

**STAFF INVESTIGATION
REPORT**

Iliad Water Service, Inc.

Docket UW-060343

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Purpose, Scope, and Authority

Purpose

Staff initiated this investigation of Iliad Water Service, Inc. (Iliad Water or company) in compliance with the commission’s Order 05 in Docket UW-060343.¹

As directed by the commission, the purpose of this investigation is to:

- ✓ Determine the nature of the relationship between the Alder Lake water system and other water systems including water systems owned or operated by Iliad, Inc.
- ✓ Provide, to the best extent possible, the cost of the proposed chlorination system.
- ✓ Determine the proper allocation of the cost of the proposed chlorination system including the tariff that allows recovery of the system cost from water system customers.
- ✓ Address alternate financing of the proposed chlorination system other than the Drinking Water State Revolving Fund (DWSRF).
- ✓ Determine Iliad Water’s financial viability.
- ✓ Develop specific recommendations regarding possible rate relief and a financial and management plan for Iliad Water.

Scope

This investigation focuses on the current financial viability of Iliad Water and the quality of its management. It also looks at Iliad Water’s relationship with (a) Iliad, Inc., an unregulated water system management company and (b) Water Services Company, an unregulated billing and customer service company.

¹ Interlocutory Order Rejecting Tariff, Deferring Action and Directing Investigation, Order 05, Docket UW-060343, February 28, 2007.

Sources

Staff used numerous sources in compiling this report including:

- ✓ Staff workpapers and the official record developed in this docket (UW-060343).
- ✓ 2004 staff workpapers in Docket UW-041830.
- ✓ Company responses to additional staff data requests.

Staff also had discussions with:

- ✓ Derek Dorland, President of Iliad Water.
- ✓ Dave Dorland of Iliad, Inc.
- ✓ Sondra LeBaron, of Water Services Company.
- ✓ Mr. Derek Pell, PE, and Mr. John Aden of the Department of Health.
- ✓ Leslie Hafford and Chris Gagnon of the Public Works Board.

Authority

Staff undertook this investigation as directed in the commission’s interlocutory order in this docket,² and under the authority of 1) RCW 80.04.110, which authorizes staff investigations; and 2) RCW 80.28 and WAC 480-110, which gives the Utilities and Transportation Commission regulatory (UTC) authority over the operations of companies that provide water services.

² Order 05 at ¶ 53

Executive Summary

Staff reviewed the operations of Iliad Water and its relationship with Iliad, Inc. Staff concluded that Iliad Water is a stand-alone water company. Staff found that Iliad, Inc., does not assert the degree of control, as defined in WAC 480-110-235, over Iliad Water to consider Iliad, Inc., and Iliad Water a combined company under unified management.

Staff also reviewed the cost of the chlorination system. Using an analysis of the prior bids received by Iliad Water for the chlorination project and adjusting for known changes, such as inflation, staff found that \$120,436 is a reasonable estimate of the project cost if private financing is used. If DWSRF financing is used, the cost increases to \$151,890.

The review of the cost included an examination of the bidding process environment. Staff found that although there is no evidence to indicate the bid process was improper, using Iliad, Inc., to administer the bid process strains the appearance of independence and, in fact, may be a conflict of interest. However, if the company succeeds in obtaining a DWSRF loan, the Public Works Board will determine if the arrangement creates a conflict.

Although the commission consistently allocates system improvement costs to all customers of a company, not just to the customers on the benefiting water system, staff concluded only the customers on the Alder Lake water system should pay for the cost of the chlorination system. Staff believes the rate impact on the customers not receiving benefit of the water system improvement would be too large based on its analysis of surcharge impacts on rates for non-benefiting customers.

Staff concluded that the proposed surcharge is the proper cost recovery method. However, staff believes the commission should consider the proposed one-time charge only if the company uses high-cost private financing to finance the Alder Lake chlorination system. If the company obtains the DWSRF loan, staff concluded it would be highly unlikely that it would be in any ratepayer's economic benefit to select the one-time charge.

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Staff concluded equity financing is unavailable to the company because of its large negative retained earnings. A DWSRF loan is the only available form of financing that provides reasonable rates. However, staff notes that using a DWSRF loan to finance the water treatment system does not correct the company's underlying financial problems, which staff addresses later. In addition, staff concluded contributions in aid of construction (CIAC) received through surcharges provide a reasonable method of servicing the DWSRF loan, or the private loan if the DWSRF loan is not obtained. Although there is a risk that customers will not fully benefit from their contributions to the company, this is consistent with CIAC financing. Staff believes in this case, the risk is offset by the benefit of receiving safe drinking water.

Finally, as a result of staff's analysis of the viability of the company, staff concluded Iliad Water is not a viable company and there is substantial doubt about its ability to continue as a going concern with its current financial structure. Staff presents two recommendations that will allow the company to return to financial viability and keep rates at a reasonable level. Staff recommends that (1) Iliad Water should file for rate relief, and (2) Iliad Water should negotiate with Iliad, Inc., Water Services Company and First California to discharge Iliad Water's debt to these companies. Iliad Water's creditors must recognize the amount of debt that exceeds Iliad Water's current net assets, \$187,749 at the end of 2006, is uncollectible and (3) Iliad Water should file an Equity Investment Plan showing its intention to build and maintain a positive equity capital structure. The company should begin work on these recommended actions immediately. The company should complete all three by the end of September 2007, the month the Public Works Board begins its review of DWSRF applications.³

³ Sarver Testimony, UW-060343, Exh. No. 64, 10:8-12.

Background

Iliad Water is a Utilities and Transportation Commission regulated water company that serves approximately 89 customers on three water systems located in Kitsap, Snohomish and Pierce counties.

In the Fall of 2000, the company's Alder Lake water system wells went dry, the result of low water levels in the nearby Alder Lake. The Department of Health informed the company's certified operator in December of 2000 that the water system was hydraulically connected to Alder Lake. That is, the ground water that the water system uses to serve its customers is geologically connected to the water in the lake, thus posing a microbial risk. Washington Administrative Code, WAC 246-290-640, requires the company to install disinfection treatment. Slightly over a year later, January 31, 2002, the Department of Health approved the company's proposed plan to chlorinate the Alder Lake water system.

According to the company, as stated in the record in this docket, it took until the next year, January 2003, before the company received a commitment from a lender to fund the project. It took Iliad Water an additional year and a half, until August 2004, before the company issued an invitation to bid to four companies. By the following month, the company received responses and selected the low bidder, a non-related company Aerie Construction LLC, as the winning bidder. The company witness testified that the reason for the long delay was "Iliad [Inc.] had a number of projects to undertake and with limited resources could not get to each project at the same time."⁴

On October 11, 2004, the company filed a tariff revision proposing a surcharge for the costs associated with the proposed chlorination system.⁵ Iliad Water requested a "*Treatment Assessment*" charging each of its customers on its Alder Lake water system a one-time charge of \$3,265.

⁴ Dorland testimony, UW-060343 Exh. No. 1, 5:4-9.

⁵ See Docket UW-041830.

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The tariff revision also provided an option for the customer to sign a promissory note that allowed the customer to pay monthly payments to a third party lender over a period of ten years. The commission staff began its review by issuing a series of data requests requesting additional information on the financing, rate design and the proposed costs of the new system. Five months after filing, on May 19, 2005, the company withdrew its filing.

On March 1, 2006, Iliad Water re-filed with the commission a revised tariff proposing to assess each of the 39 customers on its Alder Lake water system a one-time charge of \$3,405 for the costs associated with installation of a water chlorination system. The filed tariff again gave an option for customers to obtain a personal loan from a third party lender arranged by Iliad Water. The proposed private financing agreement proposed to charge customers 11 percent interest over 10 years, plus an origination fee of 3 percent to 5 percent of the loan principal.⁶ The proposed surcharge would finance all costs of the project. The company relied on WAC 480-110-455 that allows surcharges to fund 100 percent of the project.⁷

After staff objections, the company later modified its tariff. The revised tariff proposed a monthly surcharge of \$49.26 if the customer made the choice not to pay the one-time charge of \$3,405. It also removed the private financing option. The commission considered the matter at its March 29, 2006, open meeting, and suspended the proposed tariff and directed the matter be set for hearing.

On November 8 and November 9, 2006, Administrative Law Judge Patricia Clark conducted an evidentiary hearing. The following week, on November 16, 2006, Judge Clark convened a hearing in Eatonville for public comment. Twenty-two customers attended the hearing and voiced their concerns before Judge Clark.

⁶ The company did not pursue a Drinking Water State Revolving Fund (DWSRF) loan, which provides a substantially lower interest rate and a longer payback period than the proposed conventional loan.

⁷ Although staff normally takes the position that a portion of the investment should be financed through equity, Iliad Water's current capital structure reflects a major deficit in retained earnings, which makes additional equity investment unlikely.

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The commission issued its Initial Order on January 10, 2007, rejecting the company's request to revise its tariff. On February 28, 2007, the commission issued an interlocutory order affirming the initial order's rejection of the proposed tariff. However, the commission's interlocutory order deferred action and directed staff to conduct this investigation into Iliad Water. Following staff's petition for review and clarification, the commission affirmed its directive to conduct an investigation and clarified certain issues in Order 06, issued on April 27, 2007.⁸ The following is the result of the ordered staff investigation.

Iliad Water Service, Inc.'s Relationships

Section Summary

As a necessary step in determining the proper allocation of the proposed chlorination project costs, the commission directed staff to determine if Iliad Water's various systems are independent or if the Iliad Water owned water systems, and those owned and managed by Iliad, Inc., constitute a unified management.⁹

Staff reviewed Iliad Water and its relationship with other companies associated with its maintenance and operation. Staff concluded that Iliad Water is a stand-alone company. Staff found Iliad, Inc., a non-regulated water system management company, does not assert the degree of control required for the commission to consider Iliad, Inc., and Iliad Water a combined company under unified management.

