BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION	)	
	)	
Complainant,	)	
	)	**DOCKET NO. UW-010877**
v.	)	
	)	
RAINIER VIEW WATER COMPANY, INC.	)	
	)	
Respondent	)	
________________________________	)	

TESTIMONY OF

DANNY P. KERMODE CPA

STAFF OF

WASHINGTON UTILITIES AND

TRANSPORTATION COMMISSION

December 5, 2001

PART I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Danny P. Kermode. My business address is 1300 South Evergreen Park Drive S.W., PO Box 47250, Olympia, Washington 98504-7250. My e-mail is dkermode@wutc.wa.gov.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by the Washington Utilities and Transportation Commission as a Program Consultant.

Q. WHAT ARE YOUR EDUCATION AND EXPERIENCE QUALIFICATIONS?

A. I graduated from Arizona State University in Tempe, Arizona with a Bachelor of Science in Accounting in 1982. In addition, in the last half of 1982, I attended San Carlos University in the Philippines for postgraduate studies in Economic Analysis and Quantitative Business Analysis. I am a Certified Public Accountant (CPA) and also a Certified Financial Planner (CFP).

In 1992 and 1993 I was a member of the faculty at the National Association of Regulatory Commissioners (NARUC) Annual Regulatory Studies Program held at Michigan State University at East Lansing Michigan. I taught classes on Deferred Taxes and Financial and Regulatory Accounting Standards. I am one of the few private industry instructors ever invited to teach at NARUC's Annual Regulatory Studies Program.

1 See Appendix A of my testimony for resumes of my professional and regulatory
2 experience.
3
4 **Q. AS A REGULATORY ANALYST, WHAT DUTIES ARE YOU CALLED UPON**
5 **TO PERFORM?**
6 **A.** The duties of a Regulatory Analyst include the inspection, verification and auditing of the
7 books and records of regulated companies in connection with rate filings before this
8 Commission. This review includes the examination of the revenues, expenses,
9 investment, depreciation and bad debt policies, rate design and customer relations of
10 regulated companies. I am also responsible for preparing reports, exhibits and testimony
11 for presentation before the Commission.
12
13 **Q. WERE YOU INSTRUCTED TO MAKE AN ACCOUNTING EXAMINATION OF**
14 **THE TARIFF FILING OF RAINIER VIEW WATER COMPANY, INC., IN**
15 **DOCKET NUMBER UW-010877?**
16 A. Yes, I have been instructed to review this filing and to determine the revenue requirement
17 of Rainier View Water Company, Inc., based on its filed Test Year.
18
19 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS CASE?**
20 **A.** On June 15, 2001, the Rainier View Water Company, Inc., (the Company or RVW) filed
21 with the Commission proposed revisions to its tariff designed to effect a general increase
22 in its rates. I am testifying as an expert witness on behalf of Staff. I will be testifying on
23 Staff's results and recommendations in regard to restating adjustments (Part II), pro forma
24 adjustments (Part III), cost of capital (Part IV), and the recommended rate design (Part
25 V).
26
27 **Q. PLEASE SUMMARIZE STAFF'S RECOMMENDATIONS ON THESE ISSUES.**
28 A. Staff recommends that the Company's existing tariffed revenues be reduced by 5.57% or
29 $180,000.
30

1 **Q. PLEASE EXPLAIN THE DIFFERENCE BETWEEN A RESTATING**
2 **ADJUSTMENT AND A PRO FORMA ADJUSTMENT.**
3 **A.** As defined in WAC 480-09-330 (2) (b) (i), restating actual adjustments (restating
4 adjustments) are those "adjustments which adjust the booked operating results for any
5 defects or infirmities which may exist in actual recorded results which can distort test
6 period earnings. Restating actual adjustments are also used to adjust from an as recorded
7 basis to a basis which is acceptable for ratemaking."
8
9 WAC 480-09-330 (2) (b) (ii) defines pro forma adjustments as "those adjustments that
10 give effect for the test period to all known and measurable changes that are not offset by
11 other factors."
12
13 **Q. WOULD YOU PLEASE IDENTIFY THE AREAS THAT YOU WILL DISCUSS**
14 **IN YOUR TESTIMONY REGARDING RESULTS OF OPERATIONS?**
15 **A.** I will discuss my recommended restating adjustments, pro forma adjustments, and
16 revenue sensitive adjustments presented in the Results of Operations Exhibit ___ (DPK-
17 2). The adjustments on the Results of Operations are made pursuant to WAC 480-09-330
18 paragraphs (2) (b) (i) and (ii). Through these adjustments, I will also present Staff's
19 calculation of the recommended revenue requirement.
20
21
22 **Q. PLEASE DESCRIBE YOUR EXHIBIT ____(DPK-2). ENTITLED "RAINIER**
23 **VIEW WATER, INC., RESULTS OF OPERATIONS FOR THE TEST YEAR**
24 **ENDED DECEMBER 31, 2000."**
25 **A.** Exhibit ___(DPK-2) is a single page schedule showing my analysis of the Company's
26 proposed rate increase docketed under UW-010877. This schedule presents the Results
27 of Operations, Rate Base, and Return on Investment (ROI) information using:
28 (1) Unadjusted Test Year data
29 (2) Restated test year results
30 (3) Pro forma test year results

1 (4) Pro forma test year results adjusted for Company proposed rates and
2 (5) Pro forma test year results adjusted for Staff recommended rates.
3
4 **Q. PLEASE EXPLAIN EACH COLUMN OF YOUR EXHIBIT_ (DPK-2).**
5 **A.** Column (a) titled "Descriptions" contains the account descriptions.
6
7 The amounts shown in column (b) titled "Per Company Exhibit (DF-2)" reflects the "per
8 book" account balances at year-end amounts taken from the Company's Exhibit____(DF-
9 2).
10
11 Column (c) titled "Restating Adjustments" reflects both Staff's restating adjustment
12 number and the corresponding amount. These are adjustments to adjust the amounts
13 reported by the Company for the test year to a basis acceptable for ratemaking purposes.
14
15 Column (d) is titled "Restated Results" reflects the results from operations affected by the
16 restating adjustments.
17
18 Column (e) titled "Pro Forma Adjustments" presents the pro forma number and
19 corresponding pro forma adjustment amount. Pro forma adjustments reflect known and
20 measurable changes that are not offset by other factors.
21
22 Column (f) titled "Pro Forma Results" shows operating results on a pro forma basis. This
23 column represents the Results of Operations on a pro forma basis.
24
25 Column (g) titled "Proposed Rates" reflects the revenue and expense impact of the
26 Company's proposed rates. Column (h) titled "Results at Proposed Rates" shows the pro
27 forma results of operations adjusted for the impact of the Company's proposed rate
28 increase.
29

1 Column (i) titled "Staff Rates" reflects the revenue and expense impact of Staff's
2 recommended rates. Column (j) titled "Results at Staff Rates" shows the pro forma
3 results of operations adjusted for the impact of the Staff recommended rates.
4
5 **Q. IN MR. FISHER'S TESTIMONY P.14 L2-6, HE IS ASKED IF HE KNEW OF**
6 **ANY ISSUES THAT WOULD BE RAISED CONCERNING THE PER-BOOKS**
7 **AMOUNT. MR. FISHER RESPONDED THAT HE DID NOT KNOW OF ANY**
8 **ISSUES RELATED TO THE PER-BOOK AMOUNTS, DO YOU AGREE WITH**
9 **HIM.**
10 A. No. As recently as September 4, 2001, in a meeting with Mr. Fisher and Mr. Finnigan, I
11 informed the Company that Staff felt including Income Tax Expense as a element of the
12 Per-Books column, even though there was no income expense actually recorded on the
13 books, was not proper and was misleading. I suggested that it should be recorded as a
14 pro forma adjustment instead. The income tax matter was identified as an issue at the
15 September 20, 2001, prehearing conference (Tr. p17). Staff also informed the company
16 that the Company's failure to record ready-to-serve revenue as operating revenue was
17 also an issue at the September 4, 2001, meeting and again at the prehearing conference.
18 As a matter of record, Staff and the Company discussed both of these issues before the
19 Commission at the July 11, 2001 open meeting that resulted in the suspension of this
20 filing.
21
22
23 **PART II –**
24 **RESTATING ADJUSTMENTS**
25
26 **Q. WHAT DOES COLUMN (C), TITLED "RESTATING ADJUSTMENTS," IN**
27 **EXHIBIT____ (DPK-2) DEPICT FOR THE PURPOSE OF THIS CASE?**

A. The "Restating Adjustments" column applies the total adjustment to each account necessary to accurately reflect test year operations and rate base for ratemaking purposes. The summary of each adjustment is shown on Schedule 1 of Exhibit___(DPK-2).

