

Exhibit No. ___ T (DPK-1T)
Docket No. UW-051444
Witness: Danny P. Kermode

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

KAYAK ESTATES WATER, LLC.,

Respondent.

DOCKET NO. UW-051444

TESTIMONY OF

DANNY P. KERMODE

**STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION**

RE: KAYAK ESTATES WATER, LLC., GENERAL RATE CASE

March 22, 2006

LIST OF EXHIBITS

- Exhibit No. ____ (DPK-2): Qualifications of Danny P. Kermode
- Exhibit No. ____ (DPK-3): Staff Analysis
- Exhibit No. ____ (DPK-4): Revenue Analysis
- Exhibit No. ____ (DPK-5): Staff Restating and Pro Forma Adjustments
- Exhibit No. ____ (DPK-6): Washington State Employment Security Office
Occupational Employment and Wages Estimates for
March 2005 - Meter Reader.
- Exhibit No. ____ (DPK-7): Excerpt - Department of Health's Small Business Economic
Impact Study, Water Use Efficiency, Draft 01-24-06

1 I. INTRODUCTION

2
3 Q. Please state your name and business address.

4 A. My name is Danny P. Kermode. My business address is 1300 S. Evergreen Park
5 Drive S.W., P.O. Box 47250, Olympia, WA 98504. My email address is
6 dkermode@wutc.wa.gov.

7
8 Q. By whom are you employed and in what capacity?

9 A. I am employed by the Washington Utilities and Transportation Commission as a
10 Regulatory Analyst 3.

11
12 Q. How long have you been employed by the Commission?

13 A. I have been employed by the Commission for nine years.

14
15 Q. Would you please state your educational and professional background?

16 A. I graduated in 1982 from Arizona State University in Tempe, Arizona with a
17 Bachelor of Science in Accounting. Later that same year, I attended San Carlos
18 University in the Philippines for postgraduate studies in Economic Analysis and
19 Quantitative Business Analysis. I am a licensed in Washington as a Certified
20 Public Accountant (CPA).

21 In 1992 and 1993, I was a member of the faculty at the National
22 Association of Regulatory Utility Commissioners (NARUC) Annual Regulatory
23 Studies Program held at Michigan State University in East Lansing, Michigan. I

1 taught classes in Financial and Regulatory Accounting Standards and in Deferred
2 Tax Accounting.

3 Exhibit No. ____ (DPK-2) is a resume of my professional and regulatory
4 experience.

5
6 **II. SCOPE OF TESTIMONY**
7

8 **Q. Were you instructed to make an accounting examination of the tariff filing of**
9 **Kayak Estates Water, LLC, in docket number UW-051444?**

10 A. Yes, I was instructed to review this filing and to determine the revenue
11 requirement of Kayak Estates Water, LLC, based on its filed Test Year.

12
13 **Q. What is the purpose of your testimony in this case?**

14 A. On September 26, 2005, Kayak Estates Water, LLC, (the Company or Kayak
15 Estates) filed with the Commission proposed revisions to its tariff designed to
16 effect a general increase in its rates. I am testifying as an expert witness on behalf
17 of the Commission's Staff. I will testify on the Staff's results and
18 recommendations in regard to its pro forma and restating adjustments, capital
19 structure, and the recommended revenue requirement.

20
21 **Q. Please summarize Staff's recommendations.**

22 A. Staff recommends that the Company's revenues be increased by 12% or \$15,214.
23 Exhibit ____ (DPK-3) is a multipage exhibit containing the results or operations,

1 rate base computation, and cost of capital schedules. Exhibit ___ (DPK-4) is
2 Staff's revenue analysis based on monthly water usage during the test year. These
3 schedules were used to compute the impact of the proposed rate increase and
4 Staff's recommended rates. Exhibit ___ (DPK_5) are the detail schedules of Staff
5 proposed restating adjustments and pro forma adjustment.
6

7 **Q. Please explain the difference between a restating adjustment and a pro forma**
8 **adjustment.**

9 A. As defined in WAC 480-07-530(4)(e)(i), restating actual adjustments (restating
10 adjustments) are those adjustments which "adjust the booked operating results for
11 any defects or infirmities in actual recorded results, which can distort test period
12 earnings. Restating actual adjustments are also used to adjust from an as recorded
13 basis to a basis that is acceptable for ratemaking."