Iliad Water Service, Inc.

Iliad Water is a Washington corporation, incorporated June 23, 1992. The company was originally incorporated as "Iliad Utility Services, Inc." Even though the company's name was incorporated as "Iliad Utility Services, Inc.," the company mistakenly filed with the

⁸ Iliad Water Service, Inc., Docket UW-060343, Order 06. (April 27, 2007).

⁹ Interlocutory Order 05, paragraph 25.

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commission its initial tariff in August 1992 as Iliad Water Service, Inc. In 2002, the company filed with the Secretary of State to change its corporate name to “Iliad Water Service, Inc.” consistent with the company’s tariff. Mr. Derek Dorland is the sole shareholder, owning 100 percent of Iliad Water’s stock and is the company’s president.

Iliad Water provides water service to three communities with three separate water systems.

- *Alder Lake water system* - Serves 39 customers, located in southern Pierce County near the town of Elbe.
- *Cascade Crest water system* - Serves 23 customers, located in Snohomish County seven miles north of Marysville.
- *Western Stavis Water System I & III* - Serves 27 customers, located in Kitsap County approximately 13 miles west of Silverdale.

Although Iliad Water owns the three water systems, it does not have employees nor does it maintain an office. The company contracts out functions normally performed by company personnel to two different companies: Iliad, Inc., and Water Services Company.

Iliad, Inc., provides all maintenance and operational functions for Iliad Water under the provisions of a *Management Contract*. Water Services Company provides administrative functions such as billing, recording payments and customer service. Water Services Company provides its services in accordance with a separate *Billing Service Agreement* with Iliad Water.

Iliad, Inc.

Iliad, Inc., is a Washington corporation, incorporated in October 1975. It is a separate and distinct company from Iliad Water. David Dorland, the president of Iliad, Inc., is Iliad, Inc.’s sole shareholder.¹⁰

¹⁰ David Dorland is the father of Derek Dorland, the owner and president of Iliad Water.

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Iliad, Inc.’s office is located in Seattle near Boeing Field. Iliad, Inc., provides operation and maintenance services for 22 water systems in western Washington in addition to the three water systems owned by Iliad Water.¹¹ Iliad, Inc., also has a construction services division. Table 1 shows the companies the UTC regulates of the additional 22 systems associated with Iliad, Inc.

Table 1 –Other regulated water systems operated by Iliad, Inc.

System Name	Owner
Marbello Water System	Marbello Water Co.
Y Bar S Water Company, Inc.	Bliss Industries
Hunt Community I and II	Fragaria Water Co.
Fragaria Water System	Fragaria Water Co.
Cherry Creek Water System	SJM Water Service

Iliad, Inc., provides its maintenance and operational services under a management contract. The contract, titled “*Management Contract (for Maintenance and Operations)*,” states the charges for services provided for Iliad Water to maintain its three water systems. Iliad, Inc., sends its employees to Iliad Water’s different water systems to perform normal operating functions such as reading meters, collecting water samples or making repairs to the system. Iliad, Inc., then charges Iliad Water a monthly fee based on the services provided. For example, Iliad, Inc., charges Iliad Water \$65 per hour for a serviceman with truck and equipment. The hourly charge for the serviceman and the truck includes travel time to arrive at, and return from, the job site.

Staff compared Iliad, Inc.’s listed charges with other satellite management agencies in the region and found Iliad, Inc.’s charges were reasonable and consistent with the other satellite management companies. Staff asked Iliad, Inc., for the contracts of the non-jurisdictional

¹¹ See Appendix D for a listing of Iliad, Inc., operated water systems.

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companies that Iliad, Inc., manages or operates. Citing business confidentiality, Iliad, Inc., did not provide them.¹²

Water Services Company

Water Services Company is a sole proprietorship owned by Sondra LeBaron.¹³ Iliad Water originally contracted with Water Services Company in January of 1997 to provide the basic administrative, billing and bookkeeping functions. The contract states that Water Services Company will do all “billing rosters, billings, collections, delinquent collections, and customer inquiries regarding information and normal forms, payment of bills relating to operation of the water systems, and periodic reports and statements.” Water Services Company is also responsible for the 24-hour call line and customer service. The commission’s consumer affairs staff uses Water Services Company as the contact for service complaints.

Although Water Services Company provides the billing and bookkeeping services for all 25 water systems serviced by Iliad, Inc., Water Services Company is a separate entity from both Iliad Water and Iliad, Inc. Staff compared the charges of Water Services Company with other providers of water company billing and accounting services and, as with Iliad, Inc., found the charges were consistent with the other providers.

Discussion

Does Iliad, Inc., have de facto control of Iliad Water and its other contracted systems?

The question of control is relevant because if Iliad, Inc., controls the water systems with which it contracts, then Iliad, Inc., and all the controlled systems, would fall under commission jurisdiction. With all systems under commission regulation, the cost of the proposed chlorination system could then be spread over all 849 customers served by Iliad, Inc., dramatically reducing the per customer rate impact.

¹² Staff reviewed the companies regulated by the commission and that have contracts with Iliad, Inc., to determine if there were any similarities between Iliad Water and the other systems. A short discussion of the staff’s review is located in Appendix G “Discussion of Iliad, Inc., operated UTC Regulated Water systems.”

¹³ Sondra LeBaron is the daughter of David Dorland, president of Iliad, Inc.

RCW 80.04.010 defines “water company,” and states that, for the purpose of determining commission jurisdiction, any company “*having common ownership or control, regardless of location or corporate designation*” is considered a single entity for determining UTC jurisdiction¹⁴. The commission’s WAC 480-110-235 defines control to mean a water system operator or manager has discretion over the property, finances or operations of a water company that is normally exercised by an owner. Examples include whether the operator or manager may:

- ✓ Authorize the purchase or sale of all or part of the water system or its water rights.
- ✓ Authorize capital additions or improvements to the system.
- ✓ Accept contributed plant.
- ✓ Authorize the expenditure or acquisition of funds that encumber any asset of the company.
- ✓ Authorize the expenditure of funds for non-water company purposes.

Another factor in determining control is if the operator or manager receives compensation of a type or amount having no reasonable relationship to the work performed.¹⁵

If the commission determined a company, such as Iliad, Inc., had control and it met one of the jurisdictional benchmarks, either \$471 in average annual revenue per customer or the systems serve 100 or more customers, the systems would fall under commission jurisdiction.¹⁶

¹⁴ RCW 80.04.010 “That such measurement of customers or revenues shall include all portions of water companies having common ownership or control, regardless of location or corporate designation. ‘Control’ as used herein shall be defined by the commission by rule....”

¹⁵ WAC 480-110-235 also states that control does not include management by a satellite agency as defined in chapter 70.116 RCW if the satellite agency is not an owner of the water company. *Iliad, Inc., is not a satellite agency.*

¹⁶ WAC 480-110-255(b) Jurisdiction.

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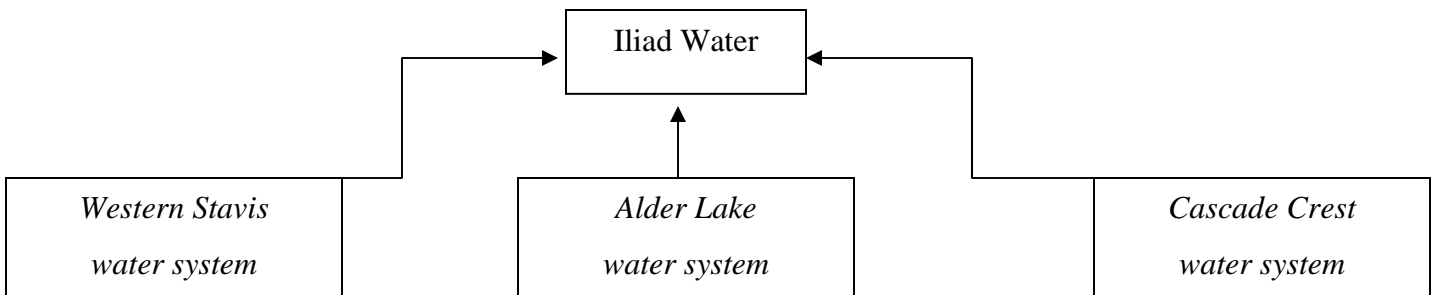
Although, Iliad, Inc., has maintenance and operational contracts with a number of additional water systems, including Iliad Water, staff has found no direct evidence that Iliad, Inc., controls any of those water systems. The hearing record in this docket does not support the premise that Iliad, Inc., controls Iliad Water’s operations. For example, when asked at hearing who has “the final decision-making authority?” Mr. Derek Dorland responded that he did.¹⁷ In a staff interview on June 5, Mr. Dave Dorland stated that he did not make major decisions for any of his managed companies, including Iliad Water, but rather each of the owners of the different water systems had the final decision and control.

Staff’s investigation into Iliad, Inc., revealed a complex organization that is involved in multiple ventures outside commission jurisdiction. Appendix E shows an organizational chart describing the results of staff’s investigation into Iliad, Inc.’s business structure.

Iliad Water is a stand-alone company

Iliad Water’s business structure is a simple corporate structure of a small company. With each of Iliad Water’s water systems in different counties, there may be an impression of complexity, however, the ownership structure is actually straightforward as shown below in Figure 1.

Figure 1 - Water systems owned by Iliad Water



¹⁷ Dorland, TR. 49:25 to 50:21.

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Iliad Water reports the three systems together in its gross revenue in the company’s annual report. In addition, Iliad Water files only revenue of the three systems in its annual income with the Internal Revenue Service. Iliad Water stands alone as a separate entity.

