

Agenda Date: August 16, 2006
Item Number: **A1**
Docket: UW-060343
Company Name: Iliad Water Service, Inc.
Staff: Danny Kermode, Regulatory Analyst

Recommendation:

Dismiss the Complaint and Order Suspending the Tariff Revisions filed by Iliad Water Services, Inc., in Docket UW-060343 and allow the revised rates, as modified, to become effective September 1, 2006.

Background

Iliad Water Service, Inc., (Iliad Water or company) is a regulated water company that serves approximately 89 customers on three water systems. Its three systems are located in Kitsap, Snohomish, and Pierce Counties. The Alder Lake Water System is located in southern Pierce County near the town of Elbe.

In the fall of 2000, the Alder Lake water system's 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 "clearly in hydraulic connection" to Alder Lake.¹ That is, the ground water that the water system uses to serve its customers has a hydraulic connection to the surface water in the lake thus posing a microbial risk. As such, the Washington Administrative Code (WAC 246-290-640) requires the company to install disinfection treatment.

Slightly over a year later, January 31, 2002, the company received approval from the Department of Health of its proposed plan to chlorinate the Alder Lake water system.

On March 1, 2006, Iliad Water filed with the commission a tariff that proposed 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.²

The original filed tariff provided an option for customers to obtain a personal loan from a third party lender recommended by Iliad Water. The proposed private financing would have charged customers 11 percent interest over 10 years, plus an origination fee of 3 percent to 5 percent of the loan principal. To obtain the private financing, the lender requires commission approval of a surcharge prior to funding the loan. The company did not pursue a State Revolving Fund (SRF) loan which provides a substantially lower interest rate and a longer pay-back period than the conventional loan.

The company is requesting all costs of the project be financed through the proposed surcharge. The company is filing for a surcharge under WAC 480-110-455 which allows

¹ Letter from Department of Health, December 19, 2000

² See timeline - Attachment A

100 percent funding.³ Staff normally takes the position that a portion of the investment should be financed through equity however, the current capital structure of Iliad Water reflects a major deficit in retained earnings. The retained earnings deficit prohibits the company from earning a return on anything short of a substantial equity investment in excess of \$100,000. Expecting the company to provide an investment of this size is without a return is doubtful.

After extended discussions with staff, the company has modified its proposed tariff. The modified tariff allows the company to charge a monthly surcharge \$49.26 if the customer does not pay the one-time charge up front.⁴

	Monthly Surcharge	Current Rate - Base	Monthly Total
Modified Proposal	\$49.26	\$23.13	72.39
SRF	17.42	23.13	40.55

The modified tariff proposal maintains the option to pay \$3,405 “up-front” however, the customer must pay the full amount within 45 days of effective date of tariff to take advantage of the option.

Company reasons for not pursuing SRF financing.

In response to a staff data request, the company stated it was not applying for a SRF loan. The company stated that it did not pursue the SRF because its engineer did an “extensive investigation” and determined a SRF loan was not economical due to:

- Increased costs
- Increased time in implementing the loan and construction requirements.⁵

Although the company stated the company’s engineer did an extensive investigation, the company has no cost analysis or any correspondence prior to May 3, 2006, when the company responded to staff’s data request, supporting the engineer’s conclusion that increased costs would off-set any SRF interest savings.

Pursuing its investigation, staff requested the company provide a detailed analysis of the increased costs caused by SRF financing referred to the company.⁶ In its response, Iliad Water provided an expansive listing of additional costs the company expected it would incur if it obtained SRF financing.

³ WAC 480-110-455(2)(b)

⁴ In addition to the current monthly rate for water service of \$23.13 monthly that includes 500 cubic feet in the minimum. Water use over 500 cubic feet is charged at \$0.76 per 100 cubic feet.

⁵ Response to staff data request 2, page 2 item 5.

⁶ Staff data request 3

Using the additional costs provided by the company, staff performed its own cost analysis on the impact on rates. Staff's analysis compares the proposed private financing and SRF financing including the estimated increased costs provided by Iliad.⁷

Staff's analysis shows that, even with the additional costs, the SRF loan has the least impact on rates. The SRF method of financing produced a monthly rate of approximately \$17 for 20 years versus the approximate \$49 a month for 10 years for the private financing method.