Q. WILL YOU PLEASE EXPLAIN EACH OF YOUR RESTATING ADJUSTMENTS, BEGINNING WITH RESTATING ADJUSTMENT, LABELED RA#1?

A. The account, Treatment Surcharge Revenue, reflects all revenue related to the Corrosion and Treatment surcharge billed by the Company for the test year. Adjustment RA#1 removes $190,201 from Treatment Surcharge Revenue to recognize the amounts that were embedded in the surcharge to fund loan principal payments. If the portion of the surcharge related to principal payments were not removed there would be an accounting mismatch when the related plant-in-service was depreciated in later periods.

Q. PLEASE EXPLAIN YOUR ADJUSTMENT TO ADD READY-TO-SERVE REVENUE TO OPERATING REVENUE IN RA#2.

A. It is Staff's opinion that the Company has erroneously recorded its Ready-To-Serve (RTS) revenue as non-utility income. Adjustment RA#2 reclassifies this revenue as operating revenue.

Q. PLEASE EXPLAIN FURTHER THE RATIONALE BEHIND RECLASSIFYING THE READY-TO-SERVE REVENUE FROM NON-UTILITY INCOME TO OPERATING REVENUE.

A. The RTS revenue in question is revenue received from developers who have sold water distribution systems to RVW using low-cost financing provided by the developer. Typically the RTS charges are collected to cover costs that are inherently associated with the transfer of the plant from the developer to the water company. For example, depreciation expense begins to be incurred immediately upon conveyance, along with property taxes and general maintenance expense. In addition, since the developer is allowed to use water for building and irrigation of landscaping until the lots are sold,

1 there are costs associated with the delivery of water, such as treatment costs and power
2 for pumping water. The National Association of Regulatory Utility Commissioners'
3 (NARUC) Uniform System of Accounts (USOA) describes Non-utility Income as gross
4 income from non-utility operations. These revenues are obviously utility related, and thus
5 should be recorded as revenue derived from utility operations.
6
7 **Q. WHAT WOULD BE AN EXAMPLE OF NON-UTILITY REVENUE?**
8 A. If the Company sold refrigerators or gas stoves, revenue from those sales would
9 obviously be non-utility related. The proper accounting turns on the question "Can a
10 company provide a function or service without being a water company?" Anyone can
11 sell a refrigerator who has the resources. However contracting with a developer to pay a
12 monthly fee until such time as the developer's lots are sold can only be accomplished by
13 a utility that has monopoly power to provide water for the area served.
14
15 **Q. WHAT IF THE COMMISSION DECIDED NOT TO INCLUDE RTS REVENUE**
16 **AS OPERATING REVENUE?**
17 A. If the Commission allows the Company to record RTS revenue as non-operating revenue
18 then the expenses related to the production of that revenue must also be removed. This
19 would include expenses such as depreciation expense, estimated power expense and a
20 prorated portion of overhead. The related plant would also have to be removed from rate
21 base. Recognizing RTS revenue as non-operating revenue and allowing the related
22 expense to remain would require the customers of RVW to subsidize the costs incurred to
23 produce the related RTS revenue.
24
25 **Q. IN MR. FISHER'S TESTIMONY, HE TALKS ABOUT HOW THE RTS**
26 **"PROGRAM" WAS DISCUSSED WITH STAFF PRIOR TO THE COMPANY**
27 **IMPLEMENTING THE PROGRAM. RELATIVE TO THESE DISCUSSIONS,**
28 **ARE YOU, OR IS ANY OTHER STAFF MEMBER, AWARE OF STAFF**
29 **MAKING THE RECOMMENDATION OR SUGGESTION TO RECORD RTS**
30 **REVENUE AS NON-OPERATING REVENUE?**

1 A. No, I have not found any member of Staff that remembers discussing, recommending, or
2 approving the company recording RTS revenue as non-operating revenue. I contacted
3 Mr. Gene Echhardt, Assistant Director of Water And Transportation since 1992, Mr.
4 James Ward, Water Program Auditor since 1989 and former Commission employee Mr.
5 Fred Ottavilli, who was the Water Program Consultant up until 1996. None of them recall
6 discussing recording RTS revenue as non-operating revenue. I also reviewed the
7 Commission files for this Company going back as far as 1993 and found no documents or
8 comments referring to the recording RTS revenue as non-operating revenue.
9

10 **Q. PLEASE EXPLAIN YOUR ADJUSTMENT TO REVENUE, LABELED RA#3.**
11 A. Adjustment RA#3 adjusts revenue by $6,708 to recognize the cash distribution received
12 from CoBank in the form of a patronage refund. CoBank annually distributes patronage
13 refunds to its borrowers. The net result is a reduction to the stated interest rate paid by the
14 Company. GAAP allows the Company to either recognize the income as a direct
15 reduction to interest expense or, as the Company has done, recognize interest income.
16 Normally interest income is not included in the computation of revenue requirement.
17 However, in this case, rather than reducing interest expense, I have increased operating
18 revenue. The end result is the same under both scenarios but by recognizing interest
19 income complicated cost of capital computations are avoided.
20

21 **Q. PLEASE DISCUSS YOUR ADJUSTMENT TO SALARIES AND WAGES –**
22 **OFFICERS, LABELED RA#4.**
23 A. This adjustment is related to the salary received by one of the owners of Rainier View.
24 Mr. Richardson currently receives a salary that, when compared to 1993, has completely
25 outpaced inflation. In 1993, Mr. Richardson was allowed $44,721 annually. He now
26 receives a salary of $92,780; over four times the rate of inflation. The restating
27 adjustment, shown on Exhibit___(DPK-3), first adjusts the 1993 allowed salary for the
28 effects of inflation. The $44,721 is restated in current dollars as $56,081. That amount is
29 then adjusted to recognize the Company's representation that Mr. Richardson spends only
30 60% of his workday on the water company resulting in an adjusted salary of $49,071. Of

this amount, 15.33% or $7,523, related to capital projects, should be capitalized and recovered in later periods, leaving $41,548 to be recovered in current rates. The 15.33% is the capitalization rate used by the Company in the test year.

Q. DID YOU ADJUST PAYROLL TAX FOR THE CHANGE IN MR. RICHARDSON'S SALARY?

A. Yes. Recognizing that payroll taxes related to the excess salary are included as an operating expense, I computed the reduction to payroll taxes associated with the reduction in salary. The computation is shown in lines 20 through 31 of Exhibit___(DPK-3).

Q. PLEASE EXPLAIN YOUR ADJUSTMENT TO LEGAL EXPENSE IN RESTATING ADJUSTMENT RA#5.

A. RA#5 is an adjustment to legal expense to remove rate case costs related to the prior rate case. The Company withdrew the prior case in the year 2000 in order to file a more recent test year. It would be unfair to require the ratepayer to pay for a case that the Company, on its own motion, withdrew.

Q. PLEASE EXPLAIN YOUR ADJUSTMENT TO BUILDING RENT EXPENSE IN RESTATING ADJUSTMENT RA#6.

A. RVW pays office rent to its owners. This relationship was acknowledged by this Commission in 1989 when Neil H. and Paula M. Richardson (owners) filed a joint application for, among other things, approval of certain affiliated interest arrangements that included lease payments to them. On January 17, 1990, the commission authorized RVW to enter into the lease as an affiliated arrangement.