Staff’s review of Iliad Water’s operations and its relationship with other companies associated with the maintenance and operations of its systems show Iliad Water is a stand-alone company. Staff found that even though Iliad, Inc., does the routine maintenance and provides occasional advice to the owner, it does not assert the degree of control over Iliad Water as defined in WAC 480-110-235 for the commission to consider Iliad, Inc., and Iliad Water a combined company under unified management.

Cost of the Proposed Chlorination System

Section summary

Citing gaps in the initial order, the commission requested staff to work with the company to determine the cost of the new facility.¹⁸ The commission directed staff to determine the cost of the proposed chlorination system. “...with reasonable accuracy.”¹⁹

In staff’s review of the cost of the proposed water treatment system, staff considered the low number of bidders and the bidding process. Staff concluded that since the proposed project consists of multiple sub-projects, many that require specialized expertise in the water industry, the pool of potential bidders is limited. Therefore, it was not unexpected that the company received a low number of bids.

Staff’s review of the costs included a review of the environment in which the bidding process was conducted. Staff found that even though Iliad, Inc., the bidding administrator, cited acceptable reasons for the limited number of bidders and there is no evidence to

¹⁸ Order 06, ¶ 18.

¹⁹ Order 05, ¶ 53 (1).

indicate the bid process was improper, using Iliad, Inc., to administer the bid process strains the appearance of independence. If Iliad Water is awarded a DWSRF loan, it will be up to the Public Works Board to determine if, in fact, there is a conflict of interest for future requests for bids for the project.

Although the bids were limited in number, staff concluded that the bids provide a reasonable basis to estimate the current cost of the project when adjusted for inflation. Staff found that \$120,436 is a reasonable estimate of the project cost if private financing is used. If DWSRF financing is used, the project cost increases to \$151,890.

Background

The cost of the proposed chlorination facility was an important issue throughout the staff review of both of the company's cases. Costs and the scope of the project differ between the prior filing in Docket UW-041830 and the current filing. For example, although the proposed cost of the project in this docket is greater than the prior case, the number of improvements is less. As the commission states in Order 05,

“Iliad received the first successful bid for the project on August 23, 2004, and the second successful bid for the project on December 15, 2005, approximately 16 months later. The scope of the project for the second bid is less than the first bid because the second bid does not include the installation of 35 water service connections. The current successful bid is approximately 59 percent higher than the first bid.”²⁰

The commission directed staff to determine, with reasonable accuracy, the cost of the proposed facility to fill in the “gaps identified in the initial order.”²¹

In support of staff's perspective on the project cost reflected in this report, staff examined information obtained in its audit of the company for this filing, the hearing record, along

²⁰ Order 05, ¶ 42.

²¹ Order 06, ¶18.

with additional data request responses from Iliad Water. Staff also engaged in an in-depth discussion with Iliad, Inc.'s president regarding his estimate of the cost of the project. As a check, staff discussed the project costs with Derek Pell, PE, of the Department of Health, who felt Iliad, Inc.'s estimated costs were not unusual for a project this size.²²

Staff emphasizes at the outset that if the Public Works Board approves the company for a DWSRF loan, the cost estimate of the Alder Lake water system chlorination project presented in this report is irrelevant. The Public Works Board will require the company to obtain competitive sealed bids for the project. The winning bid will determine the ultimate cost of the project, not the costs separately analyzed or provided here by staff. The 2007 DWSRF guidelines describe the competitive bid procedures that the company would follow.²³

The DWSRF guidelines require the company to select not only the lowest bid, but also the lowest responsible bidder. The selected bidder must meet certain guidelines including good character, integrity and reputation. Staff believes the safeguards provided by the Public Works Board requirements adequately protect the ratepayer from incurring the burden of inflated or improper costs. Staff notes that even though no evidence indicates the bid process was improper, using Iliad, Inc., to administer the bid process strains the appearance of independence and may, in fact be a conflict of interest under the Public Works Board bidding requirements. Iliad Water should clarify this issue with the Public Works Board prior to the bidding process if the company succeeds in obtaining a DWSRF loan.

Scope of chlorination project

Although the new chlorination project is limited to only the Alder Lake water system, the construction of the treatment system is not a small project. The company must build a new well house that will contain the new disinfection equipment, specifically a chlorination

²² Staff did not attempt to reconcile the difference between the 2004 bid and the 2006 bid. Although the 2004 bid was considerably lower, the winning bidder, Aerie Construction LLC, is no longer in business. Staff has no detail of the individual components for the \$68,020 2004 bid making it impossible to compare it with Iliad, Inc.'s bid.

²³ The 2007 guidelines related to competitive bid procedures are consistent with Mr. Pell's Exh. No. 71, Appendix J.

injector. Proper injection methods and amounts of chlorine must be used to provide effective water treatment. The disinfection facility must introduce chlorine safely into the well water immediately after it is pumped from the ground. The chlorine must maintain contact with the well water for an extended length of time before it is combined with the rest of the water that is available for distribution at the water storage tank.

The extended contact time requires the installation of a separate dedicated transmission main connected to the system's water storage tank. The transmission main is separate from the current distribution system that serves the company's customers. The required contact time is achieved by the length of time the treated water takes to flow through the transmission main to the system's storage tank.

The project as a whole is made up of a number of smaller projects.

- ✓ Build a pump house.
- ✓ Install the chlorine disinfection system.
- ✓ Clear (grubbing) water main right-of-way, trenching and hauling away excess excavated dirt.
- ✓ Haul in bedding material for piping.
- ✓ Install 2,060 feet of dedicated three-inch water main to the water storage tank from the pump house.
- ✓ Receive inspection and approval of project by engineer.
- ✓ Bore a hole in concrete water tank and connect the transmission main to the water system.²⁴

Chlorination project cost

On December 2, 2005, Iliad Water sent invitations to bid on the chlorination project to three regional construction companies. It did not publish a request for proposals.²⁵ According to Mr. Dave Dorland, president of Iliad, Inc., the criteria for soliciting bids were 1) the

²⁴ Interview with Mr. Dave Dorland, June 8, 2007.

²⁵ Dorland Exh. No. 14 (DD-14), page 3 of 16.

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contractor must have experience with public water systems, and 2) the contractor must be bondable.

By December 16, 2005, Iliad, Inc., the administrator of the bid process for Iliad Water, received three outside bids (not including Iliad, Inc.’s own bid) for the chlorination project. Iliad, Inc., was the low bid at \$108,163, and Iliad Water awarded Iliad, Inc., the contract to construct the new chlorination system.²⁶ Table 2 shows the contractor and the related bid amount.

Table 2 – Table of 2005 Project Bids

Contractor	Bid Amount
Sound Design & Construction, Inc.	\$ 126,208
Blue Line Construction	112,452
JP Newton	114,304
Iliad, Inc.	\$ 108,163

The low bid is the starting point for the estimated cost of the project. Along with the direct construction costs, the project requires oversight by an engineer, estimated to cost \$2,765.²⁷ The additional engineering, when added to the \$108,163 bid, brings the total direct costs to \$110,928.

Since the bid amounts are more than a year old, staff adjusted the cost of the project to include the effect of inflation on the overall construction costs. Since the end of 2006, when the company first received the bids, water-treatment facility construction costs increased at an average 4 percent inflation rate.²⁸ The cost of PVC mains increased by 14 percent due to the surge in oil prices. Staff applied the applicable inflation factors to construction costs

²⁶ See Appendix F for detail of contractor bids.

²⁷ Dorland Exh. No. 14 (DD-14), page 14 of 16.

²⁸ Cost Trends of Water Utility Construction, Pacific Region, Handy-Whitman Bulletin No. 165.

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reflected in the Iliad, Inc., bid, computing an estimated cost increase of approximately \$6,000.

As shown in Table 3, staff also adjusted the DWSRF project cost by \$33,458 for additional costs associated with the loan. The adjustment reflects the additional costs the company will likely incur if the company is successful in obtaining a DWSRF loan. Examples of costs the company would incur solely because of additional requirements of the DWSRF include additional engineering requirements and the requirement that the company pay prevailing wages.

Table 3 – Cost of Water Chlorination Project

	<u>Private Loan</u>	<u>DWSRF</u>
Iliad, Inc., Bid	\$ 108,163	\$ 108,163
Engineering	2,765	2,765
Total Construction Costs	110,928	110,928
Increase in Construction Costs	6,000	6,000
Additional DWSRF Project Costs		33,458
	116,928	150,386
Financing Costs	3,508	1,504
Total Project Costs	<u>120,436</u>	<u>151,890</u>

If Iliad Water uses a private lender charging the 3 percent loan fee, as proposed in Iliad Water’s application, the additional cost to the project would be \$3,508. However, if the company obtains a State Revolving Fund loan, the additional costs would include only a 1 percent loan fee or \$1,108. Table 3 compares the total estimated cost of the project using the two financing methods. The total project cost for private financing is estimated at \$120,436, whereas the total estimated project cost for DWSRF financing is \$151,890.²⁹ Staff’s analysis of the chlorination project cost assumes the original bids received were fair

²⁹ Although the company proposed the inclusion of prior period costs associated with the project, it remains staff’s position that those costs are already financed through additional debt and the company should follow standard regulatory accounting for its recovery.

arms-length estimates and that, in a new round of competitive bidding, the new low bid would be close, when adjusted for the effect of inflation, to the original bids.

Allocation and Recovery of Project Cost

Section summary

In its order, the commission asks “...whether the cost of the chlorination facility should be spread over only the customers of the Alder Lake system or a larger universe of customers.”³⁰ Later in the same order, the commission directs staff to find the proper allocation of the project’s cost.³¹

Staff concluded that only customers on the Alder Lake water system should be allocated the cost of the chlorination system. Although the commission consistently allocates system improvement costs to all customers of a company, not just the customers on the improved water system. In this case, the rate impact on the customers not receiving benefit of the water system improvement is too significant compared to other surcharges.

