

Agenda Date: September 28, 2005
Item Number: A5

Dockets: UW-051062
Company Names: H & R Waterworks, Inc.

Staff: Jim Ward, Regulatory Analyst

Recommendation:

Dismiss the Complaint and Order Suspending Tariff Revisions, take no action and thereby allow the revised Tariff Revisions in Docket UW-051062, to become effective October 1, 2005.

History

On July 11, 2005, H & R Waterworks, Inc., (H & R Waterworks or Company) filed a general rate increase of approximately \$256,808 (22%). The filing also would have established uniform rates for all the water systems owned by the Company. On August 29, 2005, the Company filed revised rates designed to produce an increase of approximately \$131,400 (12%) per year and establish uniform rates for all systems. On August 31, 2005, the Commission entered an order suspending the revised tariff revisions.

H & R Waterworks is located in Tumwater and will serve approximately 2,888 customers on 115 water systems in Thurston, Mason, Lewis, Kitsap, and Pierce Counties.

On December 2, 2004, H & R Waterworks merged with Meadows Water System, LLC, Quail Run Water Company, Inc., Tall Timbers Water Systems, LLC, Timberline Village Water Company, Inc., The Water Company of Washington, LLC, Transitions Water Service, LLC, and Utility Management Services, LLC. All of these companies shared common ownership. This year H & R Waterworks purchased additional assets from two companies (Trident Utilities, LLC and Evergreen Systems).

H & R Waterworks claims the benefits of these mergers and acquisitions include expanded financial resources, water quality staff, and equipment to provide all aspects of water system repair and operations. H & R Waterworks also notes that regulatory agencies and customers will deal with only one company instead of seven. H & R Waterworks is also merging Utility Management Services (UMS), a non-regulated company that provides Satellite Management Agency (SMA) functions, recognized by the Department of Health (DOH), and technical staff for all prior operations of the above listed regulated water companies.

UMS, one of the former companies, provided management services to both regulated

and non-regulated water companies and performed utility related construction work. Since the merger of the companies, H & R Waterworks has stopped performing utility-related construction work and cut back extensively the number of non-regulated management contracts. Currently, H & R Waterworks provides management contract work for only five non-regulated water systems. These five non-regulated water systems will continue to receive service until construction and upgrade contracts are completed and a suitable new management service can be arranged. Due to these actions, H & R Waterworks will see reduced revenues for services formally provided to non-regulated water systems. However, H & R Waterworks has not reduced any UMS operating costs or resources, labor or assets.

Discussion

The Company states the reason for the revenue increase is to recover full costs of operations for all water customers. The Company also is proposing to establish uniform rates for all systems. Because of the move to uniform rates, the change in rates for individual customers varies widely. All rates and services are shown on Attachment 2.1. Revised rates are shown in the far right column. A comparison of current, proposed, and revised customer billings is shown on Attachment 3.1. Attachment 3.1 uses average water consumption for each former water company and shows the average water bill under the current, proposed, and revised rates.

H & R Waterworks notified its customers of this original proposed rate change. The Commission received comments and questions from 45 customers. All who commented opposed the rate increase and consider the increase "excessive" and "unwarranted." Many customers feel it is unfair that they should have to pay the same rate as customers on systems which are more expensive to operate and maintain.

Almost half of the comments came from customers who own cabins on the Timberline Village water system and only use water for a short time during the year. These customers are very concerned about the possibility of paying over \$40 per month for water for very little usage. A few part-time customers on the Deschutes Village system voiced the same concern.

Customer Issues

After the open meeting on August 31, 2005, the Commission Staff, a Company representative and customers met to discuss the filing. Below is a summary of issues (and comments) from the customer meeting on August 31, 2005.

Agreement / contract with prior developer – Customers questioned why the

Commission could set rates different than those stated in written contracts. Customers referred to written documents stating that Arcadia Drilling, Inc., (Arcadia) owns the water systems, customers must take water service from Arcadia, and pay set rates to Arcadia. The rates established were \$18.00 base charge to include 300 cubic feet of water and \$0.45 per 100 cubic feet thereafter. The document also required customers to obtain permission from Arcadia before taking water from any other water system.

- The legislature delegated the responsibility for setting rates to the Commission. When water companies become subject to Commission jurisdiction, the Commission allows the rates to remain in effect until the company files a change to its tariff, and then the Commission determines the appropriate rates and charges for services. The owner of a public service company is entitled under the Constitution to the opportunity to earn a fair rate of return on their investment, after reasonable expenses. Once a company becomes jurisdictional, it is entitled to that opportunity as a matter of constitutional law, and depriving it of that opportunity would constitute a taking.

Jurisdiction of H & R Waterworks companies – In its notice of sale and transfer (November 2004) to customers, H & R Waterworks said that the individual water companies would seek approval to be deregulated after the sale and transfer to the consolidated company was complete.