Affiliated transactions, by their very nature, warrant closer scrutiny than non-affiliated transactions. The affiliated arrangement recognized in 1990, adjusted for inflation, was used as a benchmark to review the reasonableness of rent expense paid by the Company over the last ten years. Based on general rate filings made with Commission in the years

1 1993 through 1996, the building rent incurred ranged from 80% to 92% of the amount
2 indicated by affiliated arrangement, adjusted for inflation. However, from 1997 to 1999
3 rent expense increased from $15,600 annually to $35,580, 185% of the amount indicated
4 by the affiliated arrangement. From 1999 to 2000, rent increased an additional 40% to
5 $49,740 jumping the expense to 250% of the amount indicated by affiliated arrangement,
6 adjusted for inflation. This represents a 219% increase in rent expense when inflation
7 averaged 2.76% over the same time period. The Company has provided no evidence
8 supporting these huge increases.
9
10 For the purposes of ratemaking, Staff computed the rent amount as if the parties to the
11 lease contract complied with their agreement adjusting rent based on the Consumer Price
12 Index for all urban consumers and all items, Seattle area as specified in the lease
13 agreement. Therefore, Staff has used a $21,052 annual rent expense, the amount of the
14 affiliated arrangement, adjusted for inflation. This methodology was used in lieu of
15 original cost information.
16
17 **Q. DID YOU CONSIDER MARKET PRICE OF THE PROPERTY BEING LEASED?**
18 A. Yes, I reviewed information provided by the company in response to Staff data requests.
19 Based on the representations of the company, the fair market rental of the office space is
20 between $37,395 to $49,860 annually. However, it must be emphasized that the owners
21 of the property are also the owners of the water company. If the owners had originally
22 transferred ownership of the property to the water company, there would be no
23 suggestion that the ratepayer should be subject to market pressures for the growth boom
24 in the Parkland area, RVW would simply pay rent based on a fair return on the original
25 cost investment of the owner.
26
27 **Q. PLEASE DISCUSS YOUR ADJUSTMENT TO VEHICLE INSURANCE,**
28 **LABELED RA #7.**
29 A. The vehicle insurance recorded in the test year includes insurance expense related to a
30 1984 Ford Mercury Cougar. I removed the insurance cost associated with this vehicle

1 since it is not listed on the asset detail and does not appear to be owned by RVW. In
2 addition, RVW has claimed the cost of insurance related to a Lincoln Navigator,
3 Lincoln's luxury SUV. I have removed the costs associated with the Navigator and
4 instead recognized insurance cost equal to a Chevy C35 pickup truck. I further adjusted
5 the insurance cost related to the surrogate Chevy C35 pickup truck by 60%, the percent
6 the Company indicated that Mr. Richardson's time is related to water company business.
7
8 **Q. PLEASE DISCUSS FURTHER YOUR REASONING ASSOCIATED WITH THE**
9 **REMOVAL OF INSURANCE COSTS RELATED TO THE LINCOLN**
10 **NAVIGATOR.**
11 A. The Company's decision to purchase a luxury vehicle for the owners' exclusive use is up
12 to the Company. However, ratepayers should only shoulder the cost equivalent of a
13 vehicle reasonably expected to be used in the operation of a water Company. Using the
14 Company's own records, Staff used a Chevy C35 as a proxy replacing the Lincoln
15 Navigator throughout Staff's analysis.
16
17 **Q. CONTINUE WITH YOUR DISCUSSION OF YOUR ADJUSTMENT TO**
18 **VEHICLE INSURANCE EXPENSE.**
19 A. The end result of the two components of the adjustment cited above, removal of the 1984
20 Mercury Cougar and the adjustment removing the additional cost imposed by the Lincoln
21 Navigator, reduces the test year vehicle insurance expense by $1,700.
22
23 **Q. PLEASE EXPLAIN YOUR ADJUSTMENT TO REGULATORY EXPENSE,**
24 **RESTATING ADJUSTMENT #8.**
25 A. This adjustment is simply a formula calculation to true-up the regulatory expense to the
26 restated revenue figure.
27
28 **Q. THE COMPANY EXHIBIT____ (DF-2) SHOWS DEPRECIATION AS A**
29 **COMBINED SINGLE FIGURE, HOWEVER YOUR EXHBIT ____ (DPK-2)**

1 **SHOWS DEPRECIATION BROKEN DOWN INTO THREE DISTINCT**
2 **COMPONENTS. PLEASE EXPLAIN YOUR REASONING FOR DOING SO?**
3 A. Mr. Fisher's Exhibit _____(DF-2), line 27 is labeled "Depreciation-Amortization"
4 showing an amount of $402,532 in the per books column. However, the amount shown is
5 actually a combined net result of three different cost components. The three components
6 are deprecation, acquisition adjustment amortization and Contribution in Aid of
7 Construction (CIAC) amortization. It is important that these items be reviewed and
8 understood individually and not as a combined number. Therefore, I have expanded what
9 is one line item in the Company filing to three line items in my Exhibit _____(DPK-2)
10 column (b), lines 31 through 33. The combined amounts of these three components in
11 my exhibit, equals the $402,532 in the Company's Exhibit _____(DF-2), line 27 column
12 labeled "per books."
13
14 **Q. WOULD YOU PLEASE DISCUSS YOUR RESTATING ADJUSTMENT #9, AN**
15 **ADJUSTMENT TO DEPRECIATION EXPENSE?**
16 A. This adjustment restates the Company's depreciation expense to the amount reflected in
17 the Company's detailed asset schedule. The depreciation expense recognized by the
18 Company in its filing includes, in addition to actual depreciation expense, changes in
19 accounting adjustments and prior period adjustments. However, the Company has not
20 supported the inclusion of these additional amounts. Therefore, Staff relies on the
21 Company's detailed asset schedule. Restating Adjustment #9 reduces depreciation
22 expense by $119,040 reflecting the actual depreciation experienced in the test year.
23
24 **Q. RESTATING ADJUSTMENT #10 MAKES AN ADJUSTMENT TO CIAC**
25 **AMORTIZATION, PLEASE EXPLAIN THIS ADJUSTMENT.**
26 A. This adjustment restates the Company's CIAC amortization to the amount reflective of
27 the actual amortization experienced in the test year. As with the depreciation expense, the
28 amortization account included amounts related to a change in accounting treatment. The
29 adjustment merely adjusts CIAC amortization to the amount actually associated with the
30 test year as reflected in its financial records.

1
2 **Q. PLEASE EXPLAIN RESTATING ADJUSTMENT #11, AN ADJUSTMENT TO**
3 **TAXES OTHER THAN INCOME.**
4 A. Restating adjustment #11 is an adjustment to recognize the incremental increase in state
5 excise tax related to Staff's inclusion of Ready-to-Serve Revenue in operating income
6 (see restating adjustment #2). The Company calculated excise tax expense related to the
7 Ready-to-Serve revenue only at the 1.5% rate, whereas, if the Ready-to-Serve revenue is
8 recognized as operating revenue, it will be taxed at the 5.029% water distribution rate.
9 Therefore restating adjustment #11 increases excise tax expense by $2,735.
10
11 **Q. PLEASE EXPLAIN RESTATING ADJUSTMENT #12, AN ADJUSTMENT TO**
12 **REMOVE INTEREST INCOME.**
13 A. Interest income represents income from non-rate based investments and should not be
14 used as a component in calculating the overall revenue requirement of the Company. The
15 effect of not making this adjustment would be that the Company's short term or liquid
16 investments would provide a portion of the Company's return on its long-term
17 investments, which is not appropriate. Therefore, restating adjustment #12 removes
18 $72,094 in interest income.
19
20 **Q. PLEASE EXPLAIN RESTATING ADJUSTMENT #13, AN ADJUSTMENT TO**
21 **INCOME TAXES.**
22 A. Restating adjustment #13 removes the claimed income tax expense of $167,639 from the
23 Company's "per books" expenses. The Company's filing is misleading since this line
24 item represents to the Commission that the Company indeed has an income tax expense
25 recorded on its general ledger of $167,639. In fact, there is no income tax expense
26 actually recorded on the books of the Company for the test year, because the Company
27 has elected to be treated as an S Corporation and pays no income taxes. The proper way
28 of presenting the Company's imputed income tax expense would have been through a pro
29 forma adjustment and not by showing the expense really was incurred and recorded "per
30 books."