If the Alder Lake system is required to “stand on its own,” a consequence of this method of cost allocation is that each of the three water systems will “stand on their own,” in the event of a major cost affecting just one system. In other words, Iliad Water customers should not expect the commission to allow recovery of costs from all of the company’s customers through Single Tariff Pricing.

Staff also concluded that the proposed surcharge is the proper recovery method. However, the commission should only consider the proposed one-time charge if high-cost private financing is used to finance the Alder Lake chlorination system. If the company obtains the DWSRF loan, staff concluded it would be highly unlikely that any ratepayer would

³⁰ Interlocutory Order 05, ¶ 45.

³¹ Interlocutory Order 05, ¶ 53.

economically benefit by selecting the one-time charge because of the loan’s low interest rate.

Discussion of allocation.

The commission consistently allows the recovery from all company customers, not just the customers served by the water system with the required improvement, the costs of Department of Health required system improvements. Recovering the costs from all customers of a multi-system water company is referred to as *Single Tariff Pricing*.

In this case, the company requested recovery of the cost of the project from only the Alder Lake water system customers rather than from the customers served by all three of Iliad Water’s water systems. Although staff routinely supports Single Tariff Pricing, it does not in this case. Staff agrees with the company’s proposal that the commission allow the cost to be recovered from only the Alder Lake customer base, which is the only beneficiary of the new treatment plant.

For larger utilities, the rate impact of spreading the cost to all its customers is not significant for the customers that do not benefit from a single-system improvement. This is because of the large number of customers these companies serve. The cost of the improvement, when allocated over the larger number of customers, decreases the per-customer cost, making the increase in the individual’s monthly water bill more acceptable. In contrast, Iliad Water has only 89 customers on all three systems. Fifty customers are not on the system that will receive the benefit of water chlorination. The monthly impact to the rates for customers not receiving the water treatment will be material.

The surcharge, if spread evenly over the 89 customers, would be \$9.12 per month.³² The \$9.12 surcharge equals 36 percent of the monthly water bill for the Cascade Crest customers and 39 percent of the Western Stavis and Alder Lake customer’s water bill. Review of

³² Estimated surcharge is based on staff’s calculated cost shown on Table 3.

commission-allowed surcharges shows that the average rate impact of surcharges range between 15 percent and 23 percent of a ratepayer’s average bill. Staff believes that requiring Iliad Water’s non-beneficiary customers to carry such an additional financial burden is unfair. Therefore, staff recommends that only the Alder Lake customers should pay the cost of the treatment project for their water system.

However, if the Alder Lake water system “stands on its own,” and pays the costs of the water treatment system alone, then, as a consequence of this approach, each of the three water systems will “stand on their own,” in the event of a major cost. Iliad Water customers should not expect the commission to allow recovery of costs from all of the company’s customers through single tariff pricing.

Discussion of Recovery

In this docket, the company proposed recovering the cost of the chlorination system by using either a one-time charge or a monthly surcharge. The one-time charge would allow ratepayers choosing this option to pay the allocated cost of the treatment system up front, instead of paying a monthly charge over a period of years.

Though not clearly stated, underlying the requirement that each ratepayer make a choice between either the one-time charge or a monthly surcharge is that each individual ratepayer, when making the choice, is making an economic decision. The economic decision is a question of opportunity cost. Which choice is economically beneficial for each individual ratepayer?

To illustrate, assume a ratepayer can obtain the funds to pay the one-time charge by using the family home as security. Assume further that the bank will provide the ratepayer a loan with an interest rate of seven percent over five years. If the monthly surcharge has an embedded interest rate of 11 percent, payable over five years, it is in the ratepayer’s advantage to borrow the money at seven percent and pay the one-time charge. On the other

hand, if the surcharge has an embedded rate of 1.5 percent, as with the DWSRF, it would be more beneficial for the ratepayer to select the monthly surcharge.

As shown in the illustration above, if a private lender ultimately funds the chlorination system, it remains staff's opinion that it is in the ratepayer's interest that the commission allow the two options, the one-time charge or monthly surcharge. The option between a one-time charge or monthly surcharge gives ratepayers an opportunity to make the best economic choice that fits each ratepayer's individual circumstances.

However, if Iliad Water were successful in obtaining the DWSRF loan, it would be highly unlikely that any ratepayer could economically benefit by selecting the one-time charge.³³ With the company using a DWSRF loan, staff believes it would not be in ratepayers' interest to allow the one-time charge option that, if chosen, would most likely be to the ratepayer's disadvantage.

The commission addressed another difficulty with the one-time charge when it stated its concern of "...requiring ratepayers to become investors in a project, and that ratepayers be treated as investors, in particular if the company later sells the company to a new owner."³⁴ Unlike a true investor, payment of the one-time charge does not transfer any rights of ownership. Rather, since the chlorination system will benefit the community for years in the future, ratepayers who elect the one-time charge effectively "prepay" the costs of the chlorination system. By paying the up-front charge, customers lose any ability to recapture the amounts they "prepaid" if the company sells the system or they decide to sell their homes and move out of the Alder Lake community.³⁵

³³ Ratepayers can benefit only if (1) their investments are earning less than 1.5 percent or (2) they can borrow money to pay the one-time charge at an interest rate less than 1.5 percent.

³⁴ Order 06, ¶ 19.

³⁵ See Project Financing Alternatives for a more in-depth discussion regarding the loss of the ability to recover the prepayment.

The commission should only consider the proposed one-time charge if high-cost private financing is ultimately used to finance the Alder Lake chlorination system. Alternatively, if the company obtains a DWSRF loan, staff concluded it would be highly unlikely that any ratepayer would economically benefit by selecting the one-time charge, a result of the DWSRF loan's low interest rate.

Project Financing Alternatives

Section summary

The commission directed staff to consider the "...proper allocation of costs among investments, loans and advances for ratepayer reimbursement through surcharge."³⁶ All businesses, regulated and non-regulated, finance using debt or equity. Debt financing can be short-term or long-term funds that the company borrows with the expectation that it can repay the borrowed amount plus interest. Debt financing does not provide the lender any ownership interest and normally has a lower cost (interest) than capital provided through equity investment.

Equity financing, on the other hand, consists of long-term funds with an indefinite life. It carries an expectation that it will earn an equity return for its investor. In contrast to debt financing, equity financing does create an ownership interest and normally demands a higher return on investment than debt.

Public utilities use a third form of financing called contributions in aid of construction (CIAC). CIAC financing differs from debt and equity because customers actually transfer money (or property) to the utility with no expectation or requirement of repayment. In

³⁶ Order 05, ¶53.

addition, although customers give the funds to the company, CIAC does not create an ownership interest.³⁷

Water utilities fund growth using debt, equity and CIAC investment. Debt and equity investment increase monthly water rates for a company's customers when the investment increases a company's rate base. A company is entitled to recover its investment financed through debt and equity through depreciation and earn a return on its investment. However, regulatory principles prohibit the company from recovering the cost of plant financed by CIAC and does not permit the company to earn a return on contributed utility plant. The rate impact of CIAC is zero.

As a first stage of financing a capital project, a utility attempts to obtain a total financing mix of debt, equity and CIAC that provides the lowest possible cost while still maintaining a balanced capital structure. A balanced structure provides a combination of safety and the optimal weighted cost of capital. However, the most important component of the financing mix is the equity investment. Although it is the most expensive of the three financing methods (and the one lacking in Iliad Water), equity investment generates earnings (net income) that provide safety to the company. A company's earnings give the company the funds to meet unexpected increases in expenses or reductions in revenue without resorting to additional debt. A balanced capital structure uses lower cost debt financing while still having the security of earnings of the higher cost equity investment.

Iliad Water has allowed its equity component to severely deteriorate to a point where net equity is negative. The company's deteriorated capital structure has caused an imbalance that prohibits the company from using any reasonable financing mix. Debt financing at a reasonable rate is not available due to the highly leveraged position of the company and the lack of any equity earnings allowing coverage for interest payments.

³⁷ In contrast with other public utility sectors, when a regulated water utility receives CIAC, it is not a taxable event except for CIAC received for water service connections. See IRS § 118 Contributions to the capital of a corporation.

Equity financing

As the company’s capital structure currently sits, equity financing is not a viable option. The negative equity position prohibits an investor from receiving any return on any new equity investment. To illustrate, Iliad Water’s 2006 annual report shows negative equity of \$185,969. As shown in Table 4 below, if an investor invested \$200,000 into Iliad Water, the investor would receive a return on the difference between the negative equity balance of \$185,969 and the \$200,000 investment, or \$14,031.

Table 4 - Effect of negative retained earnings on \$200,000 equity investment

Iliad Water's Equity Balance as of 2006 Year End

Year End Equity	\$	(185,969)	source: 2006 annual report
Investment		<u>200,000</u>	
Net Investment	\$	<u>14,031</u>	

Under Iliad Water’s current capital structure, the \$200,000 investment would earn a return on only \$14,031 of the investment. The remaining \$185,969, for all practical purposes, disappears into a black hole.³⁸ Using a DWSRF loan to finance the chlorination project provides the company the ability, for the most part, to avoid using equity that would result in that immediate loss to the investor. However, if the company accepts staff’s recommendation discussed later in this report to negotiate the forgiveness of its non-recoverable debt, the negative capital structure is removed and actually results in a small but positive equity balance.

Contributions in aid of construction

Public utilities commonly use a third form of financing called contributions in aid of construction (CIAC). Of all the utility industries, water companies far exceed the others in using this form of financing. CIAC financing differs from debt and equity financing because there is no obligation, or even an expectation, of repayment nor does the contributor obtain

³⁸ The recovery of the total \$200,000 investment would remain intact in the form of depreciation expense.

ownership interest in the company.³⁹ CIAC takes the form of either contributed water utility plant, (e.g., mains, pumps or service lines) or money. Customers normally provide CIAC to water companies for one of two reasons, (1) for the provision of water service to new customers or (2) as a financing source for long-term water plant.

