[Service Date November 24, 2015]

STATE OF WASHINGTON

UTILITIES AND TRANSPORTATION COMMISSION

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November 24, 2015

NOTICE OF OPPORTUNITY TO FILE WRITTEN COMMENTS
(By 5:00 p.m., January 6, 2016)

RE: Rulemaking to Consider Proposed Pilot Program That Introduces Three Alternative Forms of Ratemaking for Regulated Water Companies
Docket UW-143295

TO ALL INTERESTED PERSONS:

On September 17, 2014, the Washington Utilities and Transportation Commission (Commission) filed a Preproposal Statement of Inquiry (CR 101), to consider rules within WAC 480-110 to, among other things, improve the financial and managerial capacity of regulated water companies and provide incentives for companies to make appropriate investments. To that end, the Commission is assessing whether current standard ratemaking methods for regulating the rates of water companies are producing results consistent with the focus of the rulemaking and the Commission's mission to promote financially viable companies that are able to support the growth of their communities and provide safe and reliable service.

The Commission is considering: (1) A two-year pilot program that would allow the use of alternative methods for establishing rates; (2) A form of financing that, over a period of years, converts non-investor contributions (i.e., contributions in aid of construction) into owner equity. After the two-year period, the Commission will review the results of the pilot and determine whether to continue using the pilot methods and develop rules or cease the use of the alternative methods.[1]

Under the pilot program as proposed, the Commission would use three innovative ratemaking approaches, each approach providing new economic incentives for increased owner investment and greater owner participation in the management and operations of the company. Along with increased managerial participation, it is expected that the financial viability of the state's regulated water companies will improve over the pilot period. During

[1] Any rate changes approved during the pilot period will continue until the company proposes new rates or the Commission acts to modify the methods in a future proceeding.

the pilot period, companies and the Commission would be able to use any of the three alternative methods to set rates in place of, in addition to, or together with, standard rate making approaches.

The Commission is seeking input from interested persons regarding the following three rate setting methods along with comments on the proposed use of *advances for construction* to finance growth. The Commission requests that interested persons submit written comments by January 6, 2016.

1. **Marginal Investment Approach (Restructured Investment).**
   The regulatory-basis financial statements of some of the state's investor-owned water companies reflect negative investment. Commonly these negative positions have been developed though years of operating losses, through lack of proper accounting or simply inherited from prior owners. Current owners of these water systems generally have little or no incentive to invest in the company since any investment would be immediately swallowed up by its negative financial position, leaving them in no better financial position than before the investment.

   The Commission is considering allowing owners of water companies with negative investment to earn a return on any new water plant investments going forward. The Commission would in effect segregate new investments from the historical operating results creating a fresh start and a strong inducement to invest.

   <u>Questions:</u>

   (a) What concerns, constraints or challenges should the Commission consider when considering the use of the Marginal Investment Approach for setting rates?

   (b) Would such an approach be unfair to rate payers or result in unjust windfall to the company?

2. **Operating Ratio Rate Setting**.
   The Commission is considering using operating ratio, a recognized measure of profitability, for setting revenue requirements for water companies that lack sufficient rate base and funds for additional investment. Although these companies commonly serve communities with little or no growth, the operating ratio approach could potentially provide cash flow to provide funds for unexpected repairs, plant replacement and possibly capital for community growth opportunities. Allowed revenue would be computed using an industry-based relationship between revenue and expenses.

<u>Questions:</u>

(a) What concerns, constraints or challenges should the Commission consider when looking at the use of operating ratio to set rates for water companies?

(b) Would such an approach be unfair to rate payers or result in unjust windfall to the company?

3. Inflation Adjustment Filing.

The Commission's process for setting rates can create challenges for many water companies. The cost and complexity of pursuing a general rate case are reasons for companies to defer or avoid requesting necessary rate increases.[2] To make matters worse, in periods of inflation, small water companies are more susceptible to the impact of increased expenses because of small investment bases.

The Commission is considering allowing companies to adjust rates for the effects of inflation on earnings using a short-form filing. Short-form filings not only would mitigate the impact of inflation-driven increases in costs on operating income but also eliminate the cost of recurring rate cases that would be passed on to ratepayers.

As envisioned, the inflation adjustment mechanism would provide a fast-track rate adjustment for the three-year period following a general rate case. The mechanism would be based on historical regional inflation levels. Once a company's general rate case is completed, the company could file an annual inflation adjustment tariff that requires only limited information; a so called "short-form." The adjustment to a company's rates would reflect the impact of inflation on expenses previously reviewed in its prior rate case, excluding depreciation and amortization expense.[3] After the three-year period following the effective date of its most recent rate case, the option to use the inflation adjustment mechanism would expire. Any further increases in rates would first require the company to return to the Commission with a full general rate case.[4]

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[2] 2015-2017 Strategic Plan at 13.

