

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND )  
TRANSPORTATION COMMISSION, )  
) )  
Complainant, )  
) )  
) ) DOCKET NOS. UW-980072,  
vs. ) UW-980258, and  
UW-980265 )  
) (consolidated)  
AMERICAN WATER RESOURCES, )  
INC., )  
) )  
Respondent.) )  
. . . . . )

WASHINGTON UTILITIES AND )  
TRANSPORTATION COMMISSION, )  
) )  
Complainant, )  
) ) DOCKET NO. UW-980076  
) )  
vs. )  
) ) FIFTH SUPPLEMENTAL ORDER  
AMERICAN WATER RESOURCES, ) INITIAL ORDER REJECTING TARIFF  
INC., ) FILING, AUTHORIZING  
AND )  
) ) REQUIRING REFILING  
Respondent.) )  
. . . . . )

Administrative Law Judge Dennis J. Moss heard these proceedings on due and proper notice on September 17, 22, and 23, 1998, in Spanaway and Olympia, Washington.

NATURE OF PROCEEDING: American Water Resources, Inc. seeks a general rate increase for water service it provides in Washington State (Docket No. UW-980258). American Water Resources, Inc. also proposes to add newly acquired water systems to its tariff and charge the customers of those systems the company's generally applicable rates (Docket Nos. UW-980072 and 980265). Docket Nos. UW-980258, UW-980072, and 980265 are consolidated. American Water Resources, Inc. also proposes to decrease its "facilities charge" from \$3,500 to \$2,500 and redefine the customers to whom the facilities charge applies (Docket No. UW-980076).

APPEARANCES: Richard Finnigan, attorney, Olympia, represents America Water Resources, Inc. Robert E. Beaty, attorney, Seattle, represents intervenor Daniel C. Williams. Mary Tennyson, Senior Assistant Attorney General, Olympia, represents the Commission Staff.

CONCLUSION: AWRI has not shown the rates, charges, terms, and conditions of service it proposes through its filings in these dockets produce results that are fair, just, reasonable, and adequate, or in the public interest. The Commission accordingly must reject the proposed tariff sheets. AWRI is authorized and required to file revised tariff sheets consistent with the discussion, findings of fact, and conclusions of law contained in this Initial Order, upon approval by the Commission following the appropriate period for review and upon the Commission's final order.

#### MEMORANDUM

Procedural Background. American Water Resources, Inc. (AWRI) filed on January 16, 1998, a proposed tariff revision designated Original Sheet No. 15.2 to reflect added service areas due to the company's acquisition of nine water systems previously not subject to Commission jurisdiction. The filing would set tariff rates for the newly acquired systems at the same level as AWRI's generally applicable rates. The Commission entered on February 25, 1998, a Complaint and Order Suspending Tariff Revision, Ordering Temporary Rates and Instituting Investigation. This matter is Docket No. UW-980072.

AWRI filed on February 27, 1998, proposed tariff revisions designated Second Revision of Sheet No. 1 canceling First Revision Sheet No. 1; Fourth Revision of Sheet No. 17 canceling Third Revision Sheet No. 17; Third Revision of Sheet No. 18 canceling Second Revision of Sheet No. 18 and Original Sheet No. 18.6; and First Revision Sheet No. 27 canceling Original Revision Sheet No. 27. These proposed tariff revisions reflect AWRI's request to increase its rates to recover additional annual revenue relative to the revenue amount produced by rates approved and effective as of August 1997. The Commission entered on March 25, 1998, a Complaint and Order Suspending Tariff Revisions, And Instituting Investigation. This matter is Docket No. UW-980258.

AWRI filed on March 2, 1998, tariff revisions designated Second Revision Sheet No. 15 canceling First Revision Sheet No. 15, First Revision Sheet No. 15.1 Canceling Original Sheet No. 15.1; Original Sheet No. 15.3; Original Sheet No. 15.4; Original Sheet No. 15.5; Original Sheet No. 15.6; Original Sheet No. 15.7; Original Sheet No. 15.8; Original Sheet No. 15.9; and Original Sheet No. 15.10. These proposed tariff revisions reflect added service areas due to AWRI's acquisition of approximately 50 water systems and would set tariff rates for those systems at the same level as AWRI's generally applicable rates. The Commission entered on March 25, 1998, a Complaint and Order Suspending Tariff Revision, Ordering Temporary Rates and Instituting Investigation. This matter is Docket No. UW-980265.