1
2 **Q. PLEASE EXPAND ON YOUR COMMENT ABOUT THE COMPANY**
3 **ELECTING S CORPORATION STATUS FOR INCOME TAX PURPOSES.**
4 A. RVW has made an election to be taxed under Subchapter S of the Internal Revenue Code.
5 Corporations that make such an election are commonly referred to as a Sub S Corporation
6 or simply an S Corporation. When a corporation makes the election, the corporate entity
7 becomes, for income tax purposes, nontaxable. It does not incur any income tax liability.
8 S Corporations are merely tax reporting entities rather than tax-paying entities. In the
9 absence of corporate income taxes, these business entities act as income conduits, passing
10 income directly through to its shareholders. Contrast this with a C Corporation that has its
11 earnings taxed at the corporate level.
12
13 **Q. WOULD YOU PLEASE DISCUSS FURTHER YOUR COMMENT REGARDING**
14 **THE DOUBLE TAXATION OF C CORPORATIONS?**
15 A. The term C Corporation refers to corporations that fall under the provisions of
16 Subchapter C of the Internal Revenue Code. C Corporations, in contrast to S
17 Corporations, are tax-paying entities. The earnings of a C Corporation are taxed at the
18 corporate level at corporate rates, and the shareholder is then taxed when the C
19 Corporation distributes dividends.
20
21 **Q. BEFORE YOU GO FUTHER, CLARIFICATION MAY BE NECESSARY**
22 **RELATIVE TO THE INCOME TAX ISSUE. HAS THE UTC APPROVED RVW**
23 **IMPUTING INCOME TAX IN ITS RATES?**
24 A. No, the Commission has not issued any order or decision approving rates for an S
25 corporation that included recovery of income taxes. The Company has filed tariffs that
26 include the recovery of imputed income tax in prior years, but all were settled cases and
27 were not adjudicated before the Commission. At the July 11, 2001 open meeting, the
28 Company stated that income tax expense had been allowed in the "last rate cases… that
29 the Company filed over the past ten years…." Chairwoman Showalter asked "In an
30 adjudicated case?" The Company responded, "Yes." The Company's response was

1 incorrect. The Company has not had any adjudicated rate filing before the Commission,
2 let alone one that addressed the income tax issue.
3
4 **Q. PLEASE EXPLAIN HOW THE REGULATORY PROCESS ADDRESSES THE**
5 **DOUBLE TAXATION OF C CORPORATIONS?**
6 A. Commonly companies regulated by this Commission are C Corporations, therefore
7 recovery of income tax expense is provided in rates. It is important to note that when
8 rates are set for C Corporations there is no recovery provision embedded in rates for any
9 income tax liabilities incurred by the Company's shareholders. The regulatory
10 ratemaking process focuses solely on the corporate entity's income tax liability and not
11 on the personal tax liabilities incurred by any of its investors.
12
13 **Q. WHAT IS THE EFFECT OF ALLOWING IMPUTED INCOME TAXES TO AN S**
14 **CORPORATION?**
15 A. Providing imputed income taxes for an S Corporation provides a windfall to the
16 shareholders. The only difference between this and simply providing a larger than
17 required return is the excess return would be provided cloaked in the guise of income tax
18 expense. The simple unavoidable fact is S Corporations do not incur an income tax
19 liability. It is not reasonable to expect the Commission to provide for, nor Company's
20 ratepayers to pay for, the personal income tax liabilities of a corporation's owners. The
21 regulatory ratemaking process provides for recovery of costs actually incurred by the
22 Company, not its owners.
23
24 **Q. HAVE YOU PREPARED AN EXHIBIT SHOWING THE EFFECT OF**
25 **ALLOWING IMPUTED INCOME TAXES ON THE RETURN ON**
26 **INVESTMENT OF THE SHAREHOLDER?**
27 A. Yes I have. It is an exhibit is made up of four schedules, I have labeled it Exhibit
28 ____(DPK-4). Schedule 1 shows the results when rates are set for a C Corporation.
29 Schedule 2 shows results assuming an S Corporation with imputed income taxes.
30 Schedule 3 shows the actual return the shareholder of an S Corporation receives when

1 imputed taxes are included in rates. And, Schedule 4 show the results based on Staffs
2 recommended approach.
3
4 **Q. IF THE COMMISSION DECIDES TO IMPUTE INCOME TAXES AND ALLOW**
5 **RVW TO RECOVER THEM IN RATES, HOW WOULD YOU RECOMMEND**
6 **THE TAX AMOUNT BE CALCULATED?**
7 A. If the Commission were to accept the Company's position to impute income taxes, I
8 would recommend the Commission use the C Corporation rate. However the tax should
9 be computed using the Company's tax-basis depreciation expense rather than the
10 regulatory basis depreciation expense. The purpose of using tax-basis depreciation
11 expense is to recognize that, had RVW been a C Corporation, deferred taxes would have
12 been accrued because of timing differences between tax-basis accelerated depreciation
13 rates and regulatory straight-line depreciation rates. The accrued deferred taxes would
14 then be deducted from rate base. However, the time and expense required to compute an
15 "imputed" deferred tax amount would be excessive for the related benefit. Using tax-
16 basis depreciation expense would eliminate the problem of deferred taxes since both the
17 tax and regulatory rates would be the same for computation purposes. But to be clear,
18 tax-basis depreciation expense would be used <u>only to compute</u> imputed income tax
19 expense. Regulatory depreciation expense would still be recognized for depreciation
20 purposes.
21
22 **Q. DO YOU RECOMMEND THE COMMISSION IMPUTE INCOME TAXES TO**
23 **RVW?**
24 A. No.
25
26 **Q. WHAT IS THE EFFECT OF STAFF'S RECOMMENDED RESTATING**
27 **ADJUSTMENTS ON THE RESULTS OF OPERATIONS?**
28 A. The effect of Staff's recommended restating adjustments is a decrease of $29,426 in
29 operating revenue, a decrease in operating expenses of $181,414,a decrease in interest
30 income of $72,094, and a decrease of $167,639 of income tax imputed by the Company.

1 The net result is a $247,533 increase in net income as shown on Column (c) L. 42 of
2 Exhibit ___(DPK-2).
3
4 **Q. IN ADDITION TO THE RESTATING ADJUSTMENT MADE TO THE RESULTS**
5 **OF OPERATIONS, REFERRING TO EXHIBIT ____(DPK-2) LINES 46-52,**
6 **WERE RESTATING ADJUSTMENTS ALSO MADE TO RATE BASE?**
7 **A.** Yes there were restating adjustments made to rate base.
8
9 **Q. PLEASE DISCUSS RESTATING ADJUSTMENT #14, ADJUSTMENTS TO**
10 **PLANT IN SERVICE AND ACCUMULATED DEPRECIATION**
11 **A.** The Washington Utilities and Transportation Commission uses an average rate base to
12 value a utility's investment for ratemaking purposes. Restating adjustment #14 adjusts
13 year-end account balances to the average test year balance for both Plant in Service and
14 Accumulated Depreciation accounts.
15
16 **Q. THE AMOUNT THE COMPANY SHOWS FOR ACCUMULATED**
17 **DEPRECIATION IS DIFFERENT FROM STAFF'S. CAN YOU EXPLAIN THE**
18 **DIFFERENCE?**
19 **A.** The Company's average accumulated depreciation is $2,721 less than Staff's number.
20 The reason for this difference is that the Company's accumulated depreciation for the
21 year 2000 does not include the annual amortization of the acquisition adjustment related
22 to the Indian Springs purchase. Therefore, the ending 2000 balance of accumulated
23 depreciation is understated by $5,443 or $2,721 using the beginning of year / end of year
24 average. Restating adjustment #14 corrects that omission.
25
26 **Q. PLEASE DISCUSS RESTATING ADJUSTMENT #15, AN ADJUSTMENT TO**
27 **CONTRIBUTIONS IN AID OF CONSTRUTION.**
28 **A.** Restating adjustment #15 adjusts year-end net CIAC to an average test year balance.

Q. RESTATING ADJUSTMENT #16 ADDS A WORKING CAPITAL COMPONENT TO RATE BASE, PLEASE DISCUSS THIS ADJUSTMENT.

A. Restating adjustment #16 adds working capital to rate base. Working capital recognizes the investment needed to pay the expenses incurred when the Company renders service prior to the receipt of the related revenue. There are three methods normally used to determine working capital: (1) the Lead-Lag method, (2) the Balance Sheet method and (3) the Formula method.

