

Agenda Date: April 10, 2002  
Item Number: 2B

**Docket:** UW-020307  
Company Name: Rosario Utilities, L.L.C.

Staff: Jim Ward, Regulatory Analyst  
Tani Thurston, Regulatory Analyst  
Penny Hansen, Public Involvement Coordinator

**Recommendation:**

Issue a Complaint and Order Suspending the Tariff Revisions filed by Rosario Utilities, L.L.C., in Docket UW-020307.

**Discussion:**

On March 12, 2002, Rosario Utilities, L.L.C. (Rosario Utilities or Company), filed for general rates in the amount of approximately \$164,000 (157 percent) of additional revenue per year. The company serves approximately 270 residential and vacation units, the Rosario Resort and Cascade Harbor Inn near East Sound on Orcas Island in the San Juan Islands. Part of the customer base is served through master meters to two homeowner's associations.

Rosario Utilities serves four basic categories of water customers: Residential, Bulk metered, Commercial, plus a Ready to Serve category. The Ready to Serve is used on an interim basis from the time a person becomes a customer until such time as the customer uses water. This normally occurs during the planning and construction of a new residence. The table below shows the customer categories, identifies the customer, shows the number of customers, and shows the number of Equivalent Residential Units (ERU)<sup>1</sup> for active and Ready to Serve customer categories.

CATEGORY	CUSTOMER	Number of CUSTOMERS	EQUIVALENT RESIDENTIAL UNITS	
			Active	Ready to Serve
Residential	Homeowners	156	156	39
Bulk Metered	Highlands HOA*	1	93	15
	Vusario HOA*	1	10	6
Commercial	Rosario Resort	1	74	50
	Cascade Harbor Inn	1	13	0
Ready to Serve	Connections	110		
TOTAL		270	346	110

\* **Note:** HOA means Homeowner's Association. Rosario Utilities provides water in bulk-metered service to the Homeowner's Association. The Homeowner's Association is Rosario Utilities' customer. Rosario Utilities' responsibilities end at the bulk master meter. Beyond the bulk master

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<sup>1</sup> An ERU is a unit of measure used to equate non-residential or multi-family residential water usage to a specific number of single family residences. Note: The quantity of water associated with an ERU is system-specific. The ERU level for one system may not apply to another system with differing demographics or water use patterns. Moreover, an ERU "level of service" for any specific system may in itself change with time (may not be the same from year to year) as water use patterns in a particular water system changes for various reasons (demographics, conservation activities, etc.). As meter records are kept and evaluated over time for any given system, it may be expected that changes in the specific level of demand associated with changing water-use patterns will result in adjustments to the system's basic ERU level. Department of Health, Water System Design Manual, June 1999

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meter, the Homeowner's Association owns and maintains the water system. Members of the Homeowner's Association are water customers of the Homeowner's Association, not Rosario Utilities.

### **Water Treatment History:**

Rosario Utilities receives its water from Cascade Lake. This water source is considered surface water by the state Department of Health (DOH) and falls under the surface water treatment rules for potable water. Currently, Rosario Utilities has water rights for 220 gallons per minute (gpm) from the lake.

In 1996 Rosario Utilities explored options for water treatment. New treatment was needed due to an aging treatment plant that was starting to fail and limited capacity to serve additional customers.

In July 1997, Rosario Utilities received a report from Hammond, Collier and Wade – Livingstone Associates, Inc. (consulting engineers) for a water treatment proposal. They prepared a planning submittal for DOH titled 'Surface Water Treatment Technical Report, Rosario Water System.' In the report, they reviewed the water system and presented the recommended predesign for a new surface water treatment system process for the Rosario water system source supply from Cascade Lake. The report proposed the installation of a multi-stage treatment system comprised of several elements. In November 1997, DOH approved this process for treatment of the surface water source.

Also during 1997, Gray & Osborne, Inc., (consulting engineers) issued a report in which they reviewed the water system and compared five methods of treatment to address the utilities' concerns of failing treatment and increased capacity. The five methods were really three distinct methods with two of the methods also employing pre-ozonation. The methods were the Hydroxyl System, slow sand (with and without pre-ozonation), and a direct filtration package (with and without pre-ozonation). The Gray & Osborne, Inc., report showed the most favorable option, based on a life cycle cost analysis, was the Hydroxyl System.