- The Commission regulates H & R Waterworks because it serves more than 100 customers. Currently, the consolidated H & R Waterworks operates under the tariffs filed by the previous companies as required by the approved sale and transfer orders issued by the Commission. This current filing proposes to consolidate the individual tariffs and also to bring various rates for services to parity among the previous water companies.
- Staff expects that, at a later date, the individual companies will ask the Commission to remove them from regulation because they no longer hold any assets, provide no water service, and have no effective tariffs. At this time, Staff is not aware of any issues that would lead us to oppose those requests to be removed from regulation.

Water Testing – Customers commented that water company employees had not asked

permission to take water samples on customer property and that the Company was not performing water tests.

- H & R Waterworks advised Staff that it is currently in compliance with DOH required testing. If customers have any questions regarding water testing, they should contact DOH at 1-800-521-0323.

Fire Hydrants - Several customers think their water system does not have fire flow or fire hydrants.

- Fire protection jurisdiction is the exclusive responsibility of the local fire marshal. Currently, the Company has no outstanding request for fire flow by any fire marshal. If customers desire fire protection service on their water system, they can contact the Company to determine what would be required. Since this fire protection is not required by a government agency, only the water customers on the affected water system would share the cost.

Profit or Return on investment – Customers questioned what return the Commission authorized for H & R Waterworks. How is ‘profit’ calculated for water companies?

- Staff provided the capital structure and weighted cost of capital calculations to customers attending the meeting. The revised rates recommended by Staff include an overall rate of return of 7.80%. The overall return is based 86.3% debt at a weighted cost of 7.19% and 13.7% equity at 12%. Additional detail is available on request.

When new lots are developed, are current customers subsidizing the builder?

- No. The Commission sets rates using historical costs. In this case, the Company used a twelve-month test period of calendar year 2004. Current customers pay for current plant. Future plant is normally recovered after it is in place and serving customers (used and useful). Regulated companies do not recover costs associated with contributions in aid of construction received from developers or customers.

- Service connection charges are designed to recover the cost of the main tap, piping out to the meter setter and meter box with a stub out of piping to the customer.

Average customer billing does not correspond to the individual customers.

- Staff and the Company used each old water company's average customer usage and the revised single tariff pricing rates to calculate the sample water bills for illustrative purposes. The amount of increase each customer will pay depends upon that customer's actual water usage and the relationship of the current rates to the rates that become effective.

Customers did not receive an Annual Survey.

- The Company believes this to be a Consumer Confidence Report that DOH requires companies to mail to customers on water systems that serve more than 15 connections (Group A water systems). The Company stated that it will send its next Consumer Confidence Report to all customers on all water systems. It is also possible that the missing survey referred to is the Cross Connection Control survey, which the Company does every three years.

Customers of two water systems expressed concerns about seasonal rates since they were not using water year round.

- The Commission has discretion to set different rates for seasonal water users. Possible seasonal rate designs include: a percentage of flat rates, rates set to recover only 'fixed' expenses, or simply a reduction from full time flat rates.
- Normally rates and revenues are set to recover the cost of service based on a twelve-month period of expenses and water use. When customers do not use water on an annual basis, there may be cost reductions to coincide with water use reductions. However, cost reduction methods have not been established to quantify a reduced bill and the Company has not collected this data. If the lost revenues are not made up by the seasonal user during seasonal period, then other customers will need to make up the lost revenues in the form of a subsidy.

- Except for power, filtration, and chemicals used in treatment, virtually all costs to provide water are fixed. In this case the revised base meter charge of \$23.55 is only 64% of the average flat rate, well below what Staff believes to be the actual fixed cost of providing water.

Staff recommends that the Commission not set separate seasonal rates because the revised base meter charge of \$23.55 is already well below fixed costs, and customers can request the Company to install a meter if they do not have one. Staff notes that if the customer requests the Company to install a meter, the customer must pay for the meter installation, the revised amount of \$156.25, which the customer would recover in the form of a credit to their water bill over the following 10 months.

Rates should be designed to reflect changes in the cost of living or other water company rates in the same location.

