

Agenda Date: October 24, 2001
Item Number: 2D

Docket: UW-010961

Company Name: American Water Resources, Inc.

Staff: Gene Eckhardt, Assistant Director of Water and Transportation
Jim Ward, Revenue Requirements Specialist
Chris Vernon, Public Involvement Coordinator

Recommendation:

Staff recommends the Commission deny American Water Resources, Inc., (AWRI) request for temporary rates.

If the Commission finds AWRI's request for additional employees compelling, Staff recommends the Commission: approve a temporary surcharge of \$3.44, subject to refund, as contingency revenue if AWRI hires additional employees; approve the surcharge for only one month, which AWRI can request the Commission to extend on a month-by-month basis if it hires additional employees; and, approve the temporary surcharge only if AWRI agrees to the conditions set forth in the memo.

Discussion:

On July 3, 2001, American Water Resources, Inc., (AWRI or Company) filed a general rate case. The proposed general rates are designed to produce an additional \$227,647 (27.5%) annually. As part of the general rate increase request, AWRI is asking for temporary rates, subject to refund, of an additional \$184,296 (22.3%) annually. AWRI serves approximately 1,822 active customers in Lewis, Thurston, Pierce, and Grays Harbor County.

At the July 25, 2001, open meeting, the Commission Issued a Complaint and Order Suspending the Tariff Revisions for permanent general rates as filed by AWRI in Docket UW-010961.

In its July 3, 2001, transmittal letter, AWRI states "In addition, the company is requesting an emergency rate increase in the amount of \$15,358 on a monthly basis until revised permanent rates are in effect." Mr. Richard Finnigan, representing AWRI, submitted a letter clarifying that the Company intended to ask for "temporary rates, subject to refund." The Commission previously concluded it has authority to allow temporary rates in WUTC v. G & W Aqua, Inc., Docket No. U-87-1089, citing RCW 80.04.130(1) as the basis for its authority, stating "Sound public policy requires that RCW 80.04.130(1) be interpreted to allow the Commission to set higher or lower temporary rates." In rejecting the showing made by the Company in that case, the Commission stated: "A finding of good cause requires a showing of unjust or harmful circumstances and their consequences for the period of the proceeding."

The Company states the requested general rates are to cover the increased cost of state-required

testing, maintenance, and increased costs of operations. Additionally, the Company is requesting that rate relief be granted, in the form of temporary rates, subject to refund, to enable the Company to continue meeting its obligation to serve.

AWRI twice postponed the Commission's consideration of this matter. On October 17, 2001, AWRI filed additional financial data for January through September 2001 and revised its request for temporary rates to \$5.65 per month. AWRI's consultant states that it "is anxious to be permitted to negotiate this emergency rate request as well as the general rate request to a mutually acceptable settlement. I am offering the following to open discussions to obtain this goal."

Filing additional financial information, revising its requested temporary increase, and requesting Staff to negotiate a settlement one week before the scheduled Open Meeting leaves little time for Staff to react. AWRI has now submitted three unaudited periods of financial information: calendar year 2000, January through June 2001, and January through September 2001. Staff calculated a fourth set of unaudited financial information for the period of July through September. The last rate case, Docket UW-991392, provides the only audited information. All of this information is presented in Attachment 3.

AWRI has completed many capital projects over the last two years. Several capital projects were done under the Department of Health critical list surcharge by V.R. Fox Company and the cost substantially exceeded the estimates on which the surcharge was based. Other capital projects were done by V.R. Fox Company and when these capital projects required funding, most projects were financed by current accounts payable or Virgil Fox issuing notes payable that were created with an interest rate of 12 percent payable to Virgil Fox. Additional funding for capital projects has also been provided by Contribution in Aid of Construction (CIAC) sources. Other costs that have increased recently are: transportation cost with vehicles leased from Virgil Fox Fleet Billing; and building rent, paid to Birchfield, LLC (owned by Virgil Fox).

Customer Comments:

The Commission received 85 comments from customers who all oppose the rate increase proposed by AWRI:

1. Customers expressed frustration and anger that AWRI is before the Commission for yet another requested rate increase. They believe that the proposed increase is excessive and they fear that their water bills will increase indefinitely unless the Commission denies AWRI's request.
2. Customers stated they are also disgruntled that they are paying a capital improvements surcharge and have yet to see improvements to their own systems. These customers do not believe the Company should be allowed to raise basic rates until the improvements for which they are already paying through the surcharge have been made.
3. The customers who are currently satisfied with their own systems want AWRI's request to

be denied because they do not believe they should subsidize the repair and maintenance of older systems purchased by AWRI.