Additional Reasons for not pursuing SRF financing

Supporting its decision not to pursue the SRF option, the company provided a letter from its engineer advising the company that Iliad Water could not obtain a SRF loan because:

- The company is a "for profit" water system.⁸
- And that because of "restrictions of the eligibility requirements... [there would be] no assurance the loan would be awarded."⁹
- company does not have an approved Water System Plan (WSP)¹⁰

Staff's response to each argument follows.

For-profit water systems are ineligible for SRF Loans

The company's engineer, Mr. McDonnell, states in his letter "I do not see how Alder Lake can qualify for State funding as a private 'for profit' system. As you know the guidelines clearly define eligibility as 'community and nonprofit non-community water systems.'"

The Alder Lake Water System is both a community water system and privately owned, neither of which disqualifies the company for SRF financing. The Washington Department of Health clearly states in its SRF guidelines under the section titled *Eligible Applicants*: "Publicly and privately owned water systems in Washington State may apply for a [SRF] loan to assist in financing water system projects that address public health risk and systems that are out of compliance..." *Emphasis added*¹¹

⁷ The company included as an additional cost the cost of a water system plan. This proposed water system plan costs are not included in the staff analysis, the reasoning is addressed later in this memo.

⁸ Letter from Mr. McDonnell, the company's engineer, dated June 6, 2006, attached to the company's response to staff data request 3.

⁹ Response to staff data request 2, page 2 item 5.

¹⁰ Letter from Mr. McDonnell, *ibid*

¹¹ Drinking Water State Revolving Fund 2006 Funding Cycle Application Guidelines, January 2006, page 13

Contrary to the opinion of its engineer, the company is eligible for SRF financing as a private for profit system.

No assurance the loan would be awarded

The company expressed concern that there is no assurance that the company would be awarded a SRF loan.¹² This concern is misplaced.

In its SRF guidelines, the Department of Health describes its system of prioritizing funding. The project proposed by the company falls into to the highest risk category, which is the category covering microbial risk and therefore has the highest priority for funding.¹³ Staff discussions with the Public Works Board staff indicates that the Public Works Board has always funded every proposed project in this highest of priority levels. There was little to no possibility the Public Works Board would have rejected the project had the company simply applied in a timely basis.

Company does not have an approved Water System Plan.

The company's engineer states in his June 6 letter that the company must provide a Department of Health approved Water System Plan as part of its SRF application. The company is not required to have a water system plan to apply for a SRF loan. The Department of Health SRF application guidelines state: "The project must be included in a current DOH-approved Water System Plan or Small Water System Management Program" *Emphasis added*¹⁴

The Small Water System Management Program (SWSMP) is a planning device used by the Department of Health to aid small system operators, such as Iliad Water. Discussions with Department of Health staff indicate that the SWSMP can be completed by Iliad Water's current management and does not require an engineer's review.

One of the cited purposes of the SWSMP is to "establish eligibility for funding under the drinking water state revolving fund."¹⁵ Additionally, a completed SWSMP is not required at the time of the SRF application; an approved SWSMP may be submitted up to seven months after the SRF application is filed.

Financing

The main issue in this case is the method of financing the company selected to pay for the costs associated with the project. The company selected to finance 100 percent of the project through a 10 year promissory note at 8 percent interest rather than actively pursuing a low-cost loan from the State's Drinking Water Revolving Fund Program. A

¹² Response to staff data request 2, page 2.

¹³ Drinking Water State Revolving Fund 2006 Funding Cycle Application Guidelines, January 2006, page 16

¹⁴ Ibid, page 6

¹⁵ WAC 246-290-105(1)(b)

loan from the SRF provides funds for projects that are repaid over a 20 year period at 1.5 percent interest, resulting in a savings for the rate payer over a private lender.

To measure the savings to the rate payer, analysts sometime use what is referred to as present value techniques. Present value allows comparison of financing alternatives with different repayment periods and interest rates. The analysis computes the amount of money a customer would need "up-front" to fund all future cash payments related to the alternative proposed methods of financing. It is assumed that customers earn a reasonable return on the up-front money until each loan payment is made.