- The legislature delegated the responsibility for setting rates to the Commission. When water companies become subject to Commission jurisdiction, the Commission allows the rates to remain as is until a change to the tariff is made and then the Commission determines the rates and charges for services. The owner of a public service company is entitled under the constitution to the opportunity to earn a fair rate of return on their investment, after reasonable expenses. Once a company becomes jurisdictional, it is entitled to that opportunity as a matter of constitutional law, and depriving it of that opportunity would constitute a taking. Setting rates based upon cost of living indexes or what customers pay on other water systems is inconsistent with the requirement that companies recover reasonable operating costs and an opportunity to earn a reasonable return.
- The Commission is required to set rates that are fair, just, reasonable, and sufficient. The Commission uses a rate base / rate of return methodology to do that.
- Regulated companies are entitled to recover prudent, reasonably incurred expenses and an opportunity to earn a reasonable return. A company that proposes a rate change bears the burden to demonstrate that it requires additional revenue and that the proposed rates are fair, just, reasonable, and

sufficient. To determine a company's revenue requirement, Staff audits the company's books and records and applies regulatory principles to identify reasonable operating costs, company investment, customer contributions, appropriate rate base, and appropriate return. Staff has reviewed the supporting information filed by H & R Waterworks and audited the Company's books and records. Staff concludes that the H & R Waterworks has demonstrated it needs the revised revenue requirement of \$1,362,456.

Customers oppose the change to uniform rates for all systems, also known as Single Tariff Pricing.

- Customers explained that their water system is unique and has little, or no, cost similarities to other water systems in other areas. Although customers state that they are willing to pay the costs of their individual water system, they do not feel they should subsidize, or be subsidized by, customers on other water systems.

Rates are designed using company operating data to produce the target revenue requirement. There are many different ways to design rates.

Individual Water System - The Commission could set a separate rate for each water system that reflects the cost (capital, operating and maintenance) the Company incurs to operate that water system.

"Old" Water Company - The Company filed its rate case using a test year in which the seven water companies still operated as separate companies. That provides a snapshot of costs by water company. Three of the seven water companies operate multiple water systems. The Commission set uniform rates, using Single Tariff Pricing, for each of the "old" water companies. Assets were separated by water company. Operating and maintenance costs were allocated between the various companies using allocation factors set in a settlement agreement entered into by Staff and the water companies. Although, the recent rate levels of the various water companies might provide a reasonable basis for setting rate differences in the very short term, Staff does not believe that would be appropriate over a longer period of time because of the changing nature of water system infrastructure and associated costs.

County (or other geographical area) - H & R Waterworks operates water systems scattered across five counties. One way to “package rates” would be to aggregate water systems within a geographic area, similar to a Public Utility District that operates county wide. Attachment 4 is a spread sheet showing the H & R Waterworks water systems separated by county.

System Size - Generally, larger systems are more cost effective than smaller systems.

Systems with filtration or treatment - Generally, water systems with filtration or treatment are more expensive to operate than systems without filtration or treatment

Company Wide (Single Tariff Pricing) - The Commission has, with a few exceptions, consistently used Single Tariff Pricing since the early 1990s. Very simply, Single Tariff Pricing is the practice of setting a single rate that applies to every customer within a customer class served by a water company. Single Tariff Pricing distributes rate base, system upgrades, operating and maintenance costs, and improvements for the entire water company equally across all customers.

The Commission has consistently supported Single Tariff Pricing for water companies and Staff recommends the Commission use Single Tariff Pricing to set rates for this rate case also. All systems will require capital improvements sooner or later. Under Single Tariff Pricing, some customers pay more and some customers pay less than rates set on a stand-alone cost basis. Single Tariff Pricing distributes the risk of the individual water customer in much the same way as an insurance pool.

In 1997, the National Association of Water Companies (NAWC) reported that twenty-eight states use Single Tariff Pricing. In September 1999, the U.S. Environmental Protection Agency and the National Association of Regulatory Utility Commissioners issued a joint publication titled "Consolidated Water Rates: Issues and Practices in Single Tariff Pricing." The report states that only ten states regulate more than ten multi-system utilities and nine (including Washington) have approved Single Tariff Pricing.

Customers who live on systems that require investment to upgrade or replace facilities or install expensive filtration or treatment like Single Tariff Pricing.

They pay lower rates because Single Tariff Pricing distributes the costs spent on their system to customers on other systems. Customers who live on systems with a good water source that is well designed, constructed, and maintained do not like Single Tariff Pricing because they pay higher rates than they would on a stand-alone basis.

However, the factors (newer construction, lower operating costs, good water quality, etc.) that result in a relatively low level of rates today are exactly those factors that will, or are very likely to, change in the future so that rates will become relatively high. For example; capital plant needs replacement or upgrades, water use leads to a decline in quality requiring treatment or filtration, increased Safe Drinking Water Act quality standards require new expensive filtration or treatment, and aging infrastructure requires increased operating and maintenance costs. In short, today's snapshot of costs on a single system is not a good predictor of costs in the future and the current costs provide no reasoned basis for allocating costs or setting rates over the long term.