Q. COULD YOU PLEASE GIVE A BRIEF OVERVIEW OF THE METHODS?

A. The Lead-Lag method is the most detailed and therefore the most time consuming and expensive of the three approaches. A Lead-Lag study is an analysis of the test year transactions to compute the time lag between when a service is provided and the related revenue is received, and the time lag between when a cost is incurred and the actual payment for those services. The difference between the time the expense is paid and the revenue is receive is multiplied by the average cash operating expenses resulting in computed working capital.

The Balance Sheet method recognizes working capital as the difference between current assets over current liabilities. Even though the Balance Sheet method is the simplest of the three methods, it is not practical for the average water company. The Balance Sheet method assumes an accurate monthly recording of current liabilities and current assets. The average water utility normally does not have the staff or the expertise to do this. It is common for a company to maintain a cash basis system until year-end and then, at which time the company's accountant <u>may</u> record its current liabilities and assets. As a practical matter, the balance sheet approach is not reliable for the average water company.

The Formula method provides a calculation of working capital based on assumptions of cash flow needs related to the lag of revenue collection and expense payments. I chose

the Formula method in order to avoid the costs associated with a lead-lag study and provide a more practical approach for a water company than using the Balance Sheet method. The calculation makes use of a 45-day net lag between payment of cash operating expenses and the collection of related revenue, excluding power costs which is a 15-day net lag.

Q. DO YOU HAVE ANY MORE RESTATING ADJUSTMENTS?

A. No, I do not.

PART III

PRO FORMA ADJUSTMENTS

Q WHAT DOES THE COLUMN (e) TITLED PRO FORMA ADJUSTMENTS IN EXHIBIT____ (DPK-2) DEPICT FOR THE PURPOSE OF THIS CASE?

A. The "Pro forma Adjustments" column applies the total adjustment to each account necessary to accurately reflect known and measurable changes to the test year expense levels for this Company that would be allowable for ratemaking purposes. The summary of each adjustment is shown on Schedule 3 of Exhibit__(DPK-2).

Q. WOULD YOU PLEASE EXPLAIN EACH OF YOUR ADJUSTMENTS IN THE COLUMN (e) TITLED "PRO FORMA ADJUSTMENTS" ON EXHIBIT NO.__(DPK-2), BEGINNING WITH PRO FORMA ADJUSTMENT #1, AN ADJUSTMENT TO SALARIES AND WAGES - EMPLOYEES?

A. Yes, pro forma adjustment #1 recognizes the wage increases given to the Company's employees after the end of the test year. Shown on Line 12 of Exhibit ____(DPK-2), pro forma adjustment #1 increases Salaries and Wages – Employees by $92,428. In addition, Line 34, Taxes Other Than Income, is increased by $7,071. The $92,428 increase represents $109,164 in increased payroll costs less 15.133% of capitalized labor.

1

2 **Q. EXHIBIT NO.__(DF-2) OF THE COMPANY'S FILING SHOWS AN INCREASE**
3 **OF $109,164 TO SALARIES AND WAGES – EMPLOYEES. CAN YOU**
4 **EXPLAIN THE DIFFERENCE FOR US?**

5 **A.** Yes. The Company's adjustment reflects a change from the schedules the Company
6 initially filed in support of its proposed tariff changes. In its initial filing in this docket,
7 the Company showed capitalized labor costs of 15.33%. The $92,428 pro forma amount
8 now used by Staff is the same as what the Company had originally filed. However, it
9 now appears that the Company has decided to no longer recognize labor costs associated
10 with capital projects. In addition, if the 15.33% adjustment is not recognized and the
11 Company continues to capitalize labor costs the Company will over recover salary
12 expense by recovering the capitalized portion twice, once in operating expenses and
13 again in depreciation expense. The Company provided no testimony supporting the
14 change in accounting. The Company's lack of capitalized labor costs is the only
15 difference between the Staff figure and the Company's new amount. Staff sees no
16 compelling reason to recognize for this case a prospective change in an accounting
17 principle that has been maintained by the Company for at least the last 10 years.
18

19 **Q. PLEASE DISCUSS YOUR ADJUSTMENT TO EMPLOYEE BENEFITS, PRO**
20 **FORMA ADJUSTMENT #2.**

21 A. Pro forma adjustment #2 recognizes the increasing costs of insurance. The $49,798
22 increase represents $47,396 in medical coverage premiums not included in the test year
23 and $2,402 increase in dental premiums also experienced after the close of the test year.
24

25 **Q. PRO FORMA ADJUSTMENT #3 INCREASES PURCHASED POWER EXPENSE**
26 **BY $39,935. COULD YOU PLEASE EXPLAIN WHY THE INCREASE IS**
27 **REQUIRED AND HOW YOU COMPUTED IT?**

28 A. Yes, currently RVW purchases power from three electric utilities, Tacoma Power,
29 Peninsula Light, and Puget Sound Energy. After the close of the test year all three
30 companies announced increases in their rates. Since electric power represents a large part

of the Company's operating expenses it is important to provide the increased costs in rates. The increase was computed in two ways. For Puget Sound Energy, the increase was computed by applying a 7% increase to test year consumption figures. However, for Tacoma Power, the size of the increase required the recomputation of the test year usage by the utility itself, which was submitted by the Company in response to our data request. This allowed for the best estimate of the impact of the rate increases on the filed test year data. Peninsula Light also had an increase, their new cost per kilowatt-hour was applied to the test year total kilowatt-hours used to compute the adjusted power costs. The three amounts were then combined to derive the pro forma increase included as PA#3.

Q. PLEASE DISCUSS PRO FORMA ADJUSTMENT #4, AN ADJUSTMENT TO MATERIALS AND SUPPLIES.

A. This adjustment recognizes costs associated with the installation of backup generators on the water systems owned by RVW. The costs reflect the expenses expected to be incurred when the generators become fully operational. In contrast with the Company's filing, Staff's costs include the costs associated with the second year maintenance contract. The net difference is an increase of expenses of $23,918.

Q. PLEASE DISCUSS YOUR ADJUSTMENT TO VEHICLE INSURANCE EXPENSE.

A. Pro forma adjustment #5 is made up of two parts as shown on Exhibit ____ (DPK-5). The first portion of the adjustment reduces vehicle insurance expense by the amount the cost of insuring the Lincoln Navigator exceeds the cost to insure a Chevy C35. The insurance amount is further adjusted to recognize that the vehicle used by the owner is used only 60% of the time for water company business.

Q. PLEASE DISCUSS YOUR ADJUSTMENT TO GENERAL LIABILITY INSURANCE EXPENSE, PRO FORMA ADJUSTMENT #6.

A. Pro forma adjustment #6 recognizes the increased insurance expense costs associated with Property, Inland Marine, General Liability and umbrella coverage.

1

2 **Q. PLEASE DISCUSS PRO FORMA ADJUSTMENT #7, AN ADJUSTMENT TO**
3 **RECOGNIZE RATE CASE EXPENSE.**

4 A. Pro forma adjustment #7 provides for the recovery of $29,500 in rate case expense over
5 the three years proposed by the Company, or $9,833 annually. The adjustment also
6 removes $3,500 from miscellaneous expense.

7

8 **Q. WHY DID YOU REMOVE THE $3,500 COST OF MAILING NOTICES FROM**
9 **THE MISCELLANEOUS EXPENSE ACCOUNT?**

10 A. The test year 2000 already includes the cost of mailing notices related to prior rate case
11 the Company filed, prior to the current case, but during the current case's test year. That
12 case was later withdrawn. The Company has included a cost of mailing notices in its
13 proposed rate case expense amount. It also kept in the cost related to the prior case. The
14 Company cannot have both the cost of mailing notices related to the withdrawn case <u>and</u>
15 an estimated amount for the current case. Therefore, pro forma adjustment #7 reduces
16 Miscellaneous Expense by the company's estimated mailing cost of $3,500.

