8, attached updated Ex. JMP-9.

- 114 AWR's current capital structure is 35 percent debt and 65 percent equity.¹⁰¹ Staff's recommendation for the Docket Account reduces AWR's equity by \$125,113, to \$374,557, and results in a capital structure of 42.2 percent debt and 57.8 percent equity.¹⁰²
- 115 AWR calculates the Company's capital structure based on an equity figure of \$499,670, which results in a capital structure of 35.38 percent debt and 64.62 percent equity.¹⁰³
- 116 The difference in the capital structures proposed by Staff and the Company rests on Staff's treatment of the regulatory liability obligation. Staff reduced rate base and equity by \$125,113; AWR did not. Our decisions on the treatment of the Docket Account disallowed Staff's Restating Adjustment RA-06, which would reduce AWR's rate base by the regulatory liability obligation amount, \$125,113. Therefore, for purposes of this Order the Commission adopts AWR's proposed capital structure.
- 117 Table 5 summarizes the decisions related to cost of capital in this order:

Ln #	Item	Capital Structure	Embedded Cost	Rate of Return
1	Debt	35.38%	7.53%	2.66%
2	Equity	64.62%	12.00%	7.75%
3	Total Capital	100.00%		<u>10.41%</u>

¹⁰¹ Parker, Ex. 100T at 35.

¹⁰² Ward, Ex., 41T at 51.

¹⁰³ Parker, Tr. 184.

118 The above decisions result in a weighted cost of debt of 2.66%, which will be used in this order to recalculate Pro Forma Debt (Interest Synchronization) Adjustment, P-04.

6. Actual Results of Operation and Rate of Return

119 The Results of Operation show that the Company's current rates and charges produce a rate of return that does not exceed the rate of return authorized in this proceeding.

7. Penalty Assessment Against Mr. Fox, Docket No. UW-031596

120 On October 22, 2003, the Commission entered an order issuing a penalty assessment of \$3,700 against Mr. Fox, President of AWR, based on seven violations relating to AWR's failure to deposit required amounts in the Docket Account, and for unauthorized use of funds from the Docket Account to pay taxes associated with the gain on sale of the View Royal system, and income taxes on the Docket Account itself.

121 On November 6, 2003, Mr. Fox filed an application for mitigation of penalties. Mr. Fox supports his request for mitigation of the penalties with the following arguments.

122 Mr. Fox explains that the tax liability related to the View Royal sale arose unexpectedly. He acknowledges that it was a result of the Company's outside accountant making a good-faith error in estimating the available net operating loss carry forward.¹⁰⁴

¹⁰⁴ AWR Initial Br. at 28.

- 123 As for the tax liability related to the Docket Account itself, Mr. Fox explains that the situation arose because AWR could not meet the threshold required by the Commission to access those funds, so the funds remained unused in the Docket Account and incurred an income tax liability.¹⁰⁵ Mr. Fox states that the Company attempted to solve the dilemma by approaching Commission Staff on at least two occasions. According to Mr. Fox, the Company received no help from Commission Staff other than a statement that the Company's proposals were not something Commission Staff would support.
- 124 Further, Mr. Fox contends that the penalty is miscalculated. He explains that he was fined \$400.00 for the June deposit not having been made until October. According to Mr. Fox, the "June" deposit is in reality the billing made in June, with money received in July. Thus, the deposit should have been made in July, and it was three months late, not four. Mr. Fox asserts that the same miscalculation occurs for the July, August, September, October, and November matters. These are the months the billings went out, not the month the deposit was to have been made. Mr. Fox argues that, for this reason alone, the fine should be reduced \$600.00.¹⁰⁶
- 125 Finally, Mr. Fox asks that the Commission take into account the totality of the circumstances and mitigate the penalties assessed against him. He argues that the violations involving failure to deposit funds occurred because AWR did not have funds available.¹⁰⁷ Mr. Fox notes that 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.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Penalty Assessment Against Virgil R. Fox, President, American Water Resources, Inc.*, Docket No. UW-031596, Application for Mitigation of Penalties.

