UW-070944
Attachment A
Customer Comments – Staff Response

1.0.0 **Water Rights**

1.1.0 **Question:** Who was the prior owner of the water rights associated with Rosario Utilities/Washington Water Service Company?

Staff Analysis: The answer to this question is not entirely certain. There are two kinds of rights at issue, appropriated water rights and permit water rights.

In this case, the appropriated water rights were adjudicated several years ago. This means a court decided the ownership of water rights, and this is documented in volumes of certificates kept by the Department of Ecology (DOE). These rights generally run with the land.

The appropriated water rights at issue in this case likely belonged to the person or entity who owned the resort real property. The current owner of the resort real property is Oly Rose, LLC. Oly Rose, LLC is a subsidiary of Oly Rose, LP. Absent any prior transfers of water rights from landowners, Oly Rose, LLC owned all the rights of this type up until last year, when it transferred all of them to Orcas Water Holdings, LLC (OWH). OWH is also a subsidiary of Oly Rose, LP.

Permit water rights are water rights documented by a permit issued by DOE. The permit at issue here is Permit S1-27676P. Prior (and current) ownership of this permit is likely with Rosario Utilities, LLC (RU), because, among other things, that is the entity named in the DOE notice that preceded the grant of the permit in the name of "Rosario Utilities." Within the last 12 months there has been a purported conveyance of the permit from Oly Rose, LLC to OWH, and then a conveyance from OWH to RU. Consequently, either the permit has belonged to RU all along, or, until recently, it belonged to Oly Rose, LLC.

Staff Action: Staff has advised Washington Water Service and RU that an assignment of the water rights will need to occur and be documented as part of the sale and transfer under Docket UW-071357.

1.2.0 **Question:** How were the water rights transferred?

Staff Analysis: In general, appropriated water rights are transferred when the real property is transferred. Nothing more is required. Staff understands that permit water rights may be transferred via an assignment that must be filed with DOE. However, staff is aware of the argument that once permit rights are perfected by being put to a beneficial use, the rights may be transferred by deed, and an assignment is not required to be filed with DOE. In any event, the actual water rights transfers are as follows:

- 283 Acre Feet per Year (AFY) of domestic water rights were transferred from Oly Rose to OWH in a conveyance recorded with the San Juan County Auditor on November 14, 2006. This conveyance included all of the permit rights (110 AFY) as well as some appropriated rights (173 AFY). Oly Rose followed the above permit transfer by filing an assignment of the water rights permit (110 AFY) to OWH with DOE. DOE processed that filing on January 5, 2007. As we discuss in the next bullet, not all of these 283 AFY of water rights were transferred by OWH to RU.

- OWH conveyed 193 AFY of domestic water rights (all 110 AFY of the permit rights plus 83 of the appropriated rights) to RU in a conveyance filed with the San Juan County Auditor on April 2, 2007. OWH has not filed an assignment of the permit to RU with DOE. RU is paying for only 10 AFY of rights (out of 193 AFY total), which come from the appropriated rights. OWH charged nothing for the remaining (183 AFY) water rights.

Staff Action: None. RU will transfer all of these rights to Washington Water Service after the sale is completed.

1.3.0 **Question:** Will Rosario Utilities have enough water allocation from the DOE for build-out and growth (cost of future water rights and buying from unregulated party)?

Staff Analysis: Based on the following information, staff concludes that under existing conditions (including existing DOH policies), RU has enough water to serve its existing 198 customers, and its existing 88 ready to serve commitments. RU's existing and ready to serve customers equal 508 Equivalent Residential Units (ERU's). Average historical usage by RU customers equals 273 gallons per day per ERU. Therefore, based on historical usage, the requirement in AFY for 508 ERU's equals 155 AFY. This leaves 38 AFY or 12.4 million gallons of water in reserve. Whether this "reserve" is sufficient to serve additional growth, and if so, how much growth, will depend on actions by DOH, changes in current customer usage patterns, and changes in the system.

Staff understands that new development (i.e., beyond existing customers and existing ready to serve commitments) will be performed by developers. Developers will need to acquire water rights in order to develop the property. The likely source of such rights will be OWH. In this scenario, the developer would purchase the water rights from OWH and provide them to RU, to enable the company to provide service. It is possible for the developer itself to form a water company, but staff considers that scenario unlikely.