AWRI filed on January 20, 1998, a tariff revision designated as Second Revision Sheet No. 25 canceling First Revision Sheet No. 25, to

reflect a decrease in Facilities Charges from \$3,500 to \$2,500. The proposed tariff sheet also would redefine to whom the facilities charge applies. The Commission entered on February 25, 1998, a Complaint and Order Suspending Tariff Revision, Ordering Temporary Rates and Instituting Investigation. This matter is Docket No. UW-980076.

The Commission entered an Order of Consolidation and Notice of Prehearing Conference with respect to Docket Nos. UW-980072, UW-980258, and UW-980265, and a Notice of Prehearing Conference in Docket No. UW-980076, on June 2, 1998. A joint prehearing conference was set for June 17, 1998, and convened on that date at the Commission's offices in Olympia, Washington before Administrative Law Judge Dennis J. Moss. A procedural schedule established at the prehearing conference set the evidentiary hearing for September 22 and 23, 1998. Subsequently, public comment hearing dates of September 17 and 23, 1998, were set by notice.

The Commission received sworn public comment from 35 participants including ratepayers and current and former legislative representatives elected from districts which include AWRI customers. During the evidentiary phase, the Commission heard from five witnesses for AWRI and Staff. The record includes 594 transcript pages and 57 exhibits, including 7 sets of prefiled direct and rebuttal testimony cumulating more than 200 pages. Among the exhibits are numerous written public comments received on Public Counsel's motions as illustrative of public concern and sentiment.

AWRI, Staff, and Williams filed briefs on October 13, 1998.

Discussion. AWRI is a product of fragmented regulatory responsibilities and residential developer practices that have given rise to significant, even gross, inefficiencies and inadequacies in water provisioning for thousands of Washington State households. Largely as a result of water rights law and regulation that fails to address adequately the development and use of one of our most vital natural resources, residential property developers in Washington State have built hundreds of so-called six-pack water systems in suburban, ex-urban, and rural locations. Relying on these systems that do not require water rights permits from the Department of Ecology, developers "improve" raw land with water supply and other necessary infrastructure and sell the improved lots as homesites, or build out six-house projects and sell the completed homes.

Some projects built around these six-pack water systems are relatively more rural in character (e.g., two to five acre mini-estates) and may be surrounded by agricultural acreage or woodlands; other projects

are tract subdivisions with perhaps dozens of small lots (e.g., two to three lots per acre) with each six lots served by a separate six-pack water system. Often, developers quickly lose interest in these small water systems, maintenance becomes spotty or nonexistent, and problems predictably ensue. Exh. T-40 at 2-5 (Fox). This development pattern continues unabated despite extant and potential, direct and indirect harm to those who purchase or build homes tied to inherently risky water systems.

In addition to numerous six-pack systems, there exist in Washington State a significant number of small, central-facility systems that serve a few hundred customers in tract subdivisions. These systems' small size and limited customer bases mean they cannot operate cost effectively over the long term. They nevertheless may operate for substantial periods without economic oversight by keeping rates and customer numbers below the thresholds that trigger Commission jurisdiction.

As small, central-facility system operators realize the extraordinary difficulty of providing adequate service at affordable rates, they, too, lose interest in operating their systems with predictably adverse consequences for customers. See e.g., Exh. 20; Exh. T-40 at 11-12 (Fox); Exh. T-43 at 4. In sum, these systems, like the even smaller six-pack systems, exhibit histories of poor management, poor maintenance, and unsatisfactory service to customers. Customers on the worst of these systems suffer no less than those on the worst six-pack systems. Low pressure, turbidity, contamination, and other physical problems unite with sometimes unresponsive, indifferent management and personnel to create a sense of true crisis among customers who suffer diminished quality of life and health as the water systems upon which they depend consistently fail to meet minimally acceptable quality of service standards. See e.g., TR. 48 (Brownell); 67 (Graves); 71-75 (Huestess); 86 (Winchell); 96 (Livengood); 114 (Thompson); 543-48 (Melius); 562-63 (Bossert).

A little more than two years ago AWRI says it recognized opportunity in this crisis and set out to purchase and place under common ownership and management "dozens, perhaps hundreds, of very small water systems." AWRI Brf. at 1. AWRI has grown rapidly; just during the test year its customer base increased from around 600 to more than 1,700.