- 126 Staff argues that none of the reasons articulated by Mr. Fox are sufficient to mitigate the penalty assessment. Staff asserts that the capital gains tax on View Royal was foreseeable and should have been paid from the sales proceeds.¹⁰⁸ According to Staff, spending the entire amount of the proceeds was imprudent, regardless of the purpose.
- 127 Assuming AWR owes a tax liability on the Docket Account, Staff argues that the money in the Docket Account accumulated as a direct result of Mr. Fox's imprudent decision to sell View Royal. Staff asserts that due to the sale of View Royal, AWR no longer needed additional employees to provide service. Since AWR would not hire the additional employees, it would not qualify to use the Docket Account funds. Nonetheless, Mr. Fox allowed AWR to collect \$125,113 from its customers over approximately 21 months.¹⁰⁹
- 128 Staff maintains that AWR's cash flow problem stems from Mr. Fox's shortsighted decision to sell View Royal, which resulted in a net cash decrease of \$12,000 to \$13,000 in AWR's average monthly revenue.¹¹⁰ The sale also resulted in higher per-customer fixed costs.¹¹¹ Staff argues that Mr. Fox had options available to him other than violating the Commission's Order. According to Staff, he could have sought rate relief by either asking the Commission to amend the Order Accepting Settlement Agreement or filing a rate case.
- 129 Staff asserts that the penalty amount is properly calculated. Staff argues that the calculation of the penalty took into consideration that the deposit for June 2002 was due in July 2002. According to Staff, the penalty began in July, continued

¹⁰⁸Staff Reply Br. at 31. Staff acknowledges that AWR's 2000 tax return had to be amended, which resulted in the net operating loss being reduced.

¹⁰⁹ Staff Initial Br. at 53.

¹¹⁰ Ward, Exhibit No. 41T at 37; Parker, Exhibit No. 100T at 30-31.

¹¹¹ Fox, Exhibit No. 120T at 40.

during August and September, and ended in October. The penalty was assessed for each month AWR failed to make a deposit.¹¹²

130 Finally, Staff maintains that the totality of the circumstances demonstrate the Commission should deny the application for mitigation and order Mr. Fox to pay the full amount of the penalty. Mr. Fox allowed AWR to use the Docket Account funds for unauthorized purposes. According to Staff, not only were the Docket Account funds never intended to pay taxes, but both taxes arose due to Mr. Fox's imprudent decisions. Following the sale of View Royal, AWR no longer needed the set-aside funds. Mr. Fox allowed AWR to collect \$125,113 from its customers over approximately 21 months. Moreover, Mr. Fox allowed AWR to fail to deposit funds as required, although the funds were being collected. Staff asserts that mitigation of the penalty is not appropriate, and recommends that Mr. Fox be required to pay the entire amount of the penalty within 15 days of entry of the final order in this case.

Commission Discussion and Decision

131 Based on our review of the record and the parties' pleadings, we deny the application for mitigation of penalties. We note that Mr. Fox has a history of disregard for the responsibilities that accompany ownership of a regulated utility. In this instance, Mr. Fox used money, earmarked by the Commission for a specific purpose, for an unrelated purpose, without seeking the Commission's approval. This was a direct violation of the Commission's Order in Docket No. UW-010961, and a misappropriation of funds. Mr. Fox's asserted "mitigating factor" — that the funds were used for other Company expenses — is unpersuasive.

¹¹² See *Penalty Assessment Against Virgil R. Fox, President, American Water Resources, Inc.*, Docket No. UW-031596, Penalty Assessment Order.

132 As the owner of a regulated company, Mr. Fox is accountable to the Commission and to his customers. As Staff points out, Mr. Fox had options available to him other than violating the Commission's Order and the trust of his customers. Accordingly, we hold Mr. Fox accountable for the seven violations¹¹³ relating to AWR's failure to deposit required amounts in the Docket Account, and for unauthorized use of funds from the Docket Account. Mr. Fox is ordered to pay the full penalty amount of \$3,700 within 15 days of the entry of this Order.

II. FINDINGS OF FACT

133 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 Commission now makes the following summary of the facts. The portions of the proceeding detailed findings and the discussion pertaining to the ultimate facts are incorporated herein by this reference.

134 (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.

135 (2) American Water Resources, Inc. (AWR) is a public service company subject to the jurisdiction of the Commission.

136 (3) American Water Resources, Inc. is a water company engaged in the business of furnishing potable water to the public for compensation within Washington State.

¹¹³ Our review of the record also supports Staff's position that the penalty amounts are calculated correctly.