Staff Action: None. Staff is satisfied that RU's acquisition of 193 AFY of water rights is sufficient to meet current demand.

1.4.0 **Question:** Were water rights transferred without permission (RCW 80.16, Affiliated Interests)?

Staff Analysis: Commission statutes require certain filings when a public company transfers property (RCW 80.12), or receives property, services or rights (etc.) from an affiliate (RCW 80.16). In this case, it appears that RU received water rights from affiliates. Under RCW 80.16.020, RU was required to make an affiliated interest filing for that transfer. RU did not make any such filings. However, the statute does not require prior commission "permission" for such a transfer to be effective between the parties.

Staff Action: Staff has addressed affiliated interest issues in this rate case, as they relate to cost of service. Staff notified RU that filings are required and RU made an affiliated interest filing on August 22, 2007 (UTC Docket UW-071730).

1.5.0 **Issue:** Cost of future water rights and buying from unregulated party.

Staff Analysis: Upon sale of the company to Washington Water Service, which will include the water rights currently owned by RU, the company's existing and ready to serve customers will have enough water. This is based on DOH requirements for water quantity and calculations made by RU using historical usage data.

Staff understands customer concerns that OWH may charge high prices for sales of water rights. However, OWH is not subject to commission jurisdiction. Consequently, staff has no basis for recommending the commission take specific action to address this issue. Staff notes this same customer concern applies whether or not RU is sold to Washington Water Service.

Staff Action: None.

2.0.0 **Treatment Plant**

2.1.0 **Issue:** Customers believe the purchase of the water treatment plant was not a prudent decision.

In Docket UW-020307, staff prepared a memorandum (dated June 26, 2002) that carefully analyzed this issue. Staff concluded that the company's decision to build the water treatment plant using a hydroxyl treatment system instead of another type (such as a slow sand filter) was prudent because it was based on sound data that weighed the economic and technical merits of one treatment method over another. The commission accepted staff's recommendation on cost in that docket. DOH approved the hydroxyl treatment system design on November 20, 1997.

Although staff's prior analysis showed that RU's decision in 2002 to build the treatment plant was prudent, and the commission allowed the proposed rates to become effective, the commission did not formally decide the prudence issue. The commission would normally decide this issue via an adjudicative process. The commission could set this, and other issues, for formal hearing in this docket. Parties would present expert testimony and legal arguments to support their positions and the commission would issue an order resolving the issue. Any aggrieved party could seek judicial review of that decision. However, a formal hearing would be expensive, in both time and money, and the cost of such a proceeding to the company would affect rates. Because staff has already conducted a detailed evaluation of this issue, staff does not recommend the commission conduct a rate case hearing to address it.

Staff Action: No further action. The prudence of a company's investment decision is based on the information reasonably available at the time. The company must also make prudent decisions regarding the asset over its useful life. Staff is not aware of any additional information reasonably available at the time RU made the investment decision that would change staff's prior analysis. Staff is not aware of any information to indicate RU has not prudently managed that facility.

2.2.0 **Issue:** Customers did not have input into the decision to build the water treatment plant.

Staff Analysis: DOH regulations and standards require treatment of surface water from Cascade Lake. The company is not bound by rule or statute to solicit input and comment from its customers on how it runs its business in order to meet requirements like those imposed by DOH. Therefore, it is at the discretion of the company to determine if, and when, it needs input into a decision. The commission's jurisdiction in this case is limited to whether or not ratepayers will bear the cost of new capital investment. In Docket UW-991913, the commission allowed rates and charges to go into effect that were calculated using an estimated cost of the water treatment plant.

Staff Action: None

2.3.0 **Issue:** The current capacity of the water treatment plant is not sufficient to meet demand.

Staff Analysis: The company built the water treatment plant in 2000 to provide 220 gallons per minute of flow. Due to existing piping from the lake to the water treatment plant, flow calculations limited the water treatment plant capacity to 200 gallons per minute, enough for 127 new connections, as approved by DOH. The company has received loans from the Public Works Board Drinking Water State Revolving Fund (DWSRF) to increase that flow capacity. In addition to meeting existing customer needs, this DWSRF project is expected to add capacity for 57 new connections. RU has demonstrated to staff that the treatment plant meets DOH capacity requirements for the number of approved connections.