4. Commission staff received comments on seven of AWRI's water systems stating various water problems. Staff found that according to the Health Departments associated with these water systems, six of these systems were within the water quality level requirements. The seventh system's water quality reports showed high levels of manganese. Manganese is a secondary contaminant. The Department of Health does not require water companies to install treatment for manganese unless the customers vote to pay for the treatment. Lewis County Environmental Health (LCEH) oversees this system. Staff continues to work with both LCEH and AWRI to reduce the level of manganese on that system. Staff also investigated three water pressure complaints. Two of these complaints were in the Crescent Park Water System. AWRI found a leak in this system's line and repaired it on July 27. Both customers have seen a significant improvement in their water pressure and are satisfied with the outcome. Staff is continuing to work with AWRI on the remaining water pressure complaint. Another customer stated there might be a problem with low pressure of a fire hydrant near his home. Pierce County Fire Department performed a fire flow test and found the flow to be adequate on this customer's system. Finally, a customer stated AWRI provided a water availability certificate promising a water connection for its Lazy Acres water system. AWRI then found this system is at full capacity and cannot provide another connection to this customer. Staff is working with AWRI to determine if a connection can be provided based on a historic water usage analysis.

Per Customer Revenue Impact:

The annual per customer revenue impact of this filing will be approximately \$124.44 (\$10.37 per month) for general rates and, as originally filed, \$103.08 (\$8.59 per month) for temporary rates, which AWRI has now revised to \$67.80 (\$5.65 per month). The current, proposed, temporary, and revised temporary rates are shown below.

<u>Monthly Rate Schedule</u>	<u>Current</u>	<u>Proposed</u>	<u>Temporary</u>	<u>Revised Temporary</u>
3/4" Meter Base	\$ 17.70	\$ 21.00	\$ 21.00	NA
1" Meter Base	\$ 30.08	\$ 35.07	\$ 35.07	NA
1 2" Meter Base	\$ 59.98	\$ 69.93	\$ 69.93	NA
2" Meter Base	\$ 96.00	\$ 111.30	\$ 111.30	NA
4" Meter Base	\$300.28	\$ 356.27	\$ 356.27	NA
Flat Rate Residential	\$ 34.00	\$ 45.51	\$ 44.24	NA
Consumption, up to 500 cubic feet	\$.0121	\$.0166	\$.0159	NA
Consumption, over 500 cubic feet	\$.0175	\$.0243	\$.0230	NA

NA – Not Available

The history of general rate case filings for AWRI follows:

Docket No.	Status	Proposed Flat Rate	Approved Flat Rate
UW-971237	Settled	\$35.00	\$32.40
UW-980258	Hearing	\$37.60	\$29.40
UW-991392	Settled	\$36.46	\$34.00

This history clearly shows that the Commission approved after hearing, or allowed to become effective by operation of law, rates that were consistently less than what AWRI requested. Staff has not yet completed its audit in this case. Both Staff and the Commission need to exercise caution in taking action based on the unaudited information.

Capital Structure:

In the last litigated rate case, Docket UW-980258 (consolidated under Docket UW-980072, et. al.), the Company had a debt-to-equity ratio of 94% debt and 6% equity. The debt component had a cost of 9.91 percent with equity allowed at 12.6 percent. This allowed AWRI an overall rate of return of 10.45 percent on rate base. AWRI asked the Commission to set the return using a hypothetical capital structure of 50% debt and 50% equity. Staff asked the Commission to set the return using AWRI's actual capital structure, because using a hypothetical capital structure increased the cost to customers without providing any benefit in the form of a more reasonable capital structure. In determining the overall rate of return, the Commission provided AWRI a debt to equity ratio of 80% debt and 20% equity. The Commission stated in its Sixth Supplemental Order at Page 9 in Docket UW-980258:

Hypothesizing increased equity, then, benefits AWRI's shareholders so long as return on equity exceeds interest on debt but imposes higher rates on AWRI's customers without actually improving AWRI's financial security. We approve the 80 percent hypothetical debt ratio determined under the Initial Order only because it is realistic to believe AWRI can achieve an actual structure at that ratio, or better, in the short term and improve on the ratio further during the intermediate term, and certainly before AWRI's next rate case when the issue can be reconsidered. Thus, we reward AWRI up front with a modest hypothetical adjustment to promote action by AWRI and its principal shareholder and creditor, Mr. Fox, to steer the company immediately toward a more secure capital structure.