As a simple example, assume a customer must make a single loan repayment of \$100 at the end of the year. Also, assume the customer can earn an average of 8 percent on her money. A present value computation computes the amount of money the customer needs at the beginning of the year to make the \$100 payment at the end of the year. The present value of \$100 at 8 percent is \$92.59.

Therefore: \$ 92.59 Beginning of year amount
 7.41 Interest for the year
 \$100.00 Total at year-end

Optimal Financing

The financing of a project that produces the least amount of up-front money (the lowest present value) is the optimal financing providing the greatest amount of savings over the life of the loan. Below is the staff computed present value amounts for both the proposed private financing and the SRF financing.

<u>Finance Method</u>	<u>Present Value</u>
Private Financing	\$ 148,743
SRF Financing	\$ 92,416

Since the SRF financing produced the lowest present value, the SRF is the optimal method of financing this project.

It appears the company was ill-advised by its engineer who provided incorrect information regarding the impact of the additional costs and requirements for the application of a SRF loan. Relying on the advice of its engineer, the company did not file for a SRF loan before the May 2006 deadline.

The question of current SRF financing is now moot since the deadline for filing applications passed on May 8. The company would need to wait until the 2007 SRF application cycle with the related 2007 funds not available until 2008.

Department of Health Concerns

In an April 2006, letter from the Department of Health's Northwest Regional Compliance Manager to the company, Ms. Ingrid Salmon expresses the department's concern that the company has not yet started the installation of a permanent disinfection system.¹⁶ In addition, Ms. Salmon, in conversations with staff, has discussed her concern of the Alder Lake water system's continued vulnerability to surface water pathogens. The lack of proper water treatment places its customers at risk of water borne illnesses.

For the company to pursue SRF funding at this point in time would mean that it could not begin the water treatment project for another two years. The Department of Health is unwilling to defer enforcement of its requirement an additional two years. "Waiting for the next round of SRF funding will not be in the interest of public health..."¹⁷

Commission Treatment of Surcharges

The Commission has consistently allowed recovery of the costs of system improvements that are required by the DOH from all of the systems owned by a company and not just the water system with the improvement. This is referred to as Single Tariff Pricing.

In this case, the company owns three water systems that are located in three different counties:

- Alder Lake – Pierce
- Western Stavis – Kitsap
- Cascade Crest - Snohomish.

Normally the impact on other non-affected customers is not material because the number of customers the company serves. The amount is distributed to the relatively large number of customers making any increase more palatable. However, in this case, there are a total of only eighty-nine customers on all three systems. Fifty of the customers are not on the system receiving the chlorination. If the surcharge was spread evenly to all customers, all customers would receive a \$21.58 rate increase. The \$21.58 surcharge equals 86 percent of the monthly water bill for the Cascade Crest customers and 93 percent of the Western Stavis and Alder Lake customer's water bill.¹⁸ Review of

¹⁶ In the same letter, Ms. Salmon asks the company to "keep in mind that low-interest loans are available through the [SRF]."

¹⁷ Letter from Denise Clifford, Director Office of Drinking Water, August 10, 2006

¹⁸ The highest surcharge to water bill relationship in the sample was for Rosario Resorts at 63% (UW-991913). Rosario is distinguished from this case in that the surcharge paid for water treatment and generators that all its systems benefited from. In addition the Rosario systems are all located in the same geographic area.

commission allowed surcharges shows that the average impact of surcharges of regulated water companies range is between 15 percent to 23 percent of a ratepayers average bill.

Although Single Tariff Pricing is normally used in providing surcharges, due to the materiality of the proposed surcharge, staff supports allowing assessment of only the Alder Lake system.

Staff Recommendation

The commission is required to provide rates that allow the company to comply with the requirements of the Department of Health. Although staff believes the company and its management company should have been aware that it could pursue SRF financing of this project, the company was misinformed by its consulting professional engineer who apparently did not fully understand the requirements of the SRF loan process for privately owned water companies.

Therefore, staff believes we have no other option but to recommend the commission Dismiss the Complaint and Order Suspending the Tariff Revisions filed by Iliad Water Services, Inc., in Docket UW-060343 and allow the revised rates, as modified, to become effective September 1, 2006. Staff also requests that Iliad Water be required to provide quarterly financial information to monitor the results of the surcharge and related loan payments.

Attachment