Developers or homebuilders contributing water-system infrastructure inside their development to the local water utility are an example of providing a CIAC in exchange for the provision of water service. The utility becomes the owner of the infrastructure serving the new development, and in exchange, the developer or homebuilder receives water service. Additionally, the water system’s current customers benefit from the exchange since growth pays for growth. That is, the new customers pay for the system transferred to the water company through the prices of their new homes, shielding the current customers from the burden of paying for the new system through water rates. Customers may also provide CIAC to a water company as a source of additional (or only) financing for capital improvements that benefit the system or company as a whole, such as in the case of Iliad Water.

In its order in this docket, the commission used the term *advances for ratepayer reimbursement through surcharges* and defined it as “advances customers pay to a company for projects the company may construct for customer benefit...”⁴⁰ Surcharges are contributions in aid of construction and fall under ratemaking and accounting requirements for CIAC.⁴¹ Although the commission’s order expresses the commission’s understanding that the proposed surcharge requires the ratepayer to become investors in the project, a surcharge is CIAC and does not carry any ownership attributes.⁴² Investors expect a return on, and a return of, their investment. In contrast, when customers pay a surcharge there is no

³⁹ WAC 480-110-245 defines CIAC as “...any money, services or property received by a water company to fund capital investments at no cost to the company with no obligation to repay.”

⁴⁰ Order 06, ¶ 19.

⁴¹ WAC 480-110-455(2)(c).

⁴² “Our concern is the consequence of requiring ratepayers to become investors in a project...” Order 06, ¶19.

expectation or requirement for repayment. The contributed funds become zero cost capital, lowering the company's financing costs for all of the company's customers.

As long as the UTC continues to regulate the company, owners cannot recover any of the surcharge amounts customers paid to the company. If a regulated company sells one of its systems to another private investor, the sold water system remains under commission jurisdiction and the surcharge amounts remain protected from recovery.⁴³

Unfortunately, when an entity such as a public utility district, homeowners association or a city purchases a water system, the commission cannot protect the customers of the sold system from owners profiting from customer contributions. At the point of sale, the commission loses its jurisdiction over the rates of the sold water system.⁴⁴ The commission has the power to require the company to share any gain with customers on the remaining systems. However, the customers of the sold system receive no benefit of the gain.⁴⁵

Staff understands the commission's desire that ratepayers of systems that are sold be reimbursed, or recover a share of their capital contributions along with any gain made on the sale. However, since the commission removes the system that is sold from commission jurisdiction, the commission has no power to provide post-sale reimbursement through rates. The jurisdictional authority of the commission does not allow post-sale capture and reimbursement of customers' contributions for systems sold to, or condemned by, non-jurisdictional entities such as a public utility districts or cities.⁴⁶

⁴³ The selling company's CIAC balance recorded on its books transfer to the new company's books. The transfer of the CIAC amount from one company to the other remains a requirement under both a sale of stock and an asset-only purchase.

⁴⁴ WAC 480-110-255(2).

⁴⁵ WUTC v. American Water Resources, Inc., Docket No. UW-031284 (consolidated), Order No. 08.

⁴⁶ A Maryland Court of Appeals case does directly address the ownership of CIAC and found that, in the case of eminent domain, the utility had a property interest in the contributed property and that CIAC "could not be considered trust property...." See Washington Suburban Sanitary Comm'n v. Utilities, Inc., of MD, 775 A.2d 1178 (2000).

Equity financing currently is unavailable to the company because of its large negative retained earnings. A DWSRF loan is the only available form of financing that provides reasonable rates. However, using a DWSRF loan does not correct the underlying financial problems of the company, but merely pays for the needed treatment plant.

Surcharges provide a reasonable method of servicing the DWSRF loan but they carry a risk that customers will not fully benefit from their contributions. Staff believes the risk in this case is offset by the benefit to the ratepayers of receiving safe drinking water.

Company Viability

Section Summary

In Order 05, the commission expressed its concern regarding the “financial footing” of the company and the abilities of the company’s management.⁴⁷ The commission ordered staff to determine whether the company is currently viable. Staff tested the viability of the company using four aspects:

- ✓ Current viability based on its current balance sheet.
- ✓ Future viability based on current rates.
- ✓ Failure to request rate relief.
- ✓ Viability as evidenced by the quality of management.⁴⁸

Staff concluded Iliad Water is not a viable company and there is substantial doubt about its ability to continue as a going concern. However, staff presents two recommendations: (1) Iliad Water should file for rate relief, and (2) Iliad Water should negotiate with Iliad, Inc., and Water Services Company to discharge Iliad Water’s debt to these companies. Iliad Water’s creditors must recognize the amount of debt that exceeds and (3) Iliad Water should

⁴⁷ Order 05, ¶ 24.

⁴⁸ Interlocutory Order 05, ¶ 53(2).

file an Equity Investment Plan showing its intention to build and maintain a positive equity capital structure. Staff believes these recommendations will allow the company to return to financial viability and keep rates at a reasonable level. Staff believes the company should begin work on the recommended actions immediately. The company should complete all three by the end of September 2007, the month the Public Works Board begins its review of DWSRF applications.⁴⁹

Current viability based on current balance sheet

Staff's review of Iliad Water's balance sheet shows a distressed company. The balance sheet reflects a rapidly increasing debt load along with the complete absence of equity. For example, in the year 2000, the company's total debt was \$149,010. In a six-year period since, debt increased to \$273,883, an 84 percent increase. Of the \$273,883 accrued debt, only \$86,134 finances the company's utility plant at the end of 2006. The remaining \$187,749 is either prior accrued interest or operating losses, both of which are nonrecoverable in rates. To the extent that the \$187,749 exceeds the company's net assets, the company is insolvent.

The company's negative retained earnings has grown from a negative \$35,647 in 1996, to a negative \$185,969 in 2006. Operating losses and accrued interest drive the continued deterioration of the company's equity position.

Iliad Water's creditors are Iliad, Inc., and Water Services Company, companies owned by family members of Iliad Water's sole shareholder, and First California Capital Market Group, Inc., (First California), a California corporation.⁵⁰

⁴⁹ Sarver Testimony, UW-060343, Exh. No. 64, 10:8-12.

⁵⁰ First California holds three promissory notes originally signed in 1990 and 1992, by Iliad, Inc. The promissory notes predate the incorporation of Iliad Water. According to David Dorland, Iliad, Inc., transferred the promissory notes to Iliad Water when Iliad Water purchased the water systems. Investigation Data Request No. 9.

Staff Investigation – Iliad Water Service, Inc.

Analysis of Iliad Water’s financial position shows the company is unable to service its liabilities, nor does the company have available assets sufficient to pay off the accrued debt to a manageable level. In 2000, interest represented 23 percent of total annual revenue. In 2006, interest represented 80 percent of the company’s total annual revenue. The continuing operating losses and increasing accrued interest expense clearly show that Iliad Water, as it is currently structured, is not a viable company. The company cannot pay its debts as they become due.

Future viability based on current rates

Review of the company’s operating results show a continued history of operating losses. The company’s continuing losses will persist in putting stress on the company’s ability to continue to operate as a going concern. It is not a question of “if the company can continue to provide service.” Rather, it is a question of “how long the company can continue to provide water service with the weight of its climbing debt for operating expenses.”

Failure to request rate relief

The company has not filed any requests for a rate increase since 1992, when Iliad Water filed its initial rates with the commission. The company has maintained the same rates for fifteen years without adjustment. Clearly, staff’s analysis indicates the need for a rate increase. The company has been effectively subsidizing water service to its customers over the years. When staff asked Derek Dorland why the company had never filed for a rate adjustment, he stated in a written response “Iliad Water Service, Inc., believed that a rate increase was based on a positive rate base, which the company does not have.” The company also stated that the estimated cost of seeking a rate increase could cost the company a third of its annual gross revenue.⁵¹ Staff has clarified this misconception with the company. The company can obtain rates that recover its reasonable operating expenses, including rate case costs, but the rates would not include any net income (profit) until the company has a positive equity balance. Although the regulatory process, including rate filings may at times be time consuming, it is a necessary fact of running a regulated public utility.

⁵¹ Investigation Data Request No. 5.

Viability as evidenced by the quality of management.

Staff believes the management of the company has failed to maintain rates that provide for the financial viability of the company and for the safe and reliable operations of its three water systems. The company's president needs to become more aware of the regulatory environment in which Iliad Water operates. The owner is ultimately responsible for the failing financial health of this company. The history of the company, including the shortsighted financing of the water treatment system along with the total lack of needed rate relief, reflects the owner's long-term neglect of the company's financial health.

Staff concluded Iliad Water is not a viable company and there is substantial doubt about its ability to continue as a going concern without a rate adjustment and debt forgiveness.

Staff Recommendations for Restoration of Financial Viability

Recommendations

The company is failing because of chronic net operating losses that result in continued negative cash flow and lack of working capital. The lack of cash flow from operations has also resulted in an accumulating debt load with the associated increasing interest costs. The following recommendations are high-priority recommendations. It is important that Iliad Water take them seriously and begin immediate action to implement them.

Recommendation 1: File for rate relief. Over the last 15 years, Iliad Water has consistently experienced operating losses that have translated into substantial negative retained earnings. At the same time, Iliad Water has not filed a rate increase in the 15 years since it first became regulated in 1992. The company explained in a data request response that it had a misunderstanding of the regulatory process thinking that a company with negative retained earnings could not receive rate relief.⁵² Through technical assistance, staff

⁵² Investigation Data Request No. 5.

believes it has clarified this misconception with the company. Until the time the company has a positive equity balance, it can obtain rates that recover its operating expenses, but the rates would not provide net income (profit). Nor would rates pay for interest on debt incurred to pay past operating expenses or past-accrued interest.