14 WAC 480-07-530(4)(e)(ii) defines pro forma adjustments as those
15 adjustments that "give effect for the test period to all known and measurable
16 changes that are not offset by other factors."
17

18 **Q. Would you please identify the areas that you will discuss in your testimony**
19 **regarding results of operations?**

20 A. I will discuss my recommended restating adjustments, pro forma adjustment, and
21 revenue sensitive adjustments presented in the Results of Operations Exhibit ___
22 (DPK-3). The adjustments on the Results of Operations are made pursuant to

1 WAC 480-07-530 paragraphs (4) (e) (i) and (ii). Through these adjustments, I will
2 also present Staff's calculation of the recommended revenue requirement.

3
4 **Q. Please give a summary of Schedule 1.1 of your Exhibit ____ (DPK-3) entitled**
5 **"Results of Operations for the Test Year Ended December 31, 2004."**

6 A. Schedule 1.1 is a single page schedule showing my analysis of the Company's
7 proposed rate increase docketed under UW-051444. This schedule presents the
8 Results of Operations, Rate Base, and Return on Investment (ROI) information
9 for:

10 (1) Unadjusted Test Year data as filed by the Company, Column (C),

11 (2) Restated test year results, Column (E),

12 (3) Pro forma test year results, Column (G);

13 (4) Pro forma test year results with the Company's proposed rates, Column (I)

14 and,

15 (5) Pro forma test year results with Staff's recommended rates Column (K).

16
17 **Q. Please explain each column of Schedule 1.1 Exhibit ____ (DPK-3).**

18 A. Column (A) titled "Descriptions" contains the account descriptions. Column (B)
19 gives the account number or source of the line. The amounts shown in column
20 (C) titled "Results as filed - Company" reflects the "per book" account balances at
21 year-end amounts taken from the Company's Exhibit ____ (RK-2).

1 Column (D) titled "Total Restating Adjustments" reflects Staff's restating
2 adjustment amounts. These are adjustments to adjust the amounts reported by the
3 Company for the test year to a basis acceptable for ratemaking purposes.

4 Column (E) is titled "Restated Results" and reflects the results from
5 operations affected by the restating adjustments.

6 Column (F) titled "Total Pro Forma Adjustments" presents the pro forma
7 amounts. Pro forma adjustments reflect known and measurable changes that are
8 not offset by other factors.

9 Column (G) titled "Pro Forma Results" shows operating results on a pro
10 forma basis.

11 Column (H) titled "Proposed Rates" reflects the revenue and revenue
12 sensitive expense impact of the Company's proposed rates. Column (I) titled
13 "Results at Proposed Rates" shows the pro forma results of operations adjusted
14 for the impact of the Company's proposed rate increase.

15 Column (J) titled "Staff Rates" reflects the revenue and revenue sensitive
16 expense impact of Staff's recommended rates. Column (K) titled "Results at Staff
17 Rates" shows the pro forma results of operations adjusted for the impact of Staff
18 recommended rates.

19
20 **Q. How are the restating adjustments arranged in your testimony and exhibits?**

21 A. A schedule and description of the underlying calculation for each adjustment is
22 provided in Exhibit ___ (DPK-5). If the complexity of the adjustment requires,
23 adjustments are discussed more fully in my testimony. Each adjustment provided

1 with the exhibit is pre-tax. The income tax effect, if any is reflected on line 49 in
2 Schedule 1.2.

3
4 **Q. Will you please explain Schedule 1.2 labeled "Summary of Restating
5 Adjustments"?**

6 A. Schedule 1.2 provides the summary of Staff's restating adjustments to the
7 Company's per book amounts. The Schedule summarizes and details each
8 restating adjustment reflecting the effects of the adjustment of the results of
9 operations and rate base.