- 137 (4) American Water Resources, Inc. provides domestic water service to over 1,500 homes and businesses, serving largely residential customers, through 130 water systems spread across parts of several counties in Washington.
- 138 (5) On August 13, 2003, the Commission reopened Docket No. UW-010961 and consolidated it with Docket No. UW-031284, a complaint against AWR to determine whether AWR failed to comply with the set-aside requirements ordered by the Commission in Docket No. UW-010961, to review AWR's rates, and to determine whether AWR should be required to make a new tariff filing reducing rates.
- 139 (6) On October 22, 2003, the Commission entered an order in Docket No. UW-031596, issuing a penalty assessment of \$3,700 against Virgil R. Fox, President of AWR, for violations of the Commission's order in Docket No. UW-010961, relating to the Docket Account.
- 140 (7) On November 6, 2003, Mr. Fox filed an application for mitigation of penalties assessed in Docket No. UW-031596.
- 141 (8) On February 2, 2004, the Commission consolidated Docket No. UW-031596 with Docket Nos. UW-031284 and UW-010961.
- 142 (9) The 12-month period ending June 30, 2003, is an appropriate test year to examine for ratemaking purposes in these proceedings.
- 143 (10) Federal income tax expense should be calculated at a rate of 15%.

- 144 (11) 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 \$51,900 decrease in net operating income and a \$107,368 decrease in rate base. These adjustments are consistent with generally accepted ratemaking principles and should be adopted.
- 145 (12) Four contested rate base adjustments to the per book numbers for the test year are listed in Table 2, and the decisions related to these adjustments are listed there as well. These adjustments are consistent with generally accepted ratemaking principles and should be adopted.
- 146 (13) Seven contested net operating income adjustments to the per books numbers from the test year are listed in Tables 3 and 4, and the Commission's decisions are listed in Table 4. These adjustments are consistent with generally accepted ratemaking principles and should be adopted.
- 147 (14) The appropriate capital structure to be used in setting rates for AWR is 35.38 percent debt and 64.62 percent equity.
- 148 (15) The appropriate cost of equity to be used in setting rates for AWR is 12 percent.
- 149 (16) The appropriate cost of debt to be used in setting rates for AWR is 7.53 percent.
- 150 (17) The appropriate overall return for the Company is 10.41 percent.
- 151 (18) The Results of Operation show that the Company's current rates and charges do not provide the Company with an excessive return.

- 152 (19) The Docket Account created by the Commission in Docket No. UW-010961 is no longer needed for the purpose for which it was intended and customers should be refunded the \$125,113, that should be in the Docket Account, plus interest as set forth in this Order.
- 153 (20) Mr. Fox's application for mitigation of penalties fails to supply sufficient mitigating factors that would reduce the penalty amount.

III. CONCLUSIONS OF LAW

- 154 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.
- 155 (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.*
- 156 (2) The Results of Operation show that the Company's current rates and charges do not provide the Company with an excessive return.
- 157 (3) AWR should be ordered to file a tariff that will refund the balance in the Docket Account, \$125,113 plus interest, to customers as set forth in this Order.
- 158 (4) Mr. Fox should be ordered to pay the full penalty amount of \$3,700 for violations of the Commission's order in Docket No. UW-010961 within 15 days of the entry of this Order

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

IV. ORDER

160 Based on the above findings of fact and conclusions of law, the Commission
hereby makes and enters the following Order.

- 161 (1) The Commission has jurisdiction over the subject matter of and the parties
to this proceeding.
- 162 (2) AWR must file a tariff five (5) days after the entry of this order that will
refund to customers \$4.40 per customer per month until the Docket
Account Balance of \$125,113 plus interest is reduced to zero, at which time
the Company should file to terminate the tariff schedule. Interest will be
compounded monthly using the accepted debt rate from this proceeding
of 7.53%.
- 163 (3) Commission Staff must examine the compliance filing, and must provide
its analysis of whether the compliance filing meets the requirements of
this Order, no later than five business days after the Company's
compliance filing is made with the Commission.
- 164 (4) The Commission secretary may approve by letter the compliance filing.
- 165 (5) Mr. Fox must pay the full penalty amount of \$3,700 for violations of the
Commission's order in Docket No. UW-010961 within 15 days of the entry
of this Order.

- 166 (6) The Commission retains jurisdiction over the subject matter of and the parties to the proceeding to effectuate the provisions of this Order.

DATED at Olympia, Washington, and effective this 1st day of November, 2004.

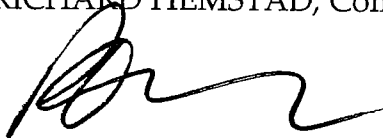
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION



MARILYN SHOWALTER, Chairwoman



RICHARD HEMSTAD, Commissioner



PATRICK J. OSHIE, Commissioner

NOTICE TO PARTIES: This is a final order of the Commission. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this order pursuant to RCW 34.05.470 and WAC 480-07-850, or a petition for rehearing pursuant to RCW 80.04.200 or RCW 81.04.200 and WAC 480-07-870.