Staff Action: None

2.4.0 **Issue:** The water treatment plant was financed by a loan from affiliate Olympus Partners at a 9.25 percent interest rate. RU did not refinance or renegotiate that loan after interest rates dropped in 2003-2004.

Staff Analysis: Construction on the water treatment plant started in 1999 and the cost was initially estimated to be $1,000,000. Olympus Partners (the resort owner before Olympus Partners formed Oly Rose, LLC and transferred to RU to Oly Rose) issued a seven year note at 9.25 percent. The prime rate at that time was 7.75 percent. Market rates for water companies generally run two to three percent over the prime rate. The commission has used prime plus two percentage points as a reasonable cost for affiliated water company loans.

The commission approved a surcharge and a facilities charge on January 15, 2000. Those charges were not included in the 2002 rate case because they were established for a specific purpose (construction of the new treatment plant) and treated separate from general rates.

Staff Action: Staff did not use the 9.25 percent interest rate in calculating the cost of service. At the time of the 2002 rate case, prime plus two percentage points equaled 6.75 percent. Staff recalculated the water treatment plant loan using a 6.75 percent interest rate. This decreases interest expense, and it decreases the loan balance by $36,125. Staff included these decreases in its analysis of the company's cost of service in UTC Docket UW-070944.

2.5.0 **Issue:** The $279,552 balance of the water treatment plant loan is now being applied to rate base because when DOH reduced the number of authorized connections from 187 to 124.

Staff Analysis: The revenue generated by the commission-approved surcharge and facilities charge did not pay off the loan because DOH reduced the number of authorized connections from 187 to 124. That action resulted in an unpaid loan balance of $279,552, which the company proposed to add to rate base. As indicated in 2.4.0 above, staff reduced the amount of the loan included in the rate base by $36,125. Staff believes this is a reasonable method for the company to recover the costs of the treatment plant that were not recovered by the original surcharge and facilities charge.

Staff Action: See 2.4.0 above.

2.6.0 **Issue:** The water treatment plant was defective and customers believe they were not getting the intended benefits of the monthly surcharge they paid.

Staff Analysis: In Docket UW-020307, staff confirmed that there were substantial delays in the treatment plant going online. However, the surcharge that customers were paying related to the costs incurred by RU to build the treatment plant as designed. Cost overruns were not included as part of the surcharge. Other costs were absorbed by RU's vendor, such as the costs for engineers, consultants, etc., for work required during construction and startup of the plant. These costs were not passed on to RU ratepayers. Consequently, staff believes customers were fairly treated under the surcharge.

Staff Action: None

3.0.0 **Sale and Transfer to WA Water**

Issue: Timing of rate increase, sale and transfer and master plan (rate increase designed to maximize the sale price of the company). A rate case should not be filed now. One should be filed after the sale, when Washington Water Service can better assess its actual costs of operating the system.

Staff Analysis: The commission cannot order a company to refrain from filing a rate case. Staff has evaluated the cost of service in detail. Staff's cost of service analysis finds the rate increase RU filed is cost-justified. Indeed, staff's analysis shows the company's rate filing is conservative. For example, neither staff nor company included rate case expense in the cost of service. Also, staff's analysis did not include in rate base the $100,000 purchase of 10 AFY of water. Staff also considered the impact of likely efficiencies under Washington Water Service ownership, but those efficiencies would not offset the impact of including rate case expense and the water right purchase. Consequently, staff is satisfied that the staff recommended rate levels in this case are reasonable under either RU ownership or Washington Water Service ownership.

Staff Action: None.

4.0.0 **Rate Case**

4.1.0 **Question:** In the rate proposal and the sale and transfer, how will debt be treated?

Staff Analysis:

The debt in the rate case is used to calculate the weighted cost of capital (as adjusted for the interest rate issue discussed above). From that calculation the average rate of return is applied to rate base to determine the company's return portion of the revenue requirement.

Debt is not considered in the sale and transfer application.

Staff Action: None.

4.2.0 **Issue:** The allocation of the utility's fixed costs to the Rosario Resort should reflect the additional capacity the utility needs to meet the resort's peak summer demand.