Since that time, AWRI has increased debt to Mr. Fox and now has negative equity. As of December 31, 2000, AWRI reported \$1,213,596.01 of long-term debt and negative \$76,163.52 equity. AWRI paid \$153,214.66 in interest during the test period. AWRI's debt exceeds its rate base. To ensure that customers pay only for capital used in providing water service, Staff adjusted the amount of debt to equal rate base. Debt creates an obligation to pay principal and interest every month. Equity does not create an obligation to pay return of investment or return on investment each month, allowing the company greater cash flow and flexibility in its operating structure.

Cash Management:

The revenue a water company receives throughout the year varies by season (Attachment 1). Although non-metered customers pay a flat rate year-round, regardless of the amount of water they use, metered customers pay higher bills during the dry, hot summer months because they use more water and pay lower bills during the cool, wet winter months because they use less water. Cash management is very important. If a company does not reserve money during the high-revenue summer months to supplement the low-revenue winter months, it will not have sufficient funds to pay operating expenses during the winter months.

Staff has become convinced the AWRI's problems stem from its inability or unwillingness to manage its cash.

Payables:

AWRI reports the following payables on its Balance Sheets:

	<u>December 2000</u>	<u>June 2001</u>
Accounts Payable	\$150,425.15	\$111,888.45
Notes Payable	\$ 76,396.99	\$ 27,184.19
Long Term Debt	\$1,213,596.01	\$1,264,984.85

These payables reflect either capital or operating costs incurred in the past, Staff does not know which at this time. General rates are designed to provide sufficient revenue to pay reasonable current operating expenses and provide the Company with an opportunity to earn a reasonable return on investment. General rates are not designed to fund prior accounts payable or capital costs, which should be paid with long-term financing, capitalized and depreciated or amortized over the life of the asset.

Interest Expense:

In the previous litigated case, Docket No. UW-980072, et. al., the Commission adjusted the interest rate on Mr. Fox's note from 12.0 percent to 10.5 percent, concluding the appropriate rate

should be calculated as the prime rate, plus 200 basis points. AWRI has continued to pay Mr. Fox 12.0 percent interest on all notes. AWRI has not yet provided Staff with the detail to explain what interest rates were used to calculate the interest payments set forth in AWRI's expense statements. Staff adjusted the interest rate for the note held by the owner to 10.5% (prime plus 2.0%) as authorized in the Docket UW-980258.

AWRI's long-term debt now exceeds its rate base. AWRI paid \$200,000 more than rate base when it purchased two regulated water companies. AWRI issued debt to Mr. Fox for the \$200,000. In Docket UW-980072, et. al., AWRI asked the Commission to approve a \$200,000 acquisition adjustment, so customers would begin paying rates that would include the return of (depreciation) and return on (interest) the \$200,000. The Commission denied the request. Staff believes that AWRI has continued to pay interest to Mr. Fox for the \$200,000 that the Commission previously rejected as an appropriate cost for rate payers.

Accounting Expense:

Staff cannot conclude the accounting expenses shown on AWRI's 2001 Income Statement are appropriate to include in rates. Staff does not understand the Accounting Expenses shown in AWRI's 2001 Income Statement and has not had an opportunity to audit those expenses. Although Staff has not audited these expenses, these expenses are clearly not ordinary accounting expenses. After incurring \$11,007 in accounting expense during calendar 2000, AWRI incurs \$59,801 during the first six months of 2001, \$27,663 in June alone. Rainier View, Inc., a regulated water company serving more than 10,000 customers reports less outside accounting expense for the entire calendar year 2000. Staff assumes that the accounting expenses incurred by AWRI in 2001 are non-recurring, and thus would not be appropriate to include in rates. If the non-recurring expenses relate to a general rate case, surcharge rate case, or a capital project, they should be capitalized, not expensed. Also, the amount of these expenses requires a much closer review to determine whether or not the expenses were prudent.