There is an important exception to Single Tariff Pricing. It has been Commission policy that customers who want utility plant that exceeds government requirements pay for the plant on a stand-alone system basis. Examples of voluntary upgrades include;

- fire flow when not required by the Fire Marshal.
- backup generators that are not required by the Department of Health (DOH), and
- treatment and filtration (iron, manganese, turbidity, etc.) that are not required by DOH. An example of treatment and filtration in excess of government requirements is the water treatment needed to remove iron and manganese. The U.S. Environmental Protection Agency classifies iron and manganese as secondary contaminants. Exceeding a Maximum Contaminant Level for a secondary contaminant requires a company to survey its customers to determine if the customers are willing to pay additional rates to correct the problem. Customers of a stand-alone system may ask the water company to install a treatment or filtration system, however, because there is no regulatory requirement to treat and filter, the cost associated with the treatment and filtration would not qualify as common costs to spread to all customers on a company-wide basis. Instead, the costs would stay with the customers on the individual system.

Example: Customers on the Cedar Shores water system (previously owned by Tall Timber) voted to pay an additional \$13.25 per month to pay for treatment and filtration for iron and manganese on their water system. On May 30, 2001, the Commission approved the surcharge to apply to only Cedar Shores customers.

Example: In 2000, DOH ordered Tall Timber, one of consolidated companies in this docket, to make capital improvements to 12 of its 57 water systems. In, Docket UW-001866, Tall Timber requested recovery of those costs from customers on all of its water systems. If customers on each of the 12 water systems paid only the costs associated with their systems, the monthly cost per customer would have varied from \$8.41 to \$47.08. The Commission used Single Tariff Pricing to distribute the costs over a larger number of customers, resulting in monthly rates of \$5.60 for all customers.

Water System	Monthly Surcharge	
	Stand-Alone	Single Tariff Pricing
Violet Meadows Estates 1 – 6	\$17.21	\$5.60
Violet Meadows A, B, C, D	\$20.98	\$5.60
Rainbow Lake Water	\$ 8.41	\$5.60
Sandra Avenue Water System	\$47.08	\$5.60
45 Other Water Systems	\$00.00	\$5.60

Discussion - Cost information by water system is not available at this time. The Company could separate assets on a system specific basis to develop a capital rate component. However, H & R Waterworks, and all other regulated water companies that operate more than one water system, do not maintain their financial and operating records in a way that separates, by water system, (1) capital costs or (2) operating and maintenance costs. Separating these costs would require substantial additional resources to capture information on a going forward basis. Staff questions whether the additional costs of such detail would be in the best interest of the customers. If the Commission decides to pursue set rates using an alternative method that would require more detailed accounting and operating records, the Commission could, in the interim, allocate operating and maintenance costs using allocation factors.

Staff continues to believe the Single Tariff Pricing is the best public policy and recommends that the Commission continue using Single Tariff Pricing in this docket to set uniform rates for all customers on all water systems.

During the Commission's Open Meeting several additional points were presented.

- Consolidation appears to have raised rates. Rates are increasing after consolidation. As Staff stated earlier, H & R Waterworks plans to only provide service and management to its own regulated water systems going forward and has not reduced any UMS operating costs or resources, labor or assets. Economies of scale and consolidation of companies have not yet produced any measurable savings to customers.
- Meters were promised several years ago and are still not installed. Staff understands that customers have two concerns. Customers are concerned that they are paying for meters that were not installed. The Commission sets rates using historical costs. Since the Company did not install the meters, it did not incur costs, so customers are not paying anything additional in rates. Also, costs incurred to install meters would be capitalized and depreciated. Customers felt that the Commission should require the Company to install the meters that it promised. The Commission can require the Company to install the meters, or make any other improvements, but only after hearing as required by statute. Customers have the option to request and pay for meter installation with installation cost refunded to the customer through bill credits. Staff believes this provides those customers who want a meter with an appropriate remedy.
- Backup electrical generators have not been completed for all water systems. DOH does not require water companies to install backup generators. Customers on a water system can ask the Company to install a generator on their system, but because DOH does not require generators, only those customers on the water system would pay for generator.

Recommendations

Single Tariff Pricing: Staff recommends the Commission continue to use Single Tariff Pricing as the appropriate rate design for this Company. Staff believes there is insufficient data to support a different rate design and that continuing the current relative rate relationships will result in cross subsidies between customers.

Seasonal Rates: Staff recommends that the Commission not approve a seasonal rate. Seasonal rates would either shift revenues from an annual usage basis or create subsidies among the same class of customers. Staff believes the proper remedy for part time customers is to request the Company to install a meter. Metered customers pay the base meter charge (less than the fixed costs of operating the system) every month and the usage charges for any water used.

Therefore, Staff recommends that the Commission Dismiss the Complaint and Order Suspending Tariff Revisions, take no action and thereby allow the revised Tariff Revisions in Docket UW-051062, to become effective October 1, 2005.

Note: Attachments have been shaded for portions that changed from August 31, 2005 open meeting attachments.

Attachments (4)