Staff Analysis: To determine revenue requirements and rates, staff uses a rate base consisting of the depreciated original cost of the assets. General depreciation expense does not relate to specific assets or customer meter rate design. Cost allocation is a rate design issue, not a revenue requirements issue. To properly allocate demand costs, the company needs to accurately measure any summer peaking demands. This is usually done thorough meters that read time-of-use, or peak use, as the water flowed. Currently, the company's meters only read the cumulative amount of water and not the rate that water flows in gallons per minute. Consequently, there is no reliable way to measure the cost the company incurs to meet each customer category's demand on the system.

Staff Action: None.

4.3.0 **Question:** How are direct costs (labor and materials) going to be allocated between the water and sewer plant?

Staff Analysis: Staff shares the customers' concerns about the allocation of the expenses, including employee salaries, between the utility's water and sewage businesses. Part of the concern is that because both the water and the sewage businesses are under the same company (Rosario Utilities, LLC), and only the water service is regulated, there may be an incentive for the company to allocate more costs to the water operations than are appropriate.

Staff Action: Staff reviewed RU's total operations, including sewer treatment operations. Staff reviewed the company's allocation method and the expenses using that method. During the last rate case, the company performed a study of time sheets and administrative costs. The result was the current formula of 65 percent of the time and materials for water and 35 percent of the time and materials for sewer. Staff reviewed the company's study and concluded the allocation of expenses using 65 percent water and 35 percent sewer is reasonable.

Staff also examined costs charged by the sewage operation to the water treatment plant for the disposal of water treatment by-products as compared to other customers. Staff found that the water treatment plant was being charged the same disposal rate as another sewage operation customer, Moran State Park.

4.4.0 **Question:** How will the costs of the company's future and existing upgrades to plant be allocated between residential and resort customers?

Staff Analysis: Costs to improve and upgrade plant that benefits all customers, residential and resort, are allocated to both customer groups through the rate design. In general, plant capacity upgrade costs are funded by users of the capacity. Future customers (either residential or resort) seeking service from the company will pay facilities charges (currently $3,100) to offset capital costs and provide funds for upgrades benefiting them directly.

Staff Action: None

4.5.0 **Issue:** Plant improvements going forward should not be placed in the same pool since the water treatment plant will need to be greatly expanded for the development of the resort.

Staff Analysis: The answer to the question of who pays for future upgrades to the water treatment plant depends directly on who benefits from that upgrade. If an upgrade is made to expand service to the resort or to add new residential customers, the costs for that upgrade should be recovered from the resort or new residential customers, respectively, via a facility charge or through a construction contract. Construction contracts identify what services the developer needs and the company's cost to provide those services. These contracts between the company and any developer for construction or service require commission review and approval.

The company's tariff includes the following for all new customers: a facilities charge of $3,100 and a new connection charge of $240 for each new ¾ inch meter

Staff Action: None

4.6.0 **Issue:** The new rate schedule does not encourage conservation because the rate differential between tiers is so small it is effectively a flat rate.

Staff Analysis: A conservation-based rate design is one in which the price per unit increases as the usage increases. The company and staff have agreed to a conservation-based rate design. To provide a further incentive to customers to conserve water, the first block will be $.85, compared to the $.52 rate the company initially proposed. In addition, staff increased the block amount of usage to more closely generate revenue based on usage. Of course, the actual conservation that results from these changes depends upon how customers react to the new rate design.

Staff Action: Staff recommends the commission approve the revised rates.

4.7.0 **Question:** How is the base and ready-to-serve rate calculated and how does it take into account the fair allocation of fixed costs between these two types of ratepayers?

Staff Analysis: Revised rates have been calculated to set meter base charges and ready-to-serve charges equal to each other. Rate design does not attempt to allocate company plant fixed cost versus variable cost. As calculated, the revised rate design is based on the company's revenue requirements allocated to customer categories based on how much water they use. Staff believes the revised rates are fair, just, reasonable and sufficient.

Staff Action: Staff recommends the commission approve the revised rates.

4.8.0 **Question:** The depreciated value of the plant is part of the rate increase calculation and the company is entitled to make part of its profit on the depreciated value of the plant. Ratepayers paid for the plant. Are we now being asked to give an 11 percent return on that money in a new rate increase?

Staff Analysis: No. The company earns a return on its rate base, which is the original cost, minus accumulated depreciation, minus contributions in aid of construction.