17

18 **Q. THE COMPANY HAS FILED IN ITS DIRECT CASE A RATE CASE EXPENSE**
19 **OF $55,000. EXPLAIN WHY YOU HAVE CHOOSEN THE $29,550 FIGURE**
20 **PROPOSED BY THE COMPANY IN ITS ORIGINAL FILING.**

21 A. With the filing of its direct case, the Company has more than doubled its estimate of rate
22 case costs with absolutely no supporting rationale. The Company's direct testimony
23 consists solely of testimony and exhibits of Mr. Fisher, the Company's controller. As
24 filed, the Company is estimating that it will take Mr. Finnigan and the Company's
25 accounting firm thirty-one eight-hour days to complete this case. Staff believes this new
26 estimate is excessive and has instead used the Company's original estimated cost.

27

28 **Q. BEFORE DISCUSSING YOUR PRO FORMA ADJUSTMENT #8, THE**
29 **COMPANY IS PROPOSING RESTATING ADJUSTMENT #2 THAT**
30 **INCREASES BAD DEBT EXPENSE FROM THE AMOUNT ACTUALLY**

1 **BOOKED BY THE COMPANY IN THE TEST YEAR. PLEASE DISCUSS THIS**
2 **ADJUSTMENT.**
3 A. The Company adjustment is an attempt by the Company to recognize bad debt expense in
4 the test year since no bad debt was recognized in the test year. Staff has no argument
5 with the concept of recognizing bad debt in the test year. Staff, however, disagrees with
6 the amount of bad debt recognized. Contrary to the Company's statement on page 14 line
7 22 of Exhibit____DF(T-1) that the amount of its adjustment is "consistent with prior
8 years," the reality is, since 1996, the Company has written off bad debt only twice, in
9 1999 and in the current year 2001. The $53,723 pro forma increase to operating expenses
10 does not represent the actual bad debt expense for the test year. The adjustment uses an
11 amount that is merely the second of two adjustments to true up the accounts receivable
12 account. It is not an annual bad debt accrual.
13
14 **Q. COULD YOU EXPAND ON THE FAILURE TO WRITE OFF BAD DEBT AND**
15 **ITS IMPACT ON THE EARNINGS OF THE COMPANY?**
16 A. If a Company does not write off accounts as they become uncollectable, the Company's
17 net income is overstated along with an overstatement of the Company's accounts
18 receivable. Its accounts receivable account will continue to grow until at some point in
19 time the account must be adjusted. At such time the Company would be forced to write
20 down a large amount of the accounts receivable and also recognize a large expense.
21
22 **Q. COULD YOU PLEASE DISCUSS HOW RVW HAS HANDLED ITS**
23 **ACCOUNTING FOR UNCOLLECTABLE ACCOUNTS, THAT IS, BAD DEBT?**
24 A. Bad debt expense should be one of the more straightforward expenses. However, in the
25 case of RVW, there is confusion as to how and when to recognize bad debt. RVW has
26 failed to account for bad debt in any consistent manner. According to the Company's
27 CPA's workpapers, the Company did not write off any bad debt in 1996, 1997 and 1998.
28 In 1999 the Company wrote-off $57,540 of bad debt. This $57,540 is apparently part of
29 what had accumulated over the four-year period. In test year 2000, the Company once
30 again did not write-off any bad debt even though, $101,031 of the Company's $460,492

1 accounts receivable balance was past due. Finally, in April of 2001 the Company wrote
2 off bad debt of $57,474.
3
4 **Q. IN ADDITION TO THE INCONSISTENT WRITE-OFF OF BAD DEBT, WOULD**
5 **YOU ADDRESS THE COMPANY'S USE OF THE ALLOWANCE METHOD**
6 **FOR RECOGNIZING BAD DEBT?**
7 A. Yes, the Company has adopted the allowance method for recognizing bad debt. This
8 method allows the expense associated with bad debt to be matched with its related
9 revenue. The process recognizes that a portion of the revenue billed at any one time will
10 in fact become uncollectable. An allowance is recognized with an amount charged to bad
11 debt expense and the offsetting amount going to a contra-asset account used to offset
12 accounts receivables. The theory holds that accounts receivable, when netted against the
13 allowance account, will reflect an accounts receivable amount reasonably expected to be
14 collected. Then, as uncollectable amounts are written off to the allowance account, the
15 accounts receivable are reduced and the allowance account is reduced. Bad debt expense
16 is not charged since the expense has already been recognized when the allowance account
17 was created. RVW has a $75,000 allowance account on its books. The proper
18 accounting of a test-year bad debt write-off would be to reduce the allowance account by
19 $53,000. A new allowance amount should now be calculated through an analysis of the
20 current accounts receivables with an offsetting entry to bad debt expense.
21
22 **Q. IN PRO FORMA ADJUSTMENT #8 YOU PROPOSE A BAD DEBT AMOUNT**
23 **DIFFERENT FROM THE COMPANY, PLEASE DISCUSS THIS ADJUSTMENT.**
24 A. Yes I have. I used an average approach, which produces an average expense of $18,526,
25 and the percentage collectable approach, which produced an expected expense of
26 $18,325. Since the average expense approach does not rely on estimates of collectablity,
27 I selected the average approach and recommend a bad debt amount of $18,526. Pro forma
28 adjustment #8 for $19,153 adjusts the expense to the $18,526 level.
29

1
2 **Q. PLEASE EXPLAIN PRO FORMA ADJUSTMENT #9, AN ADJUSTMENT TO**
3 **BOTH DEPRECIATION EXPENSE AND THE PLANT IN SERVICE AMOUNT**
4 **INCLUDED IN RATE BASE.**
5 A. Pro forma adjustment #9 addresses three items: new meter-reading vehicles, new billing
6 system, and the Company's Lincoln Navigator. All of these items are shown in Exhibit
7 ___(DPK-6). The first item relates to the addition of two new meter-reading vehicles.
8 These vehicles were placed in service after the end of the test year. Depreciation expense
9 was adjusted to recognize depreciation expense of $7,675 and rate base increased by
10 $26,862, representing the average cost of the vehicles as if the vehicles were placed in
11 service in the test year. The second adjustment recognizes the new billing system
12 purchased and placed in service by the Company. Depreciation expense was increased
13 by $1,564, a full-year depreciation and average cost of $15,645 recognized in rate base as
14 if the asset had been placed in service in the test year.
15
16 **Q. THE COMPANY'S ADJUSTMENTS (PA-8 AND PA-9) RECOGNIZES THE**
17 **FULL COST OF THE VEHICLES AND SOFTWARE TO RATE BASE. PLEASE**
18 **EXPLAIN WHY STAFF INCLUDED ONLY ONE HALF THE COST.**
19 A. These assets were purchased after the end of the test year. Staff is including the costs of
20 these assets because the costs are material. However, just because they were placed in
21 service outside the test year does not exempt the investment from the average ratebase
22 principle used by this Commission. If this were not so, companies would tend to delay
23 purchases of major investments until after the end of the test year and, by doing so,
24 receive rate base recognition as if the newly acquired asset was placed in service prior to
25 the beginning of the test year. Obviously this would be inconsistent and inappropriate.
26 Staff has no alternative but to recognize an average cost for these assets "as if" the
27 Company had purchased and placed them in service within the test year.
28
29 **Q. IS IT THE COMMISSION'S POLICY TO ALLOW ALL POST-TEST PERIOD**
30 **ADDITIONS TO RATE BASE?**

1
2 A. No, it is not. However the Commission has stated that:
3 "When the occasional exception to the rule is allowed…[post-test period
4 addition to rate base] …there must be corresponding adjustments to
5 revenue, expense, and customer count or mismatches are inevitable and it
6 soon is impossible to know what rates are fair, just, reasonable, and
7 compensatory." WUTC v. American Water Resources, Inc. Docket Nos.
8 UW-980072 et al.
9 In these proposed additions, Staff has reviewed the impact of both items. The
10 new billing system is replacing an older one and therefore, other than depreciation
11 and return, there is no other cost impact. As for the meter reading vehicles, Staff
12 has recognized the increase in insurance and depreciation expense and return.
13 The new vehicles do not affect revenue or the number of customers. There should
14 be no marginal fuel costs since the test year includes fuel used by the meter
15 readers. There are no other associated costs. These investments are material and
16 should be included in the company's rate base.
17
18 **Q. PLEASE EXPLAIN THE OTHER ELEMENTS OF PRO FORMA ADJUSTMENT**
19 **#9.**
20 A. As addressed in pro forma adjustment #5. This adjustment replaces the Lincoln
21 Navigator's costs with costs associated with a 1999 Chevy C35 pickup costing $23,667.
22 In addition, since the owner allocates only 60% of his time to the water Company, Staff
23 has removed 40% of the total cost associated with other non-utility activities of the
24 vehicle from depreciation expense and rate base. The net result, as shown on
25 Exhibit____(DPK-6) line 32, is a pro forma decrease of $5,241 in depreciation expense
26 and a decrease in rate base of $25,409. When all three items, meter vehicles, billing
27 system, and owner's vehicle are combined the net result is an overall pro forma increase
28 in depreciation of $3,999 and $17,098 rate base.