During the period of 1996 through 1999 the ownership/management of the resort and thus Rosario Utilities changed several times and no treatment system was constructed.

On April 8, 1999, DOH ordered Rosario Utilities to correct the failing water treatment plant. DOH approved the use of the Hydroxyl System for surface water treatment on November 20, 1997. The current owners used that approved process and entered into a contract (May 28, 1999) for the Hydroxyl System based on cost and time constraints. Rosario Utilities was optimistic that the treatment plant could be constructed and on-line by the end of 1999. Once built, the water treatment plant required pilot testing and review by engineers and DOH.

Rosario Utilities made a filing in late 1999, effective January 15, 2000, to recover the \$1,000,000 of initial capital cost involved with placing that treatment plant in service. The \$1,000,000 loan was used for the water treatment plant \$546,100, pilot testing \$27,050, electrical \$127,250, emergency generators \$51,810, land clearing and building \$110,600, pumping upgrades \$24,500, survey & permitting \$8,150, engineering \$70,300 and legal & miscellaneous \$35,250. That filing resulted in a facilities charge of \$3,100 to new customers and a surcharge of \$22 per month for all residential customers and all ERUs for bulk and commercial customers. The surcharge was calculated to fully recover the cost of the water treatment plant and upgrades over a seven-year period. All funds collected from the facilities charge and surcharge are considered Contribution in Aid of

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Construction (CIAC) and are excluded from any future recovery through depreciation or earning a return.

During 2000 and 2001, engineering concerns and DOH evaluations of the pilot testing determined that the actual capacity of quantity and quality required modifications to the plant. These modifications caused delays until the treatment plant could produce the proposed quantity and quality.

The water treatment plant produces 220-gpm (water right limit), but the final total capacity was reduced to 456 ERUs by DOH due to engineering and filter backwash limits. The original proposal (July 1997) expected to provide sufficient water to serve up to 186 additional connections/ERUs, however the final DOH approved number (May 2001) was only 127 additional connections/ERUs. Rosario Utilities is collecting data and has engineering reviews in process to determine if additional capacity can be achieved and what plant components are currently limiting capacity. Rosario Utilities is also pursuing additional water rights from Cascade Lake.

The Company has determined that operating the water treatment plant has increased the overall expenses of the Company. The Company is seeking this rate change to recover the increased cost of operating the new water treatment plant including water testing, electrical power, property tax, labor, and chemicals. Additionally, the company contends that other operating expenses such as materials and maintenance, office rent and supplies, and transportation have also increased since the company's last rate case in 1999.

### **Customer Comments:**

The Commission received 120 letters opposed to the proposed increase. Customers concerns are highlighted below.

Customer Service: Public Affairs staff received letters stating that when customers contact the Company for information or complain about a problem with their water service that the Company is unresponsive. Many of these letters are from homeowner's association members who are not customers of Rosario Utilities. This is a unique situation. The Company provides bulk master meter water service to two homeowner's associations, the Vusario Homeowners Association and the Highland Homeowner's Association, that provide water service to their member customers, who are not customers of Rosario Utilities. When information or a situation with water service occurs with a member of an association, the member typically contacts the Company to resolve situations as they occur.

Staff's Response: Rosario Utilities' obligation is to the homeowners association as a bulk master metered customer, and not to each individual member within the homeowners associations. Vusario and Highland homeowner's association members are confused about whom to contact when they have problems or questions about their water service. Members of those two homeowners associations are also water customers of the homeowners associations and members must address all questions and concerns to the appropriate homeowners association, not Rosario Utilities. The association may need to contact Rosario Utilities. If the Company is not responsive to the association representative, the association representative should contact the Commission for assistance.

Company Management: Many customers stated concerns with the current management of Rosario Utilities and request the Commission conduct a management audit of the Company. Customers believe the Company has not made prudent decisions and believe that customers are now being requested to pay for those mistakes.

Treatment Plant: Customers believe the purchase of the Hydroxyl water treatment system was not a prudent decision.

Customers stated that the consulting firm (Gray & Osborne, Inc.) recommended not purchasing the Hydroxyl system because it had never been tested in a commercial setting.

Staff's Response: Staff disagrees with this interpretation and, based on our review, believe that Hammond, Collier and Wade – Livingstone Associates, Inc. and Gray & Osborne, Inc., recommended the Hydroxyl system. DOH approved the Hydroxyl multi-stage treatment system on November 20, 1997.