Staff Action: None

4.9.0 **Issue:** RU water system losses of water in 2006 exceeded 20 percent. The company should earn a lower rate of return until it brings this down to 5 percent.

Staff Analysis: DOH regulates water system leakage or "un-accounted for water." DOH recently adopted stricter requirements for all water companies regarding leaks. The utility addresses system water loss in its capital upgrade and replacement program, which is contained in its water system plan. Under that program, the company is currently replacing pipe, which should reduce leakage and water losses. Because the company is addressing this issue to come into compliance with DOH requirements, staff believes a rate of return adjustment would not be reasonable or necessary at this time.

Staff Action: None

4.10.0 **Question:** RU has posted losses over several years. Does the commission allow the losses to be recovered in customer rates?

Staff Analysis: No. Consistent with long-standing regulatory principles, neither the company's nor the staff's cost of service analysis includes recovery of past losses.

Staff Action: None

4.11.0 **Issue:** The rate system needs a senior discount. Also, the base rate should include 1000 gallons.

Staff Analysis: Discounts and a water usage allowance in the base charge do not fairly allocate costs of water usage. Any reduction in rate to one customer or category of customers requires an offsetting rate increase to another customer or category of customers. In other words, if a discount is given to seniors, then other customer will pay higher rates. Commission statutes permit low income discounts. Staff has not received any comments from low income customers on this issue.

Including usage in the base charge would increase the base charge to offset the revenue component associated with the usage and require customers who do not use the minimum allowance to pay higher bills. Rate designs with no usage in the base charge ensure that all customers pay only for the water they use.

Staff Action: None

4.12.0 **Issue:** The allocation of ERU's between different types of customers in the new rate design in light of meters capturing actual usage over the last two years.

Staff Analysis: Staff agrees.

Staff Action: Staff worked with the company to develop a new rate design based on historical metered usage data as further described in staff's memorandum.

5.0.0 **General**

5.1.0 **Issue:** Oppose rate increase.

Staff Analysis: Staff acknowledges RU customer concerns relating to rates. Staff's goal in analyzing any proposed rate increase is to ensure the rates are fair, just reasonable and sufficient. Staff analyzed the costs required to provide water, in sufficient quantity and quality, to RU customers and determined the company demonstrated it needs additional revenue. Staff believes the revised rates are fair, just reasonable and sufficient.

Staff Action: Staff recommends the commission allow the revised rates to go into effect.

5.2.0 **Issue:** Customers need more time to review and understand filing and rates.

Staff Analysis: The original timing of this concern relates to RU's original filing on May 11, 2007. Customers were asked to provide input at the open meeting scheduled for May

23, 2007, for rates scheduled to become effective July 1, 2007. On June 14, 2007, a public meeting was held on Orcas Island that captured additional comment from RU customers. On June 27, 2007, the company extended its effective date for rates until August 1, 2007, and then again on July 19, 2007, for a new effective date of September 1, 2007. Staff believes that customers have had sufficient time to understand the proposed rates and to receive answers to their questions. Because the company filed revised rates using staff's recommended rate design, staff believes customers should be given additional time to comment on those rates.

Staff Action: Staff recommends that the commission allow the revised rates to become effective on a temporary basis, subject to refund, to allow time for customers to comment.

5.3.0 **Question:** How does the Rosario Resort Master Plan (RMP) relate to the water company's future?

Staff Analysis: Staff carefully reviewed the RMP and asked the company to provide additional information relating to water rights and future expansion of the resort. The RMP's Section 2.10, along with RU's six-year water system plan filed with DOH, discusses future requirements for expansion in general terms. The RMP does not bind the water company in making future decisions. Staff is satisfied with the company's ongoing planning efforts.

Staff Action: None.

5.4.0 **Question:** Will the Rosario Resort contribute towards the expenses during the resort shutdown for remodeling?

Staff Analysis: Yes. The RMP discusses two options for the resort during remodeling; either a complete shutdown or continued limited operation during re-development. The resort has not stated any decision relating to these two options. However, the resort will continue to pay (both its base rate and any consumption) for its water, regardless of which option it selects, because either option will require the use of water. The company will need to monitor the usage closely so it can react quickly if the resort's usage falls enough to jeopardize revenues or cash flow.

Staff Action: None