AWRI

now owns and operates approximately 150 separate water systems that exhibit a wide range of physical sizes, conditions, and capabilities. Despite the start-up nature of its business and management's almost complete absence of experience operating a water utility "AWRI expected to

earn a reasonable profit" throughout this program of acquisition and management consolidation. AWRI Brf. at 2. Mr. Fox stated AWRI's corporate goals more fully, as follows:

1. To build a viable water utility with a long range perspective,

providing high quality and reliable service.

2. Develop a staff that is interested in the mutual benefit of our customers, owners, and regulatory agencies, all in keeping with the rules and regulations of the State of Washington.

3. To create a financially sound business that experiences the benefits of economies of scale, the benefits of a competent staff, and provides a rate of return to its management and stockholders to ensure a long range vision in investment.

4. To provide a higher than normal degree of customer service and keep a conservation minded approach to utility service and keeping an awareness of the Safe Drinking Water Act and other regulatory issues.

It is sufficient to observe at this juncture that room exists for significant debate about how well any of these goals so far have been achieved.

Still, these are generally laudable goals and the Commission legitimately may do what it can to advance their realization. The Commission's responsibility and authority vis-à-vis AWRI, however, is limited to rate regulation and the associated terms and conditions of service, including service quality aspects that overlap at times with the Department of Health's jurisdiction over water health and safety issues. Constrained by legal and accounting principles of public utility regulation that have developed over many years primarily in the course of local, state, and federal regulation of large, central facility water, electric, and natural gas delivery systems, the unique problems the Commission encounters when regulating entities like AWRI inevitably lead to results not fully satisfying to customers, the utility, or the Commission. Nevertheless, confronted with AWRI's rate increase request, the Commission must act to the best of its ability to determine rates, terms, and conditions of service that are fair, just, reasonable, and sufficient. This the Commission strives to do first through this Initial Order and, ultimately, by its final action following the opportunity for administrative review.

#### I. Docket No. UW-980258 (General Rate Case)

A. Quality of Service. AWRI's customers offered extensive comments for the record in this proceeding. It is abundantly clear these customers care deeply about two things: price and quality of service. Quality of service includes more than the question whether AWRI'

s water meets the minimum health, safety, and other standards enforced by the Department of Health; quality of service concerns also require the Commission to ask whether AWRI responds adequately to customer needs and complaints, whether AWRI communicates and interacts with its customers on a regular basis and in an acceptable manner, whether AWRI consistently delivers water at high enough pressures and possessing qualities of clarity, odor, and taste to satisfy its customers. There is significant evidence in the form of customer comments, via both written statements (Exh's 1, 4, and 8) and sworn testimony (TR. 45-119; 497-593), and from

other testimony and exhibits (see e.g., Exh's 1-4, 8, T-40 at 9-11 (Fox), 41, T-43 at 10 (Fox)), that the answers too often are "no." Put more directly, the evidence establishes that AWRI's quality of service is inadequate to meet the legitimate needs of its customers.

Price, that is, rates, must be set in accordance with generally accepted regulatory accounting principles. Much discussion in this Initial Order necessarily involves applying these sometimes complex and difficult principles to facts that may be uncertain and hotly disputed. The Commission's determination of the amount customers are required to pay for service, however, also may take cognizance of quality of service considerations as policy and judgment inform and direct decisions on particular elements embedded in the determination of AWRI's final rates. Thus, quality of service is returned to several times as individual issues are decided below.

B. Rate Base. AWRI and Staff stipulated to results for several contentious issues related to rate base by the conclusion of evidentiary hearings. Most significantly, in terms of dollars, AWRI agreed to remove from its proposed rate base "projected costs" or "planned investment" of \$340,800 the company expects to make in needed improvements to various systems. Most of these projects had not been started by the end of the test period and none were complete or under construction at the time of hearing. Indeed, AWRI informed its customers in May that in addition to cutting staff, eliminating its monthly newsletter, and eliminating its toll-free telephone number "all non-critical repairs and upgrades will be put on hold." Exh. 1 at 24, 192; Exh. 4 at 392. Since AWRI elected not to pursue this proposed addition to rate base, as to which it bore a significant burden of proof given the exceptional nature of the request, the issue requires no further discussion. The parties' stipulation on this point is accepted as adequately supported by the record and sound ratemaking principles.