Customers stated that the Hydroxyl system has been defective since the beginning and they do not believe they are getting the benefits of paying \$22 per month surcharge due to the delay for two years to get the system online and working correctly.

Staff's Response: As stated earlier in Staff's memo, there have been substantial delays in the treatment system going online. The surcharge that customers have been paying has gone to the capital cost of the treatment plant. Cost overruns were incurred when the cartridge filters were replaced with Zeolite filters at a negotiated additional cost of approximately \$80,000, which is not part of this rate case. Other costs for engineers, consultants, etc. for work required during construction and startup of the plant, were absorbed by Hydroxyl Company as part of the purchase contract.

Customers stated concerns about the cost overrun to maintain the system. Customers believe the company should have negotiated customer protections into the system maintenance contract, considering the potential risks of the system, which was still in a testing phase for commercial purposes.

Staff's Response: Rosario Utilities has entered into a maintenance agreement, at a cost of \$9,250 annually. This cost is \$13,200 less than the Gray & Osborne study projected and meets the majority of concerns.

Staff's Response: Water treatment operating costs have increased the company's cost of doing business. Some of these increased costs were addressed in the Gray & Osborn report, however actual costs were unknown during the study. Other cost increases such as personal property tax were not addressed in the study and are part of Staff's review in this filing.

Customers stated concerns that the current treatment design of the filtration system is not big enough to meet the current capacity and they fear that the company will have to upgrade the system at a greater cost to customers in the near future.

Staff's Response: Rosario Utilities did purchase a hybrid Hydroxyl system in which some components have additional capacity.

**Staff's Response:** Staff believes the current capacity of approved connections is being served. If additional customer growth occurs, the Company will need to provide additional capacity. This additional capacity may result in increased cost.

**Company Expenses:** Customers believe the Company could make some changes to reduce the operating costs, such as:

- Bill customers' quarterly instead of monthly.
- Reduce the number of full time employees.
- Refinance the plant loan to reduce the interest rates.
- Meter water usage by Rosario Resort and Cascade Harbor Inn. Customers believe the failure to meter these two commercial establishments leaves a big gap in the raw data needed to establish equitable water rates for both residential and commercial customers. Residential customers state concern about subsidizing the Rosario Resort's use of water.

**Public Meeting March 19, 2002:**

Commission staff attended a public meeting held by the company on March 19, 2002 on Orcas Island near the water system. Approximately 150 customers attended this meeting. In this meeting, the customers had many questions and issues regarding this filing. The customers' main issues were as follows:

**Treatment Plant:** The customers had significant concerns regarding the company's decision to purchase the Hydroxyl water treatment system instead of another type, such as a slow sand filter system. The customers wanted to know who made the decision and if it was the correct decision. The customers do not understand why the company did not allow their input in the decision of which system to purchase. The customers stated that they have engineering and contract expertise, which they offered to the Company but were refused. They questioned the Company's reasons to purchase the Hydroxyl treatment system. They think the expenses for this plant are much higher than what the slow sand filter plant would have been.

**Staff's Response:** Based upon our review of the two engineering studies, which included costs analyses of various options considered, Staff concludes that Rosario Utilities' decision to purchase the Hydroxyl treatment system was not unreasonable.

**Management Audit:** Due to the delays in getting the treatment plant operational and now a rate increase, the customers want the Commission to order a management audit of the Company. The customers want the Commission to determine if the Company is operating in the best interest of the Company and the customers. The customers want to know if the Company was efficient and prudent in making its decision to purchase this Hydroxyl treatment system. The customers think the Company could have purchased another system at half the cost that would have worked just as well.

**Staff's Response:** At this time, our review of the Rosario Utilities' decisions to purchase the Hydroxyl water treatment system and its response to problems in building, testing, and bringing the plant online do not indicate that the Company made an unreasonable decision.

Ownership: Customers wanted to know if the company owner reviewed the filing. They also questioned if owners of a Washington Company could live outside the State of Washington and still make decisions about service in Washington.

Staff's Response: It is certainly appropriate for the owner to review the filing, and the owner's responsibility and ability to make decisions does depend upon where the owner lives. Rosario Utilities does maintain an office at the water system and all books and records have been made available to Staff.

Rate of Return: Customers were concerned about the company's request for a rate of return of 10-12%. They felt a more reasonable rate of return should be between 6-7%.