10
11 **Q. Please give a summary of your proposed Restating Adjustments.**

12 A. My proposed restating adjustments may be divided into three categories. The first
13 category is made up of adjustments that are small true-up adjustments. These
14 adjustments merely adjust the Company's numbers to the audited numbers
15 determined by Staff in its audits and are not material. These are restating
16 adjustments R-1 for depreciation expense, R-5 for location expense, R-7 for a
17 true-up of accumulated depreciation, and R-11 which reclassifies the Company's
18 filed revenue into the appropriate revenue categories. These adjustments increase
19 rate base by \$637 and increase total expense by \$90. Since these adjustments are
20 minor I will not address them in my testimony, however, the detail of each
21 adjustment is included in my exhibit ____ (DPK-5).

22 The second category is made up of two adjustments that are revenue
23 sensitive and change based on revenue. These adjustments are R-9 for the UTC

1 Fee and R-10 which recognizes the effect of the Company's revenue on the
 2 Company's Public Utility Tax. These two adjustments increase results of
 3 operations total expense by \$1,040. Because the adjustments rely solely on a
 4 mathematical application of mandated fees and taxes I will not discuss them
 5 further in this testimony, but as with the minor adjustments above, the detail of
 6 each adjustment is set out in my exhibit ____ (DPK-5).

7 Finally, the third category is made up of material adjustments to the
 8 Company's filing. These include Adjustments to contributions in aid of
 9 construction (CIAC) amortization (R-2), management fee account that includes
 10 consulting expenses (R-3), the repairs and maintenance account (R-4), and meter
 11 reading expense (R-8). These adjustments decrease rate base by \$1,010 and
 12 decrease expenses by \$43,196. Table 1 below summarizes the adjustments.

13
 14 **Table 1**

<u>Description</u>	<u>Adjustment</u>	<u>Rate Base</u>	<u>Results of Operations</u>
CIAC amortization	R-2		(\$ 20,323)
Management fee	R-3		(\$ 8,000)
Repairs and Maint.	R-4	\$ 3,651	(\$ 7,356)
Water System Plan	R-6	(\$ 2,641)	(\$ 19)
<u>Meter Reading</u>	<u>R-8</u>		<u>(\$ 7,589)</u>
	Net Adjustments	<u>\$ 1,010</u>	<u>(\$ 43,196)</u>

1 **Q. Please discuss your adjustment in R-2, the adjustment to CIAC amortization**
2 **shown in Exhibit ___ (DPK-5) Page 2.**

3 A. Regulatory accounting principles require CIAC be amortized over the life of the
4 plant that it financed. Missing from the Company's Exhibit ___ (RK-2) is
5 recognition of the amortization of any of the Company's \$470,221 in CIAC.
6 Staff's adjustment recognizes the net CIAC balance of \$154,001 reflected in the
7 Company's filing. Based on the Company's \$154,001 balance Staff has computed
8 the embedded amortization rate of 4.32% as reflected on line 29 of Staff Exhibit
9 ___ (DPK-3), Schedule 2.2. The 4.32% amortization rate recognizes the
10 embedded amortization rate reflected in the \$154,001 unamortized balance. As
11 shown in Schedule 2.2, I have applied the 4.32% rate to all CIAC based on the
12 year that the related CIAC was received to derive the Company's net balance of
13 \$154,001.

14 On page 2 of Exhibit ___ (DPK-5) labeled Restating Adjustment #2 I have
15 shown the computation of my adjustment. The amortization amount on line 8 is
16 "reduced" by the amount amortized by the Company, which in this case is zero,
17 resulting in a net adjustment of \$20,323. This adjustment is reflected on line 32 on
18 Schedule 1.2 of Exhibit ___ (DPK-3) which then flows to line 32 on Schedule 1.1
19 of the same exhibit.

20 **Q. Restating adjustment R-3 reduces Management Fees by \$8,000. Please**
21 **discuss the basis of your adjustment.**

22 A. In the test year the Company paid the Company's former owner \$8,000 for
23 consulting services. The Company has provided no documentation that the

1 payments were anything but additional consideration for the sale of the system.