AWRI also agreed via its rebuttal testimony to Staff's proposal to use end of test period rate base and customer count rather than the more traditionally favored average rate base approach. The rationale supporting this agreed accounting convention is discussed separately below and accepted for purposes of this Initial Order.

Starting, then, with per books plant of \$1,053,224, as of December 31, 1997, the parties make various uncontested and contested restating and pro forma adjustments to determine their respective pro forma rate base positions, as reflected by Table 1. AWRI proposes the Commission accept a rate base of \$1,101,600 and Staff proposes \$882,033. This Initial Order approves a \$833,292 rate base, considering the parties' contentions, resolved as outlined below, and various adjustments required in light of the record.

TABLE 1  
AMERICAN WATER RESOURCES, INC.

Rate Base-Per Stipulation  
 Comparison of Company and Staff Positions  
 12 Months Ended December 31, 1997

Description		Company	Staff
Difference			
Per Books	\$ 1,053,224	\$ 1,053,224	0
Uncontested Adjustments:			
RA-12 Deferred Debit Accounts-Capitalized		17,245	17,245
PA-18 Capitalized Truck - Net	6,165	6,165	0
PA-19 Proforma 1998 CIAC 6/30/98	(35,479)	(35,479)	0
PA-22 Proforma 1998 Plant 6/30/98	43,780	43,780	0
Sub-Total	31,711	31,711	0
Contested Adjustments:			
JMP RA-3 1996 Reclassification	5,110	5,110	0
JMP RA-8 Contributed Operating Cost	11,555	0	11,555
RA-13 Capitalized Auto Repairs	0	(2,708)	2,708
PA-20 Net Acquisition Adjustment	0	(200,194)	200,194
Sub-Total	16,665	(202,902)	219,567
Total Adjustments	48,376	(171,191)	219,567
Pro Forma Rate Base	\$1,101,600	\$882,033	\$219,567

AWRI's and Staff's rate base amounts reflect agreed restating adjustments to capitalize and include in rate base \$17,245 in deferred debit accounts and to include \$6,165 as the net capitalized costs of a truck AWRI incorrectly expensed on its books. These amounts are undisputed and not controversial; they are essentially accounting corrections. These adjustments are accepted as adequately supported by the record.

The principal unresolved rate base issue in terms of dollars is AWRI's proposed \$200,194 acquisition adjustment addition to rate base, an amount equal to more than 18 percent of AWRI's proposed total rate base. Staff opposes the proposed addition to rate base. The issue is analyzed in detail below; it is found that AWRI's proposed addition is not supported and should be denied.

AWRI recognized the existence of plant not used and useful in the public service in its original case and adjusted rate base to reflect unutilized plant. Staff made no adjustment for plant not used and useful. AWRI, nominally in connection with its decision to adopt end-of-period methodology, dropped any used and useful adjustment on rebuttal. As discussed separately below, the evidence considered in light of sound ratemaking principles requires an adjustment to remove from rate base certain plant not used or useful as of December 31, 1997.

A significant proposed pro forma rate base adjustment that also requires further discussion below is one first proposed by Staff's prefiled testimony and accepted by AWRI via its rebuttal testimony. This proposed adjustment involves \$43,780 in additions to rate base to account for

post-test year plant additions through June 30, 1998, net of one-half year's depreciation, and \$35,479 net additional CIAC amortization through the same period. The record does not support these adjustments to rate base; they are not valid pro forma adjustments and are disallowed for purposes of establishing rates in this proceeding.

Other disputed rate base adjustments include AWRI's restating adjustment to reclassify previously expensed plant resulting in a \$5,110 addition to rate base opposed by Staff. AWRI also proposes an \$11,555 addition to rate base it claims is appropriate to reflect time allegedly contributed by officers in connection with AWRI plant acquisitions. As discussed below, these proposed additions to rate base represent retroactive ratemaking and for that reason, among others, must be denied.

The final unresolved rate base dispute concerns AWRI's proposal to capitalize \$2,868 in maintenance and repairs to the company president's personal automobile on the theory that his use of the vehicle for AWRI business justifies such treatment. Staff opposes the proposed treatment and it is rejected for reasons discussed below.

i. Year End Rate Base and Customer Count. AWRI and Staff agree to use AWRI's rate base and customer count as of December 31, 1997, the end of the test year. This departs from the more usual use of beginning and ending average test year figures. The end-of-period method is adopted, as recommended by the parties. This decision, however, must be understood to be an exception to meet the peculiar circumstances presented by AWRI's extraordinary growth during the test year. The decision to use the end-of-period approach in this case sets no precedent for future AWRI rate cases.