Personnel:

In 2000, AWRI changed its office staff and management personnel. This year, AWRI again changed management personnel and is once again being managed by the owner, Mr. Fox. During the last 5 years of operation, the Company has repeatedly asked for rate increases that included additional personnel for field operations. The Commission has consistently allowed what AWRI requested, and AWRI has repeatedly either not hired or not maintained those positions (Attachment 2). Since the hearing in 1998, AWRI has maintained it needed nine full time positions to include two managers, five field personnel and two office personnel. Last year, the Company operated with four field personnel, two office personnel and two managers. Currently, the Company has four field personnel, two office personnel, and one manager. AWRI is again asking for proforma adjustments to expenses for eleven positions. Personnel turnover and lack of requested and funded personnel continues to be the norm for AWRI.

Facilities Charge (CIAC):

Docket No. UW-980072, et. al., the Commission set AWRI's Facilities Charge and directed AWRI to use the funds collected from the Facilities Charge to finance infrastructure improvements needed to improve the quality of service AWRI provides to existing customers. Later, in May 1999, the Commission approved the 1999 Critical Item List Surcharge in Docket No. UW-990518 for the purpose of financing a list of thirteen critical water projects. AWRI used Facilities Charge funds to pay for portions of those thirteen projects. V.R. Fox Company, an AWRI affiliate, submitted low bids and received contracts for each of the projects. AWRI reported actual costs substantially exceeded the estimates on which the surcharge was based and filed a rate case to extend the expiration date of the surcharge in Docket No. UW-010866, which the Commission approved.

Surcharge (CIAC):

AWRI failed to comply with the cash management requirements the Commission ordered in Docket No. UW-990518. In that docket, the Commission approved a surcharge of \$4.54 per customer to pay for capital improvement projects that the Department of Health identified as critical projects. The surcharge became effective May 1, 1999, and the Commission ordered:

3. The funds received as a result of this 1999 Critical Item List Surcharge will be deposited into a separate reserve account exclusively for the purpose of making capital improvements identified as part of the company's water system plan approved by the Department of Health. This separate reserve account shall be listed on all company financial records and shall be considered a cash account asset (NARUC account #127). Expenditures from the reserve account shall be treated as customer contributions.

In a letter dated July 10, 2001, submitted in support of AWRI's request to extend the expiration date of the surcharge previously approved by the Commission in Docket No. 990518, AWRI states:

My review of the company's records indicates that while surcharge billings through April 2001 totaled \$208,381.25 only \$131,064.01 was ever deposited into the designated surcharge account. The \$77,317.24 difference was deposited with the water revenue into the operations account and was quickly absorbed by the cash flow needs experienced by the company most of which related to this surcharge. When this oversight was discovered, the company did not have the resources to make up this difference in the surcharge account.

Discussion:

Instead of clarifying AWRI's finances, the additional data raises more questions. In the five sets of financial information shown in Attachment 3, many of the expenses show large variances. For the purpose of considering AWRI's request to approve temporary rates, subject to refund, Staff concludes that the best we can do under the current circumstances is to estimate reasonable average monthly expenses and adjust rates, if necessary, to generate sufficient revenue to pay those

expenses. Attachment 3, Column N, titled "Staff Recommended Monthly Budget, 24-Oct-01 Memo," shows what Staff considers a reasonable estimate of monthly expenses that AWRI will incur in the short term. AWRI asks for temporary rates that will remain in effect until the Commission determines the suspended general rate case, which should be approximately six months. November through April are winter months, characterized by cool, wet weather. Staff has attempted to take those characteristics into consideration in estimating reasonable expenses for that period. Attachment 3 also identifies the source of Staff's estimates with a "box." Staff adjusted some expenses AWRI reported for the year 2000 to reflect lower costs that should result from its sale of 21 water systems serving 153 customers in the Gig Harbor area, effective July 7, 2001. Staff recommends the Commission adopt the expense budget shown in Attachment 3, Column N, titled "Staff Recommended Monthly Budget, 24-Oct-01 Memo," as a monthly expense budget for AWRI.

Also shown in Attachment 3, Column F, titled "Staff Expense Priority," is a numerical ranking of what Staff considers to be the relative importance, or priority, of the various expense items. For example, Staff believes that the power bill has a high priority, and assigned it a number one priority.

The Commission approved rates in Docket UW-991392 that were designed to generate \$34.09 in monthly average revenue per customer. AWRI filed unaudited data that shows the rates generated \$34.40 average monthly revenue in calendar year 2000, and \$33.77 average revenue through the first nine months of 2001. Although the current rates appear to remain appropriate, the Staff recommended budget with estimated expenses result in an estimated net income of \$3,526 per month. AWRI's current rates appear to generate more than enough revenue for AWRI to pay current operating expenses.