2 However, even if the former owner provided some type of consulting, the charge
3 is not recurring and should not be embedded in any new rates based on this test
4 period.

5
6 **Q. Your adjustment R-4 increases Rate Base by \$3,651 and reduces Repairs and
7 Maintenance Expense by \$7,356. Please explain the basis for your
8 adjustments.**

9 A. Referring to Exhibit ___ (DPK-5) at page 3, starting at Line 13, I have removed
10 from operating expenses the costs of main replacement which should be
11 capitalized for rate making. The total cost removed from expense is \$7,409 as
12 reflected on line 20. Line 26 reflects the \$7,409 capitalization. Because the cost
13 was accrued during the test year, I have computed the average cost for the
14 capitalized amount. Computation of the average cost is consistent with the
15 treatment the cost would have received had the Company already capitalized it.
16 The Average cost, shown on line 28, is added to rate base. In addition to the
17 capitalization, I computed the related depreciation expense and the related
18 accumulated depreciation for the capitalized plant. The capitalized asset
19 depreciated over a 70 year period results in a depreciation expense of \$106
20 annually, or on an average basis and the current test year, \$53. The detail of the
21 adjustment is shown starting on Line 31. A summary of the rate making impact of
22 R-4 is shown on Schedule 2.1 in Exhibit ___ (DPK-3).

1 **Q. Restating Adjustment 6 (R-6) is a \$2,641 adjustment to utility plant in**
2 **service. Please explain the basis for this restating adjustment.**

3 A. Water companies are required by the Department of Health to produce a
4 comprehensive water system plan every six years. The costs of preparing and
5 filing the water system plan is a recoverable expense once the plan has been filed
6 with the Department of Health and approved. When the plan is approved the
7 Commission allows recovery of the plan over a six-year recovery period. The
8 costs that I have removed in the test year represent water plan costs for a water
9 system plan not yet submitted or approved by the Department of Health. The cost
10 is therefore deferred to subsequent periods along with any related depreciation
11 expense the Company may have recognized in the test year. The detail of the
12 computation of the adjustment is shown in Exhibit ___ (DPK-5) on page 4,
13 starting at line 19.

14 **Q. Please discuss your restating adjustment 8 that reduces meter reading**
15 **expense by \$7,589.**

16 A. The Company's \$11,189 meter reading expense shown in its filing, Exhibit ___
17 (RK-2), reflects an extraordinarily high cost for reading an average of only 348
18 meters. The cost of reading each meter is equal to \$2.68 each month. Based on a
19 Draft Small Business Economic Impact Study conducted by the Department of
20 Health, Division of Drinking Water, the average cost of reading a meter averages
21 \$0.50.

22 The Company has cited a number of reasons for the high cost. One reason
23 cited has been that in the test year there were a number of requests for rereads.

1 However, the Company has not provided any support for the cost associated with
2 rereads.

3 The Company also cites a requirement by the Department of Health to
4 read the well-head meter daily. Discussion with the Department of Health
5 indicates that there is no requirement; however, it was requested by a Department
6 of Health engineer. Staff asked the Department of Health if there was any
7 restriction for a local resident to read the meter instead of sending a crew to the
8 water Company everyday. They stated that there was no restriction. It is Staff's
9 position that the Company can continue to send a crew every day, but the least-
10 cost approach should be included in the rates.

11 Exhibit ___ (DPK-5) page 6 is Staff's computation of what it believes is a
12 reasonable meter reading expense based on available information. Line 19 uses
13 the hourly wage of a single meter reader plus the related payroll taxes associated
14 with the reader. This amount is multiplied by a reasonable estimate of the time
15 required to read 348 meters each month as shown on line 20. The result, shown on
16 line 21, is annualized to derive the annual expense of \$6,000.