The company also stated its concern that the cost of filing for increased rates is substantial. Staff has also discussed this with the company. The regulatory process and rate filings may at times be time consuming, but the company must realize filing rates that recover reasonable operating expenses is a necessary fact of running a regulated public utility.⁵³ Clearly, the company's failure to file for occasional rate adjustments has not worked.

Recommendation 2: Restructure debt. Iliad Water should work with Iliad, Inc., Water Services Company and First California to reach an agreement for the write-off of a substantial portion of the debt that Iliad Water owes them.⁵⁴ The amount that both associated companies must write-off is the amount the total debt exceeds the net assets of the company, which was \$187,749 at the end of 2006. The commission does not have the authority to require Iliad Water to unilaterally write off debt because the underlining liability still exists until the creditor actually forgives the debt. The commission can only eliminate a liability imposed by the actions of the commission.⁵⁵

Iliad Water does not have any surplus assets that the company may sell or transfer for settlement of the excess debt, nor will the commission allow rates that recover past operating expenses or depreciation. Iliad Water does not have the wherewithal to pay the years of accumulated debt and unpaid interest. The company does not have the ability to pay the \$187,749 excess debt and its creditors should consider the debt uncollectible and write the debt off their books. Table 6 shows the effect of writing off the debt in excess of the Iliad Water's total assets.

⁵³ Reasonable operating expenses embedded in rates include the amortized costs of filing a rate case.

⁵⁴ \$273,883 as of the end of 2006.

⁵⁵ Financial Accounting Standard 71 Accounting for the effects of certain types of regulation ¶12.

Table 6 – Effect of discharge of debt on Iliad Water’s capital structure.

The write off of \$187,749 of excess debt

Capital Structure	<u>Current</u>	<u>Write Off</u>	<u>After Write Off</u>
Equity	\$ (185,969)	187,749	\$ 1,780
Debt	<u>273,883</u>	(187,749)	<u>86,134</u>
Total Equity and Debt	<u>\$ 87,914</u>		<u>\$ 87,914</u>

An important effect of the write-off is the elimination of the negative retained earnings and the creation of a positive equity balance. The elimination of the debt reverses years of operating losses that have flowed through the income statement. Years of operating losses are reversed by removing the cumulative effect the unpaid expenses. The positive equity position now gives the company an incentive to make a material equity investment, which staff encourages the company to do.

Recommendation 3: Equity Investment Plan. Iliad Water should prepare a plan showing the owner’s intention to build and maintain a positive equity capital structure after restructuring. The strategies the plan could include are (1) increasing equity by paying off a portion of the remaining debt, (2) investing equity to support a portion of the new treatment system and, (3) by investing equity in future plant additions.

Income tax impact of discharge of debt. Although there is no prohibition for the discharge of debt, in some cases the discharge creates taxable income.⁵⁶ Although the company must report the discharge of debt to the IRS, the law carries several exceptions to avoid taxation of the discharged debt. The exception applicable to Iliad Water is the exception that allows exclusion from income an amount equal to the amount the taxpayer is insolvent.⁵⁷ The IRS defines insolvency as the difference between the current debt and the fair market value of the company’s assets, i.e. the regulatory value or rate base.⁵⁸

⁵⁶ Internal Revenue Code §108, Income from the discharge of indebtedness.

⁵⁷ Internal Revenue Code §108 (d)(3).

⁵⁸ Internal Revenue Code §108 (a)(1).

Staff Investigation – Iliad Water Service, Inc.

The recommendations above are high-priority recommendations. Iliad Water, e.g., Derek Dorland, must take immediate action. The company should complete all three by the end of September 2007, the month the Public Works Board begins its review of DWSRF applications.

The company is in dangerous financial waters and there exists a serious risk of the company failing. Failure will occur at the time that Iliad, Inc., or Water Services Company makes the inevitable decision that they can no longer provide service without payment. Once maintenance and monthly billing cease, it would be only a short time before bankruptcy would follow. On the other hand, if the company takes the needed measures outlined above, in staff's opinion, it will obtain the ability to actually invest in the company and also receive a fair return on its investment and balance its overall capital structure.

Conclusion

This report was prepared in compliance with commission orders in Docket UW-060343. This report clarified the nature of the affiliations of Iliad Water, determined the cost of the proposed chlorination system and recommended the proper allocation and recovery of the cost from customers. This report also reviewed alternative financing of the proposed chlorination system. Finally, staff analyzed the current viability of the company and proposed recommendations for the financial management of the company that would allow the company to return to financial viability at reasonable rates.

Findings. Staff reviewed the operations of Iliad Water and its relationship with Iliad, Inc., and Iliad Water's relationship with the company's billing and bookkeeping company, Water Services Company. Staff concluded that Iliad Water is a stand-alone water company. Although Iliad, Inc., does the routine maintenance and provides occasional advice to the owner, staff found that Iliad, Inc., does not assert the degree of control, as defined in WAC 480-110-235, over Iliad Water for the commission to consider Iliad, Inc., and Iliad Water a combined company under unified management. Staff also confirmed Water Services Company is a sole proprietorship and is not part of Iliad Water.

Staff concluded that the bids when adjusted for inflation provided a reasonable basis to estimate the current cost of the project. Staff found that a reasonable estimate of the project cost is \$120,436 if private financing is used. If DWSRF financing is used, the cost increases to \$151,890.

Staff's computation of the cost of the chlorination system as shown in this report included a review of the bidding process environment. Staff found that even though Iliad, Inc., cited acceptable reasons for the limited number of bidders and there is no evidence to indicate the bid process was improper, using Iliad, Inc., to administer the bid process strains the appearance of independence and may in fact be a conflict of interest. If Iliad Water

succeeds in obtaining a DWSRF loan, the Public Works Board will determine if the arrangement does indeed create a conflict of interest.⁵⁹

Although the commission consistently allocates system improvement costs to all customers of a company and not just the customers on the improved water system, staff recommends that only the customers on the Alder Lake water system should be allocated the cost of the chlorination system. Staff believes the rate impact on the customers not receiving benefit of the water system improvement would be too large.

Staff concluded that the proposed surcharge is the proper recovery method. However, the commission should consider the proposed one-time charge only if the company uses high cost private financing to finance the Alder Lake chlorination system. If the company obtains the DWSRF loan, staff concluded it would be highly unlikely that it would be in any ratepayer's economic benefit to select the one-time charge.

Staff concluded that equity financing is unavailable to the company because of its large negative retained earnings. A DWSRF loan is the only available form of financing that provides for reasonable rates. However, staff notes that using a DWSRF loan to finance the water treatment system does not correct the company's underlying financial problems, which staff addresses later. In addition, staff concluded contributions in aid of construction (CIAC) received through surcharges provide a reasonable method of servicing the DWSRF loan, or the private loan if the DWSRF loan is not obtained. Although there is a risk that customers will not fully benefit from their contributions to the company, this is consistent with CIAC financing. Staff believes in this case, the risk is offset by the benefit of receiving safe drinking water.

Finally, after an analysis of the company financial position, staff concluded Iliad Water is not a viable company and there is substantial doubt about its ability to continue as a going concern. Staff presented two recommendations that staff believes will allow the company to

⁵⁹ Staff has discussed the issue with Chris Gagnon of the Public Works Board.

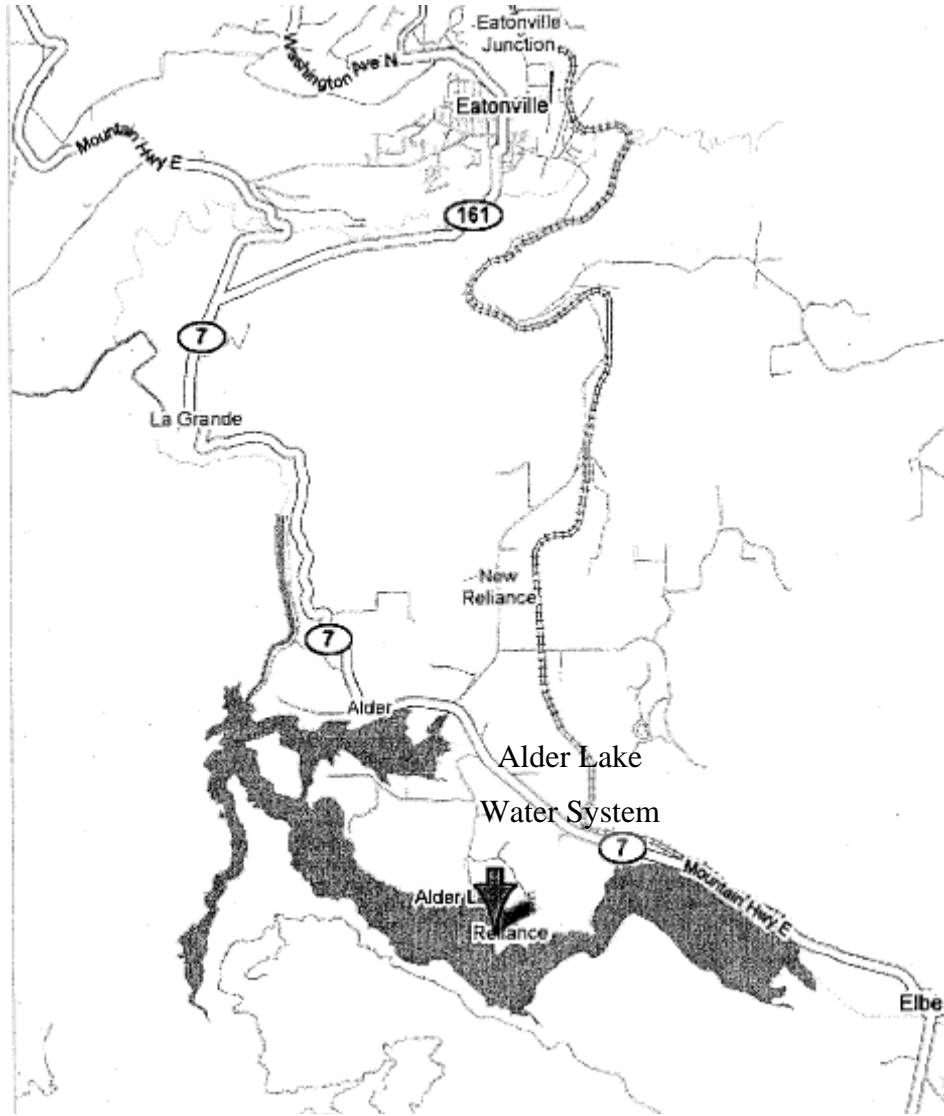
Staff Investigation – Iliad Water Service, Inc.