1

2 **Q. PLEASE DESCRIBE PRO FORMA ADJUSTMENT #10, AN ADJUSTMENT TO**
3 **INTEREST EXPENSE.**

4 A. Cost of capital is computed as close to the actual time in which rates will be in effect as is
5 practical. For example, if the cost of debt carried by a company increases from the end of
6 the test year to the time that rates will become effective, interest expense will be
7 increased to reflect the higher costs of doing business. It works the same way when rates
8 go down. Interest rates have declined steadily with the prime rate dropping 400 basis
9 points since December 2000, the end of the Company's test year. Although some of
10 RVW's debts are based on fixed rates, over two-thirds of its debt is based on adjustable
11 rates pegged against the prime rate. Due to the dramatic decrease in the prime rate in the
12 past nine months, RVW's interest expense is significantly overstated. Pro forma
13 adjustment #10 reduces test year interest expense by $136,601 reflecting the actual
14 interest costs experienced by the Company as of November 2001.
15

16 **Q. THERE ARE TWO COMPANY ADJUSTMENTS, PRO FORMA #2 (PA-2) AN**
17 **ADJUSTMENT TO METERED SALES, AND PRO FORMA #10 (PA-10), AND**
18 **AN ADJUSTMENT TO *CONTRACT SERVICES – LEGAL* THAT YOU DO NOT**
19 **INCLUDE IN YOUR ADJUSTMENTS. PLEASE DISCUSS THE ADJUSTMENTS**
20 **AND WHY YOU HAVE NOT INCLUDED THEM, WHOLE OR IN PART, IN**
21 **YOUR ANALYSIS.**

22 A. The Company proposed an adjustment to *Metered Sales* in *PA-2*. *PA-2* reduces test year
23 revenue by $45,433 for the proposed decrease in the Indian Springs system's rates. The
24 cited decrease relates to a portion of the filed tariff currently before the Commission. The
25 decrease, as currently proposed, would become effective along with the other rates in this
26 case. Therefore the adjustment is not properly included in pro forma adjustments to
27 account for known and measurable changes to test year results. Unless the Company
28 requests the immediate decrease of the Indian Springs system's rates, the adjustment
29 should be instead included in the Company's "PRO FORMA EFFECT OF PROPOSED
30 RATES" column.

1

2 **Q. PLEASE DISCUSS THE COMPANY'S ADJUSTMENT TO *CONTRACT***
3 ***SERVICES – LEGAL* PRO FORMA #10 (PA-10).**

4

5 A. With PA-10 the Company is proposing to recognize an expense clearly outside of the test
6 year. The costs detailed in Company Exhibit ____(DF-9) relate to the cost of litigation
7 incurred in year 2001. Increasing the test year's legal expense by including a 2001 legal
8 expense is inappropriate. This adjustment, as proposed, is equivalent to proposing the
9 reduction of test year's legal expense based on the mere absence of litigation in 2001. In
10 addition, the Company's filed testimony associated with this proposed adjustment would
11 be appropriate had the test year been 2001. However, the testimony provides no
12 supporting discussion as to why the expense is related to the test year or why it would be
13 proper rate making policy to include it in the test year. In the Commission's American
14 Water Resources order the Commission said:

15 "Given the ten month period our governing statutes permit to
16 investigate and determine rates consistent with due process
17 requirements, and the regulatory lag inherent to careful, balanced
18 decision-making processes, pro forma adjustments to actual test
19 period data are allowed to account for known and measurable
20 changes not offset by other factors. Pro forma adjustments, then,
21 are "known and measurable" at the time the case is filed. That,
22 necessarily, is where the line is drawn. When parties suggest the
23 use of ever changing data in rate proceedings the suggestion must
24 be rejected absent compelling reasons." Page 11 American Water
25 Resources, Sixth Supplemental Order in Docket No. UW-980072
26 et al.

27

28 It is Staff's opinion that the mere fact that the Company has incurred legal expenses
29 outside the test year, does not provide "compelling reasons" to include those costs in the
30 test year. And even if those costs were considered extraordinary enough to be included,

there would be a further question as to if the costs should be amortized over a specific period rather than allowing the full amount recognized in one year. For the above reasons the proposed adjustment should not be allowed.

PART IV

COST OF CAPITAL

Q. WHAT IS THE PURPOSE OF THIS PORTION OF YOUR TESTIMONY?

A. I will testify on the overall rate of return that RVW should have the opportunity to earn. I will address the Company's capital structure, the cost of debt, the proper return on equity and debt service coverage requirements.

Q. PLEASE DISCUSS YOUR APPROACH IN YOUR ANALYSIS OF THE DEBT PORTION OF THE CAPITAL STRUCTURE?

A. Using the Company's records a list of debt was compiled along with the related interest rates. The notes with adjustable rates were identified and the rate currently charged, based on the current prime rate, was computed. As of the end of the test year the debt component associated with RVW totaled $3,747,442 with a weighted cost, as of November 2001, of 5.55% as shown on line 14 of Exhibit ____(DPK-7).

Q. COMPARING THE TOTAL DEBT IN YOUR EXHIBIT___(DPK-7) TO THE COMPANY'S EXHIBIT (DF-10), YOUR TOTAL DEBT FIGURE IS $1,136,820 GREATER THAN THE COMPANY'S. PLEASE EXPLAIN THE DIFFERENCE IN THE TWO EXHIBITS.

A. My Exhibit____(DPK-7), lines 23 through 34, reconciles the differences. Accounting for most of the difference is $934,447 the Company did not include in its debt listing. This debt is related to the corrosion surcharge currently collected by the Company. It appears that the Company believes that this debt should not be included in the overall capital

1 structure because it is related to a surcharge. Normally, if the surcharge collected only
2 costs needed to service the associated debt, that approach would be acceptable, and
3 probably even necessary, to remove the related debt along with the related revenue and
4 interest. However, this is not the case here. This surcharge is unique in that it was
5 designed to collect not only debt service costs, but also the maintenance and supply
6 expenses associated with RVW's corrosion control program. Due to the nature of
7 operating expenses, the surcharge could over-collect or under-collect costs related to the
8 corrosion control program. It would be too difficult, if possible at all, to remove the debt,
9 debt costs, related assets and depreciation, and all related corrosion expenses from the
10 case and at the same time defer or accrue an over/under collection. As a practical matter
11 it is better to include all costs and revenues associated with this surcharge in the general
12 case and allow any over/under collection to be absorbed by general rates.
13
14 **Q. ARE THERE OTHER DIFFERENCES BETWEEN THE COMPANY'S TOTAL**
15 **DEBT AND STAFF'S FIGURE?**
16 A. Yes, of the remaining difference, the most material is $285,945 related to the
17 misstatement of the debt related to developers. The Company, in DF-10, appears to have
18 used the 1998 developers total debt figure of $445,651 and not the test year amount of
19 $731,596. The remaining amounts are detailed in Exhibit___(DPK-7).
20
21 **Q. OTHER THAN DIFFERENCES IN AMOUNT OF DEBT AS YOU HAVE**
22 **DISCUSSED ABOVE, ARE THERE ALSO DIFFERENCES IN INTEREST**
23 **RATES REFLECTED IN THE COMPANY'S DEBT SCHEDULE AND STAFF'S?**
24 A. Yes, as discussed on page 23 starting at line 15, over two-thirds of RVW's debt is based
25 on adjustable rates, adjustable rates pegged against the prime rate. Exhibit___(DPK-7)
26 shows debt with interest rates adjusted to the current rate incurred by the Company as of
27 November 2001. It should be noted that in Exhibit ___(DF-10) the Company adjusts a
28 portion of the CoBank loans to reflect what its interest rates would be with a prime rate of
29 6.75%, an interest rate below year-end levels. However, the Company did not
30 synchronize the adjustement reflected in its exhibit with the interest expense on its pro