17
18 **Q. How did you derive the applicable cost of the meter reader?**

19 A. I used three sources. The first source came from the data provided by the
20 Washington State Employment Security Office for occupational employment and
21 wages estimates for March 2005. Exhibit ___ (DPK-6). Company I also used the
22 Department of Health's draft Small Business Economic Impact Study.
23 Exhibit ___ (DPK-7). I reviewed the data obtained from the Washington State

1 Employment Security Office for meter readers and used the upper wage range of
2 \$20.06 or \$20 rounded.

3
4 **Q. How did you derive the applicable number of meters that a meter reader can
5 read per hour?**

6 A. I relied once more on the Department of Health's Small Business Economic
7 Impact Study (SBEIS), Exhibit ___ (DPK-7) and on discussions with Mike Ireland
8 from Washington Water. In Exhibit ___ (DPK-5) I assumed the meter reader can
9 read 29 meters per hour, which, according to my discussion with Mr. Ireland is
10 the low end of the average number that a meter reader normally reads. In contrast
11 the Department of Heath's SBEIS indicates as a low, 38 meters per hour.

12
13 **Q. Returning to your adjustment on page 5 Exhibit ___ (DPK-5), please explain
14 how you derived you final adjustment to meter reading expense.**

15
16 A. On line 24 of my exhibit I show the Company's filed meter reading expense of
17 \$11,189 from its Exhibit ___ (RK-2), I subtract that amount from my computed
18 amount shown on line 22 to derive a reduction in meter reading expense of
19 \$5,429.

20
21 **Q. Have you included any funds so a local resident may be hired to read the
22 well-head meter?**

1 A. Yes, on line 28, I have included \$240 which is \$60 per month, or approximately
2 \$2.00 per read, for the months starting June and ending in September.

3

4 **Q. What is your total adjustment to Meter Reading Expense?**

5 A. My total adjustment is a net reduction of \$5,189. The adjustment is reflected on
6 page 5 of Exhibit ___ (DPK-5), line 30 and on Schedule 1.2, page 2 of Exhibit
7 ___ (DPK-3).

8 **Q. With the addition of the revenue sensitive adjustments and adjustments for**
9 **minor true-ups that are detailed in your Exhibit ___ (DPK-5), do you have**
10 **any other restating adjustments?**

11 A. No.

12

13 **Q. Please explain your pro forma adjustment labeled P-1.**

14 A. Pro forma adjustment P-1 recognizes \$3,000 of rate case cost. As shown on page
15 8 of Exhibit ___ (DPK-5), the rate case cost is amortized over a three-year period
16 resulting in an annual rate case expense of \$1,000.

17

18 INCOME TAXES

19 **Q. You testify below that Staff is providing income taxes, notwithstanding the**
20 **fact that the company is not a corporation. Please explain your approach to**
21 **the calculation of the provision for income taxes.**

22 A. In my Exhibit ___ (DPK-3) page 12, Schedule 5.1 shows my computation of
23 income tax expense. The Schedule is structured in the same format as the Results

1 of Operations schedule, Schedule 1.1. Income taxes are computed for restated
2 results, pro forma results, at proposed rates, and at Staff recommended rates.

3 The company is Limited Liability Company (LLC) and the owners have
4 elected to be taxed as a partnership. That is, the income from the company “flows
5 through” to each owner based on a prior agreement or on percentage of
6 ownership. The company itself is not taxed; rather the owners recognize their
7 share of the LLC’s income on their personal income taxes. Consistent with the
8 income being taxed as individual income I have used the concepts consistent with
9 personal income taxes to compute the related income tax provision.

10 For example, on line 9 of Schedule 5.1 I recognize that the partners will be
11 able to use, at the minimum, a standard deduction of \$10,000. The same logic
12 follows the deduction of an assumed two exemptions to derive taxable individual
13 income.

14
15 **Q. Why do you not use the actual income tax deductions of the owners?**

16 **A.** In order to compute the income taxes based on the actual income tax deductions
17 of the owners, the owners need to provide to the Commission their individual
18 income tax returns as filed with the Internal Revenue Service. The forms would
19 be required to be un-redacted and complete. At this time, the owners have not
20 offered to provide their individual returns for Staff’s review.