return to financial viability and keep rates at a reasonable level. Staff recommended that (1) Iliad Water should file for rate relief, (2) Iliad Water negotiate with Iliad, Inc., Water Services Company and First California to discharge Iliad Water's debt to these companies. Iliad Water's creditors must recognize the amount of debt that exceeds Iliad Water's current net assets, \$187,749 at the end of 2006, is uncollectible and (3) Iliad Water should file an Equity Investment Plan showing its intention to build and maintain a positive equity capital structure. Staff believes the company should begin work on these recommended actions immediately. The company should complete all three by September 2007, the month the Public Works Board begins its review of DWSRF applications.⁶⁰

⁶⁰ Sarver Testimony, UW-060343, Exh No. 64, 10:8-12.

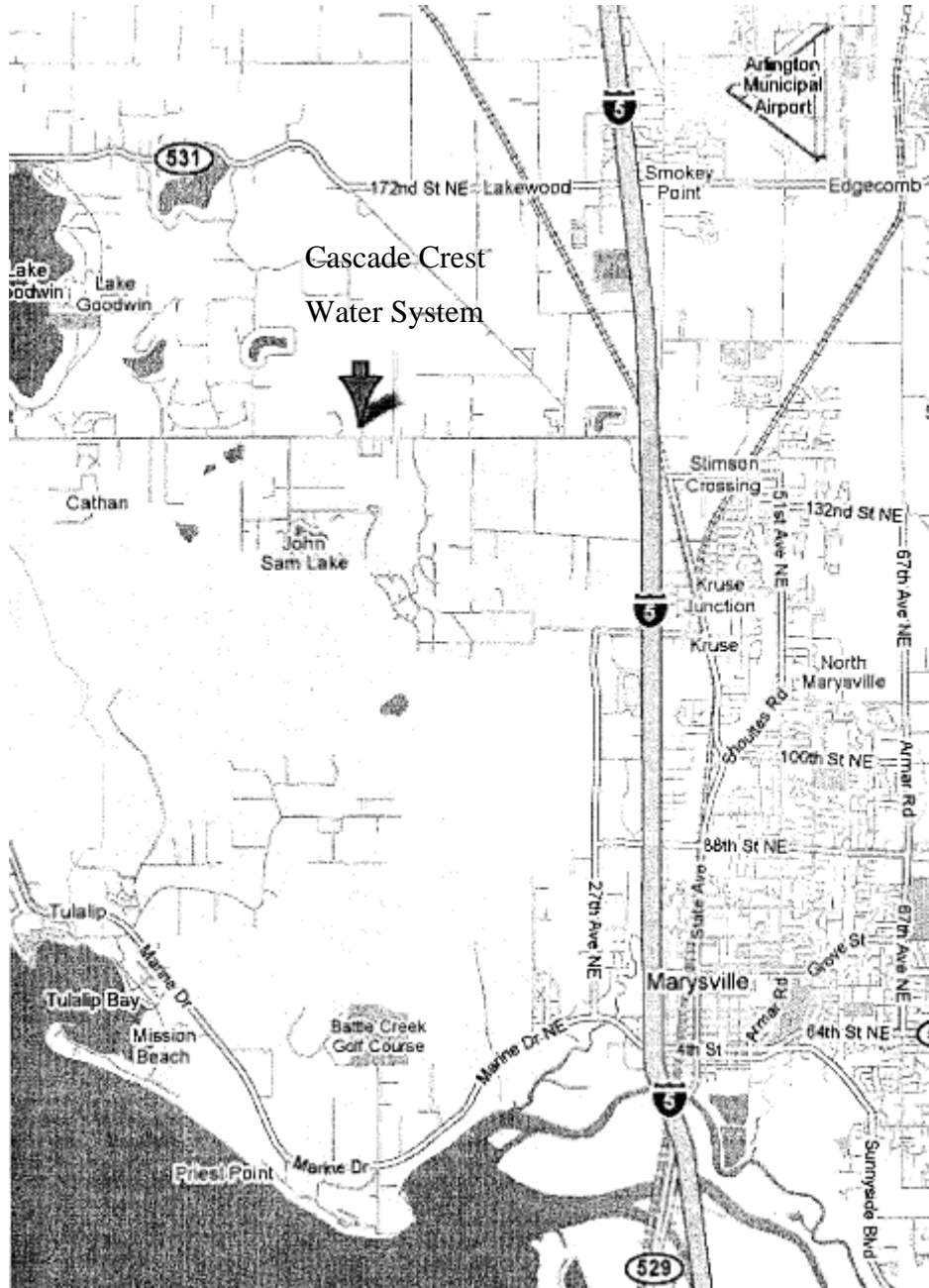
Appendix A

Alder Lake water system area map



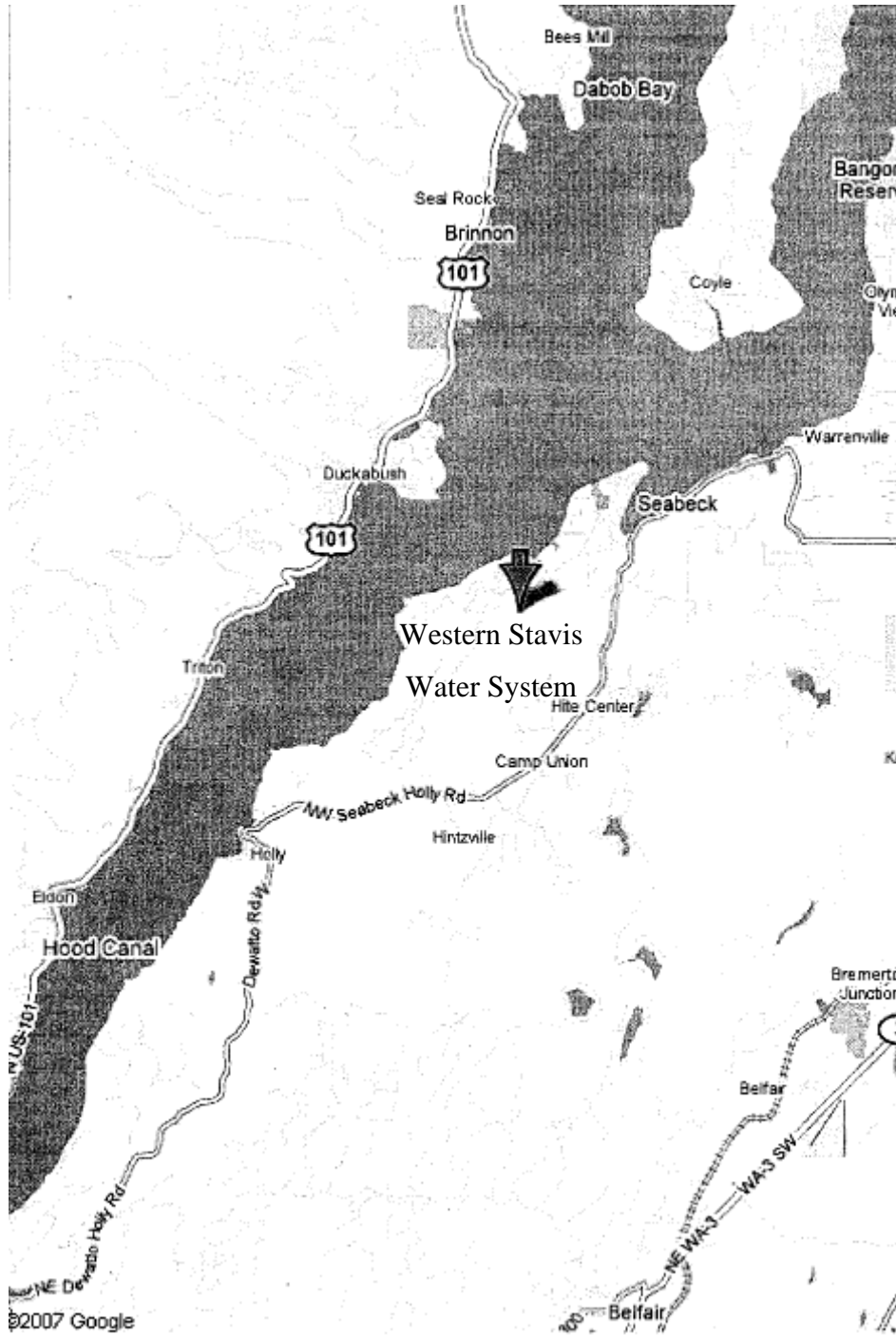
Appendix B

Cascade Crest water system area map



Appendix C

Western Stavis water system area map



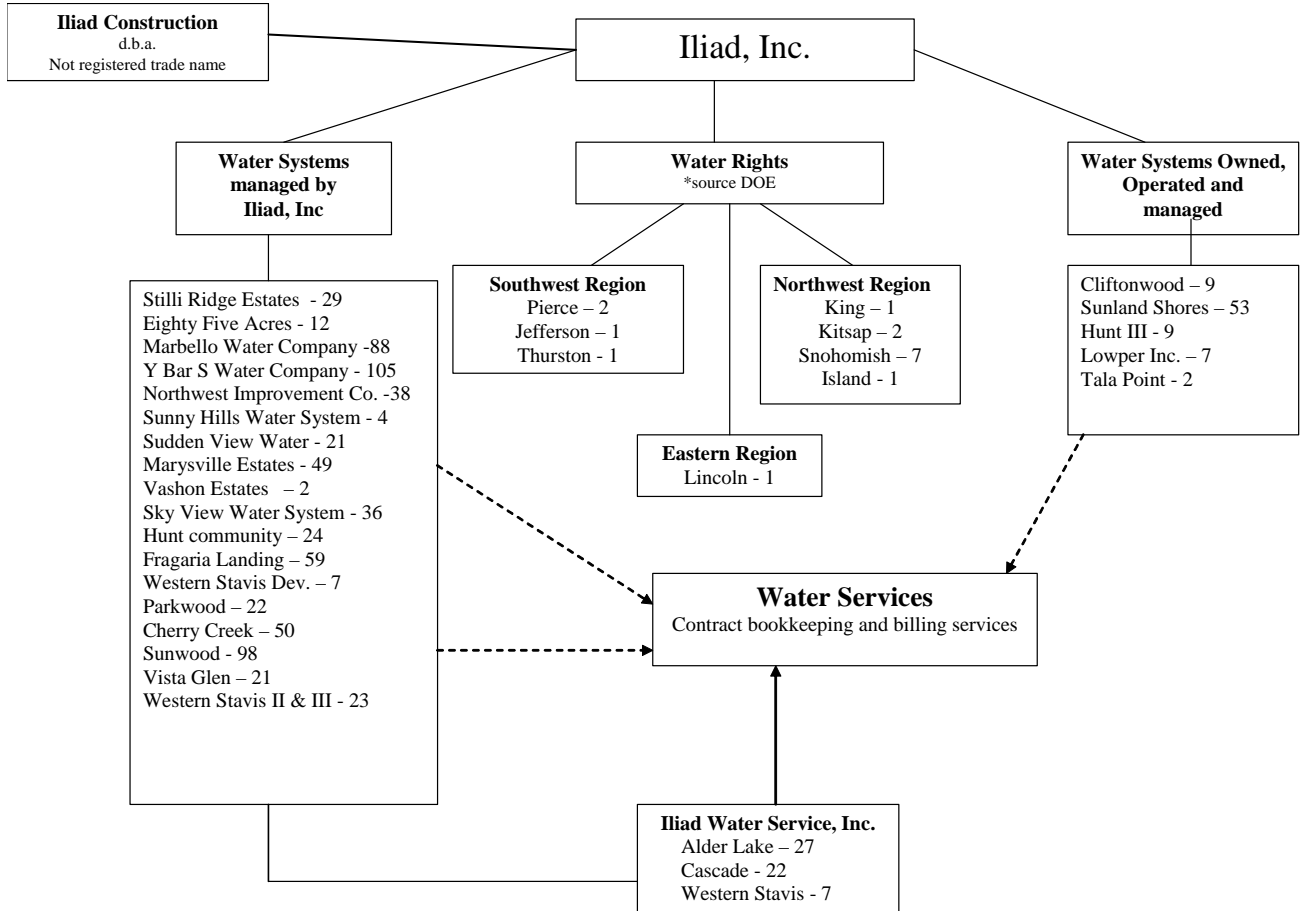
Appendix D

Iliad, Inc., Operated Water Systems

Source: Department of Health

DOH System ID	System Name	System County	ResPop	ResCom	TotalCom	Approved Services	System Age Years	Company/Owner Name
00567	HUNT COMMUNITY	KITSAP	45	24	24	24	16	FRAGARIA WATER COMPANY
01668	WESTERN STAVIS WATER SYS II & III	KITSAP	46	23	23	33	15	ILIAD WATER SERVICES INC
09404	MARYSVILLE ESTATES-AQUA HILLS WS	SNHOMISH	100	49	49	52	26	STATE WATER SERVICES COMPANY
12451	SUDDEN VIEW	SNHOMISH	60	21	21	48	25	STATE WATER SERVICES COMPANY
18707	STILL RIDGE ESTATES	SNHOMISH	72	29	29	44	26	MORTENSEN, DAVIDYEN, JIN
22590	EIGHTY FIVE ACRES	KING	36	12	12	20	37	MORTENSEN, DAVIDYEN, JIN
23101	CHERRY CREEK WATER SYSTEM	KING	104	50	50	53	29	SJM WATER SERVICES INC
23191	PARKWOOD	ISLAND	53	22	22	27	28	SJM WATER SERVICES INC
23391	SUNNY HILLS WATER SYSTEM	LINCOLN	20	4	23	33	5	G & G WATER COMPANY
26651	FRAGARIA LANDING	KITSAP	75	59	59	86	22	FRAGARIA WATER COMPANY
26995	ALDER LAKE COMMUNITY WATER SYSTEM	PIERCE	45	27	27	0	22	ILIAD WATER SERVICES INC
31141	SKY VIEW WATER SYSTEM	SNHOMISH	90	36	36	48	22	GEORGE WHITE
31203	CASCADE CREST WATER SYSTEM	SNHOMISH	50	22	22	22	22	ILIAD WATER SERVICES INC
32027	CLIFTONWOOD	KITSAP	30	9	10	9	22	ILIAD INC
51530	MARBELLO WATER SYSTEM	SNHOMISH	291	88	88	97	37	MARBELLO WATER COMPANY, INC
61947	NORTHWEST IMPROVEMENT COMPANY	SNHOMISH	87	38	38	0	28	MILLER, B.K./UTILITIES CO
62034	SUNWOOD WATER SYSTEM	PIERCE	198	98	98	126	17	JMG
64340	VISTA GLEN WATER SYSTEM	SNHOMISH	30	21	21	25	17	JIRA DENISON
66257	SUNLAND SHORES INC	CLALLAM	121	53	53	50	28	ILIAD INC
98875	Y BAR S WATER COMPANY INC	KING	240	105	105	86	37	BLISS INDUSTRIES, INC. DIBIA Y BAR S WATER COMPANY
01591	HUNT III COMMUNITY	KITSAP	18	9	9	16	15	ILIAD INC
01959	LOWPER INC WATER SYSTEM	CLALLAM	15	8	8	6	15	ILIAD INC