1 forma income statement. That is to say, the interest expense in the filed pro forma
2 income statement, Exhibit___(DF-2), is not adjusted to reflect the lower rates.
3
4 **Q. IN THE STAFF'S ANALYSIS, WAS INTEREST EXPENSE SYNCHRONIZED**
5 **WITH YOUR DEBT SCHEDULE IN EXHIBIT ____(DPK-7)?**
6 A. Yes, pro forma adjustment #10 decreases interest expense from $344,648 to $ 208,047 to
7 match the computed debt structure.
8
9 **Q. WHAT FUNDAMENTAL PRINCIPLES RELATE TO THE DETERMINATION**
10 **OF A FAIR AND REASONABLE RATE OF RETURN?**
11 A. Two landmark cases define the legal principles underlying a fair and reasonable rate of
12 return. The Bluefield Water Works & Improvement Co. v. Public Service Commission
13 of West Virginia, 262 U.S. 679 (1923) and the Federal Power Commission v. Hope
14 Natural Gas Company, 320 U.S. 391 (1944). These decisions require that the
15 Commission's allowed rate of return must: (1) provide a return to its owner that is
16 commensurate with returns on investments in other enterprises having corresponding
17 risks, (2) assure confidence in the financial integrity of the company, and (3) be adequate
18 to maintain the company's credit worthiness and ability to attract capital.
19
20 **Q. DID YOU PREPARE ANY EXHIBITS RELATIVE TO YOUR RATE OF**
21 **RETURN TESTIMONY?**
22 A. Yes, I have labeled it Exhibit ____(DPK-8).
23
24 **Q. PLEASE EXPLAIN HOW YOU DERIVED YOUR COST OF COMMON**
25 **EQUITY?**
26 A. I began by collecting a sample of six publicly traded water companies, all of which are
27 traded on the New York Stock Exchange. The data on the six water utilities are
28 published in Value Line, a national publication. Using the Value Line data and current
29 stock price information I employed a general Discounted Cash Flow (DCF) model, to
30 estimate what return investors are expecting from companies in the water industry.

1

2 **Q. DID YOU DETERMINE A COST OF EQUITY FOR RAINIER VIEW WATER?**

3 A. Yes, by using the six water utilities and the DCF formula I calculated the base return
4 expected by investors in the water industry. The computed return using the 52-week
5 average is 9.31% on equity. Rate regulation recognizes that small, closely held water
6 companies such as RVW inherently carry higher risks than the publicly traded companies
7 upon which DCF analyses necessarily rest. Therefore a 150 basis point premium was
8 added to this base amount recognizing the increased risk intrinsic to small water
9 companies relative to large publicly traded water companies. The 150 basis point
10 adjustment is consistent with this Commission's decision in WUTC vs. American Water
11 Resources, Inc., in Docket Nos. UW-980072, et al. This brings the indicated equity
12 return to 10.81%.

13

14 **Q. IS IT YOUR OPINION THAT A 10.81% RETURN IS THE REQUIRED COST OF**
15 **EQUITY FOR RAINIER VIEW WATER?**

16 A. No. One of the attributes of a fair and reasonable return is that the allowed return be
17 adequate to maintain the Company's credit worthiness. RVW currently has loan
18 covenants that require the Company to maintain a 1.25 Debt Service Coverage Ratio
19 (DSCR). The components and computation of the DSCR are shown on Exhibit___(DPK-
20 9). If a 10.81% was used as the cost of equity, and no other adjustments were made, the
21 DSCR would be 1.14, well below the required 1.25 ratio.

22

23 **Q. IS IT UNUSUAL THAT LENDERS WOULD REQUIRE 1.25 DEBT SERVICE**
24 **COVERAGE RATIO?**

25 A. No, it is not unusual. It is standard for lenders to require an earnings cushion to protect
26 the borrower's ability to make its required payments.

27

28 **Q. KEEPING IN MIND THE 1.25 DEBT SERVICE COVERAGE RATIO**
29 **REQUIRMENT, WHAT IS YOUR RECOMMENDED RETURN ON EQUITY?**

1 A. The Company requires a 15.46% return on equity invested in ratebase in order for the
2 allowed rates to obtain a 1.25 DSCR.
3

4 **Q. WHAT IS THE REASON THE COMPANY REQUIRES A HIGH RETURN IN**
5 **ORDER TO MEET THE DSCR REQUIREMENT?**

6 A. The reason lies in the fact that the capital structure, which is funding its rate base, is
7 highly leveraged. The rate base's capital structure, 29.30% equity and 70.70% debt,
8 produces relatively high debt service costs and, with the smaller equity amount, must
9 provide earnings high enough to maintain the required DSCR.
10

11 **Q. THE COMPANY'S EXHIBIT (DF-10) SHOWS A CAPITAL STRUCTURE OF**
12 **44.66% EQUITY AND 55.34% DEBT, PLEASE EXPLAIN WHY YOUR**
13 **CAPITAL STRUCTURE IS DIFFERENT.**

14 A. The most significant difference is due to the Company's $1,136,820 understatement of
15 debt as I explained on page 30 of my testimony. This adjustment alone accounts for an
16 increase of 8% of the debt component. In addition, the Company's equity component is
17 reduced to recognize that over a half a million dollars of company assets are non-rate
18 base investment. As of the end of the test year, $553,793 of the Company's assets
19 financed by equity are in cash or short-term liquid assets and are not included in rate
20 base. The process of reconciling rate base to capital structure requires that the equity
21 component related to current assets or non-rate based investments be removed from the
22 regulated capital structure. This adjustment accounts for a decrease of approximately 7%
23 in the equity component. In short, the combined effect of the increased liabilities and
24 decreased equity results in the Staff's capital structure of 29.30% equity and 70.70%
25 debt.
26

27 **Q. BASED ON YOUR ANALYSIS OF THE CAPITAL STRUCTURE AND COST OF**
28 **CAPITAL, WHAT IS YOUR RECOMMENDED RETURN ON INVESTMENT?**

1 **A.** Using the actual capital structure financing rate base the weighted cost of capital is
2 7.09%. This is based on the cost of equity of 15.46% and the weighted debt cost of
3 5.55%.

4 **PART V**

5 **RECOMMENDED REVENUE REQUIREMENT**

6
7 **Q. HAVE YOU ANALYZED THE COMPANY'S TEST YEAR DATA USING THE**
8 **COMPANY'S INCOME STATEMENT AND RATE BASE ADJUSTED FOR**
9 **STAFF RECOMMENDED RESTATING AND PRO FORMA**
10 **ADJUSTMENTS AND, IF SO, PLEASE DISCUSS THE RESULTS OF**
11 **YOUR ANALYSIS.**
12 A. Yes, I did complete such an analysis. Based on the analysis of the test year pro forma
13 income statement and ratebase, the Company is earning an overall return of 11.23%, with
14 a return on equity of 24.92%. The analysis indicates that the Company is over-earning.
15
16 **Q. BASED ON THE ANALYSIS THAT STAFF HAS PERFORMED HAVE YOU**
17 **CALCULATED THE OVERALL REVENUE REQUIREMENT FOR THE**
18 **COMPANY?**
19
20 A. Yes. Based on test year data, after Staff's recommended restating and pro forma
21 adjustments, the indicated revenue requirement for RVW is $3,050,349. The pro forma
22 results, column (f), reflect an operating revenue of $3,230,349, which is $180,000 greater
23 than the indicated revenue requirement of $3,050,349, column (j). Therefore, Staff
24 recommends that the overall rates be decreased by 5.57%
25
26 **Q. DOES THIS CONCLUDE YOUR TESTIMONY AT THIS TIME?**
27 **A.** Yes