Staff's Response: Staff recommended a 10.8% return on equity in the Commission's last litigated water case. The overall rate of return on investment is a function of the total capital structure and the weighted cost of capital. We have not completed our review of this issue.

Sewer Costs: Customers questioned the Company's sewage expenses. They were concerned about the allocation of the expenses between the utility's water and sewage businesses. They wanted to know what proportions of the employees' salaries are allocated to the water versus the sewage business. Also, they were very concerned that the owners of both the water and the sewage business was the same owner and, therefore, may have inflated the sewage expenses to the utility.

Staff's Response: Staff is reviewing the total cost of Rosario Utilities including the sewer treatment portion of the Company. This review looks at affiliated allocations and the expenses behind the allocations.

Owner Debt: Customers had many questions about the operation and the expenses of the water treatment system. They wanted to know why the Company does not refinance the current loan of 9.25% to a lower rate that would exist today.

Staff's Response: Staff has asked the same question of the Company and we will consider the owner-held debt in our recommendation to the Commission.

Employee Salaries: Customers questioned the increase of the employee's salaries. Also, they are concerned they have to pay this high rate when they still have mortgages and other expenses. They state the increase the Company is requesting is a considerable burden on their incomes.

Staff's Response: Staff is reviewing total number of employees, wages and salaries, and allocations for both water and sewer portion of the utility.

Commercial Meters: Customers wanted to know when meters will be installed for the Cascade Harbor Inn and Rosario Resort. Both are currently unmetered. They felt the Company was neglecting to do this. The company advised the customers that the residential meters were being installed before commercial meters.

Staff's Response: Staff has asked the same question of the Company. Because of the affiliation with Rosario Resort, Staff will be recommending the Commission order the owner to immediately install meters for all commercial customers and bill accordingly.

Treatment Capacity: Customers wanted to know if this treatment plant could be expanded to allow for additional capacity.

Staff's Response: Staff has found that Rosario Utilities did purchase a hybrid Hydroxyl system in which some components have additional capacity. Rosario Utilities is collecting data and has engineering reviews in process to determine if additional capacity can be achieved and what plant components are currently limiting capacity. Rosario Utilities is also pursuing additional water rights from Cascade Lake.

Rate Design: Customers wanted to know why the base rate was so high before any water was used. They stated the rates were not increasing consistently between the commercial and the residential accounts. The commercial rates were increasing by 220% while the residential, was increasing by 280%.

Staff's Response: Staff has not yet determined an appropriate rate design. Staff is reviewing the usage data available to more closely tie the rates and revenues to the usage patterns.

### Proposed Rates and Recovery

The company's last general rate increase was effective August 1, 1999 and was based on information from 1998. The average monthly residential customer impact of this rate change would be approximately \$42.45. The current and proposed rates are provided below: **These proposed rates are in addition to the current surcharge of \$22.00 per month.**

<u>Monthly Base Rate*</u>	<u>Current</u>	<u>Proposed</u>	
Residential flat	\$ 27.05	\$ 69.75	Per Customer
Commercial flat	\$ 27.05	\$ 69.75	Per ERU**
Residential metered	\$ 18.55	\$ 52.00	Per Customer
Commercial metered	\$ 18.55	\$ 52.00	Per ERU**
Bulk metered (HOAs)	\$ 12.70	\$ 39.00	Per ERU**

\* Zero Allowance of water in monthly base charge

\*\* ERU Equivalent Residential Unit

<u>Monthly Usage Rate</u>		
0 - 1,500 cu. ft. (per 100 cu. ft.)	\$ .75	N/A
0 - 1,200 cu. ft. (per 100 cu. ft.)	N/A	\$ 1.50
> 1,500 cu. ft. (per 100 cu. ft.)	\$ 1.50	N/A
1,200 - 2,000 cu. ft. (per 100 cu. ft.)	N/A	\$ 2.25
> 2,000 cu. ft. (per 100 cu. ft.)	N/A	\$ 3.00
Ready to Serve	\$ 6.40	\$ 8.40

The water system is currently at the maximum capacity established by DOH and cannot issue any new connections.

Rosario Utilities has not yet demonstrated that the proposed rates are fair, just, reasonable, and sufficient. Therefore, staff recommends that the Commission Issue a Complaint and Order Suspending the Tariff Revisions filed by Rosario Utilities, L.L.C., in Docket UW-020307.