[3] Depreciation is excluded because depreciation represents recovery of historical amounts whereas expenses are meant to be prospective in nature and forward looking.

[4] Any company electing to file for an inflation adjustment during the two year pilot will be allowed to file for such adjustments for three years following its prior rate case regardless of a decision by the Commission to cease the program.

<u>Questions:</u>

(a) What concerns, constraints or challenges should the Commission consider when looking at the use of an inflation adjustment filing?

(b) Would such an approach be unfair to rate payers or result in unjust windfall to the company?

(c) Is a three year filing window for the proposed inflation adjustment the correct length of time? Is there reason to make the filing period longer or shorter?

4. Contributions in Aid of Construction (Advances for Construction).

Developers routinely contribute funds or facilities to water companies as a prerequisite to receiving water service. The contribution of water facilities provides a water company zero-cost financing known as Contributions in Aid of Construction (CIAC) and allows any business risk to remain with the contributor. Assets funded by contributions are excluded from a company's rate base for rate setting purposes since the funds are not investor supplied.[5]

It is not unusual for water companies to rely on CIAC to finance system improvements and upgrades. However, two issues arise with this form of financing: (1) There is no depreciation or return on investment available when those systems later need capital for replacement or improvements; (2) Municipalities or districts that purchase water companies use valuations that fix the value of the plant financed by CIAC at fair market value regardless whether the owner paid for or was given the assets, commonly resulting in owners receiving an unearned monetary windfall.

To lessen the negative consequences of CIAC financing, the Commission may consider a rule permitting, or even compelling, the use of Advances for Construction (Advances). This form of financing allows a water company to achieve over a period of years, an increased level of equity investment in its water company.

Similar to CIAC, advances are given to the water company by developers and are in the form of water facilities or funding provided to expand water service or future installation of new water facilities. As with CIAC, assets funded by advances are excluded from rate base for rate setting purposes, however unlike CIAC, the company repays a portion of the

[5] Which prevents the collection of any return-on-investment by the company owners and recovery of depreciation expense associated with the contributed assets.

advance, and once paid, that portion is no longer excluded from rate base and effectively acts as an addition to rate base.[6]

Advances are used in many states and are recognized in the NARUC uniform system of accounts. Annual repayments to developers are based on the revenue received by the company from the customers associated with the advances.[7] Therefore, if a development is unsuccessful, no or limited repayments are provided by the company, if it is a successful development, then more payments are provided lessening the negative consequences of CIAC.

<u>Questions:</u>

(d) What concerns, constraints or challenges should the Commission consider when looking at the use of advances for construction?

(e) Would such an approach be unfair to rate payers or result in unjust windfall to the company?

WRITTEN COMMENTS AND RESPONSES

The Commission requests written comments and information in response to this notice. Written comments must be filed with the Commission no later than January 6, 2016. The Commission requests that the comments be provided in electronic format to enhance public access, reduce the need for paper copies, and facilitate quotations from the submissions. You may submit comments via the Commission’s Web portal at www.utc.wa.gov/e-filing or by electronic mail to the Commission's Records Center at records@utc.wa.gov. You must include:

- The docket number of this proceeding (UW-143295).
- The commenting party's name.
- The title and date of the comment or comments.

An alternative method for submitting comments is by mailing or delivering an electronic copy to the Commission’s Records Center on a flash drive, DVD, or CD including the filed documents(s). Parties must furnish electronic copies in MS Word 6.0 (or later) supplemented by a separate file in .pdf (Adobe Acrobat) format. The Commission will post on its web site all comments that are provided in electronic format. The web site is located at http://www.utc.wa.gov/143295. If you are unable to file your comments electronically or to submit them on a flash drive, DVD, or CD, the Commission will accept a paper document.

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[6] See NARUC Uniform System of Accounts: Deferred Credit Account 252 – Advances for Construction.

7 There are various methods used to compute the refund amount ranging from 10 percent of total revenue for ten years (Arizona) to revenues exceeding a certain set level such as the amount by which actual revenue exceeds three times the originally estimated annual revenue (Indiana).

If you have questions regarding this Notice, you may contact Danny Kermode by email at dkermode@utc.wa.gov or by calling (360) 664-1253.

STEVEN V. KING
Executive Director and Secretary