09264	VASHON ESTATES COMMUNITY WATER SYS	KING	4	2	2	0	26	STATE WATER SERVICES COMPANY
60203	TALA POINT	JEFFERSON	24	13	13	17	18	ILIAD INC
63216	WESTERN STAVIS DEVELOPMENT WATER	KITSAP	15	7	7	17	18	SJM WATER SERVICES INC
Totals			1,869	829	849	939		

Appendix E
Iliad, Inc.



Appendix F

Detail of Contractor Bids Received

Cost Category	Sound Design & Construction			Iliad, Inc.
	Inc.	Blue Line	JP Newton	
Mobilize	2,500	2,400	2,150	2,500
TESC (Total Erosion & Settlement Control)	6,000	4,500	5,494	3,745
Clear rightaway	13,950	10,360	11,532	8,475
Well House	15,000	14,800	14,600	13,500
Well House Piping	9,500	9,065	6,883	10,460
3" piping HDPE *High-density Polyethylene	30,900	31,140	28,799	29,360
Bedding material for trenching	6,575	5,786	6,049	5,950
Export (removing and disposing excess fill dirt)	6,575	5,786	5,523	5,950
Storage tank boring and connection	10,000	7,520	9,713	7,150
Flush System and Testing	10,000	6,500	9,929	6,575
Restoration and clean up	5,000	5,500	4,387	5,750
	116,000	103,357	105,059	99,415
Tax 8.8%	10,208	9,095	9,245	8,748
Total Bid	126,208	112,452	114,304	108,163

Source: Exhibit 14 (DD-14) pages 7-12

Appendix G

Discussion of Iliad, Inc., Operated, UTC Regulated Water Systems.

In addition to Iliad Water, Iliad, Inc., operates four other UTC regulated water companies. All four companies have the same attribute of Iliad Water, a negative retained earnings balance. Recent 2006 review of all commission-regulated water companies showed 11 had negative retained earnings, Iliad, Inc., operated companies make up almost half of the 11 with all five of its companies in negative equity positions.

Table 5 – Negative Retained Earning balances Iliad, Inc. - operated regulated companies.

Company Name	Retained Earnings as of 2006
Marbello Water Co.	Negative \$163,333
Bliss Industries	Negative \$139,780
Fragaria Water System	Negative \$24,829
SJM Water Service	Negative \$183,643
Iliad Water Services	Negative \$185,969

In addition, all five companies have large debt balances with interest expense ranging from 41 percent of total revenues to 80 percent of total revenue. Similar to Iliad Water, the debt load of the other Iliad, Inc., operated companies averages twice the related net assets. The financial trend for each company is the same as for Iliad Water: continued operating losses along with increased debt and interest expense. A course for all these companies that is simply not sustainable.

Staff believes that, as with Derek Dorland of Iliad Water, the owners are failing in their financial management responsibilities of the systems they own and must take responsibility for their company's financial difficulties. The owners appear to fail in understanding the seriousness of the financial dilemma facing these companies. The owners' duties are not limited to just providing water that meet quality and quantity requirements but include providing effective financial management.