1 **Q. Explain way it is proper to take the full standard deduction and two**
2 **exemptions solely out of the utility income portion of the partners' taxable**
3 **income, and how this benefits the rate payer?**

4 A. Since the rate payer is paying the owner's personal income tax on utility income
5 that accrues to the partners, the rate payer should get the benefit of any deductions
6 that the law provides to the individual. It is not reasonable to require the rate
7 payer to share the deductions with the other income of the owners since it is the
8 owners that selected the partnership form of taxation and, therefore, should not
9 benefit by having the rate payer pay more of their personal income tax than the
10 very absolute minimum.

11

12 **CAPITAL STRUCTURE**

13 **Q. What is the Company's capital structure in this case?**

14 A. As shown in Schedule 4.1 of Exhibit ___ (DPK-3) page 8, the Company's capital
15 structure is highly leveraged with 83.3% of its financing in debt and only 16.69%
16 as equity.

17

18 **Q. Do you have a recommendation as to the cost of the debt to be used in this**
19 **case?**

20 A. Yes. Schedule 4.2 of Exhibit ___ (DPK-3) shows the Company's ending weighted
21 cost of debt for the test year. Both notes payable are notes at 8.5% interest.

22 Therefore the cost of debt I used in computing the cost of debt is also 8.5%.

23

1 **Q. Do you have a recommendation as to the cost of equity?**

2 A. Yes. I have used the 12% cost of equity the Commission used in the 2001 Rainier
3 View Water Company rate case.¹

4

5 **Q. Do you believe a 12% return is reasonable in this case?**

6 A. Yes. I believe Staff recommended return of 12% is reasonable for this Company.
7 The return recommended by Staff is in fact notably higher than the 10.3% return
8 provided by the Commission in last year's Puget Sound² order. In addition, Staff
9 recommended 12% is considerably higher than the 8.95% currently being
10 recommended by Staff in the current PacifiCorp general rate case.³

11

12 **Q. Are there other factors to consider when determining if the 12% is**
13 **reasonable?**

14 A. Yes. In this case the Company is a Limited Liability Company (LLC) that is taxed
15 as a partnership for income tax purposes and therefore does not experience the
16 double taxation as a corporation would. Staff is providing an income tax
17 provision. The income tax amount provided in rates results in an after tax net
18 return to the owners that is higher than if the Company was a taxable corporation
19 and the owners were receiving a pre-taxed return.

20

21

22

¹ WUTC vs Rainer View Water Company, Inc., 6th supplemental order (July 12, 2002)

² WUTC vs Puget Sound Energy, Inc., UG-040640 and UE-040641 Consolidated., February 18, 2005

³ WUTC vs PacifiCorp dba Pacific Power and Light Company, UE-050684

1 **Q. Based on the Staff's cost of equity and the weighted cost of debt, did you**
2 **compute a Staff recommended overall cost of capital?**

3 A. Yes. As shown on Schedule 4.1 of Exhibit ___ (DPK-3), the overall cost of
4 capital is 9.08%.

5
6 **REVENUE REQUIREMENT**

7 **Q. Based on the results of your analysis, what is your recommended revenue**
8 **requirement?**

9 A. My analysis, as shown on Exhibit ___ (DPK-3), Schedule 1.1, indicates that in
10 order for Kayak Estates Water to earn 9.08% on its investment it needs total
11 revenue of \$150,431 or an increase of \$15,214, (a 12% increase). Recall for
12 purposes of comparison, that the company's filed rates would result in an increase
13 of 23.3%.

14
15 **Q. What is the impact on the average rate payer of Staff proposed increased**
16 **rates?**

17 A. Staff's proposed rates would increase the average customer bill from \$27.63 to
18 \$31.23, a \$3.61 increase (13%). The Company's proposed rates would increase
19 the average bill from \$27.63 to \$35.18, an increase of \$7.55 (27.3%).

20
21 **Q. Does this conclude your testimony?**

22 A. Yes.

23