AWRI's request for temporary rates may focus on the concern that current rates will not generate sufficient income in November to pay current November operating expenses. Although Staff concedes that may be true, Staff also points out that is not the right question. The Commission sets rates that will cover reasonable expenses and provide an opportunity to earn a reasonable return, using a representative test year, to ensure both high usage summer months and low usage winter months are represented. The rates are set as an average and will generate higher revenues during the hot, dry summer and relatively lower revenues during the cool, wet winter months. As pointed out in Staff's July 25, 2001, memorandum, water companies need to manage their cash flow to ensure they have enough cash to pay expenses during the winter months when they receive lower revenue. Therefore, Staff recommends the Commission use the revenue data from the first nine months of 2001 as the appropriate revenue estimates.

AWRI states that it needs additional employees to properly serve its customers. Staff has supported, and the Commission has previously approved, rates to pay for additional employees above AWRI's current staffing level. Even though AWRI did not employ the full authorized employees (nine) in calendar year 2000, AWRI requests again in this rate case to increase the

authorized employees to eleven employees. As stated earlier in the memo, AWRI has a history of asking for rates to pay for additional employees that remain vacant.

Staff again cautions the Commission on setting rates, even on a temporary basis subject to refund, using unaudited information. If the Commission finds AWRI's request for additional FTEs compelling, Staff recommends the Commission adopt AWRI's 2001 (January through September) average employee cost as a budget and approve a temporary surcharge of \$3.44, which is the additional amount calculated to equal AWRI's calendar year 2000 employee level, as contingency revenue to pay for additional employees if hired by AWRI. If AWRI does not hire additional employees, the temporary surcharge will go into an escrow account and continue growing. Therefore, Staff recommends the Commission approve the temporary surcharge for only one month. If AWRI hires additional employees, it can request a month-by-month extension of the temporary surcharge. Staff also recommends that the Commission approve the temporary surcharge only if AWRI agrees to the following conditions. Staff recommends these extraordinary measures because of the actions and management decisions of the owner/officer.

Conditions:

1. AWRI will establish an escrow account for the purpose of holding customer payments of the temporary surcharge and all revenue from rates that exceed \$66,011 per month.
2. AWRI will allocate and pay no more than the amount for each operating expense set forth in Attachment 3, Column N, titled "Staff Recommended Monthly Budget, 24-Oct-01 Memo:"
 - a. All payments must be made for current operating expenses for which the Company has received a bill and description of service rendered.
 - b. AWRI must prepare a report each month on the variance of the actual amount from the budget amount and an explanation of why the variance occurred.
 - c. AWRI must receive permission from the Commission to spend more than the budgeted amount for each expense item set forth in Attachment 3, Column N, titled "Staff Recommended Monthly Budget, 24-Oct-01 Memo." The escrow account administrator will provide AWRI funds in excess of the budget amount from the escrow account only after receiving approval from the Commission.
 - d. AWRI must deposit all cash not spent on current operating expenses, as budgeted for each expense item in Attachment 3, Column N, titled "Staff Recommended Monthly Budget, 24-Oct-01 Memo," to the escrow account.
3. AWRI will continue to receive the 1999 Critical List Surcharge revenue of \$4.54 per customer per month, which AWRI must use to pay off the surcharge loan as required in the Commission's order issued in Docket No. UW-990518.
4. AWRI will cease making interest and principal payments to the owner until all outstanding

payables have been paid.

5. AWRI will make monthly expense payments based on the priority rating assigned in Attachment 3, Column F, titled "Staff Expense Priority."

6. AWRI will track all costs to implement these conditions, report those costs monthly to the Commission, and pay those costs from the amount budgeted to "Salary Officers."

Conclusion:

Staff recommends the Commission deny American Water Resources, Inc., request for temporary rates.

If the Commission finds AWRI's request for additional employees compelling, Staff recommends the Commission: approve a temporary surcharge of \$3.44, subject to refund, as contingency revenue if AWRI hires additional employees; approve the surcharge for only one month, which AWRI can request the Commission to extend on a month-by-month basis if it hires additional employees; and, approve the temporary surcharge only if AWRI agrees to the conditions set forth in the memo.