The end-of-period approach is recognized in authoritative rate accounting literature as a legitimate tool to recognize rapid growth and other special circumstances that may confront rate setting bodies in individual cases. Goodman, Leonard Saul, *The Process of Ratemaking, Public Utilities Reports, Inc.*, Vienna, VA, 1998, Vol. II, pp. 736-39; *Water Utility Accounting*, 3rd ed., American Water Works Association, 1995, p. 218. Numerous jurisdictions have adopted the end-of-period approach where appropriate to recognize large expansion programs, rapid inflation, or other unusual circumstances. See e.g., *Re Matanustka Electric Association, Inc.*, PUR4th [1A APUC 310] (APUC 1976); *Re Florida Power Corp.*, 99 PUR(NS) 129, 134-35 (Fla. PSC, 1953); *Re Western Light & Tel. Co., Inc.*, 17 PUR3d 422, 424-25 (Okla. CC, 1957).

The Commission also has approved the end-of-period approach in appropriate circumstances, including circumstances that involve rapid growth, unusual inflation or earnings attrition, show a need to mitigate



regulatory lag, or demonstrate a utility's failure to earn authorized return over a historical period. WUTC v. Washington Natural Gas Co., Cause No. U-80-111, Third Supplemental Order (September 1981). Although used only rarely, the Commission has adopted the end-of-period approach from time-to-time for at least 25 years. Id.

Ordinarily, use of end-of-test-period rate base is a boon for the utility; it allows for increased return though earnings on a larger than representative rate base. Regulatory bodies take a skeptical view when a utility company proposes the approach and most often reject it for its failure to match adequately revenues and expenses; the net imbalance typically tips in the company's favor. Ironically, it is Staff that insists on the end-of-period approach in this case. Exhibit T-60, 3-4, 10-11, 16. AWRI originally proposed the beginning-and-end-of-year (BEOY) average approach. Via Ms. Parker's rebuttal testimony, however, AWRI stated it "has no objection to the use of end of period numbers." Exhibit T-15, 10-11.

Significantly, AWRI and Staff both say on brief that AWRI's rapid growth in both physical plant and number of customers provides adequate rationale to adopt the end-of-period approach. Staff Brf. at 4; AWRI Brf. at 5. Staff asserts that using beginning and end of year averages "would skew certain figures and require . . . excessive . . . adjustments," while "year-end figures more accurately matches the amount of plant in service, and the number of customers to be charged the company's new rates." Staff Brf. at 4. It does appear the beginning and ending averages approach would significantly distort the rate analysis given that measures of central tendency poorly reflect circumstances on a forward looking basis when the high and low data points are extremely far apart. Customer count illustrates the problem nicely. AWRI's customer base grew nearly 300 percent during the test year, from approximately 600 to more than 1700 customers. AWRI's average customer count is 1160 for the test year, a figure not representative on a forward-looking basis. End-of-period customer count and rate base provide a better starting point under the circumstances.

On balance, then, the better approach in this case is to accept the parties' now joint proposal to use end-of-period rate base and customer count. No further adjustments for post test year plant additions, CIAC, or customer growth are supported by the record. Relying on end-of-period data will produce more reasonable rates for the immediate future and the likely period during which the rates established here will be effective.

ii. Acquisition Adjustment AWRI proposes to add to rate base a \$200,194 net acquisition adjustment amount reflected in the company's Account 114 balance on December 31, 1997. The net acquisition amount results principally from \$225,269 AWRI paid in excess of historical booked costs (i.e., original cost when devoted to public service adjusted

appropriately for depreciation, amortization, and CIAC) to purchase the View Royal and H2O Water Systems in April and November 1997, respectively. Additional charges in AWRI's Account 114 include \$12,201 in excess costs AWRI paid for a water system in January 1997, and \$641 in excess costs paid for a water system in June 1997. These charges are offset partially by Account 114 credit entries of \$17,795, \$1,622, and \$16,615 to reflect amounts less than historical booked cost AWRI paid for three systems acquired in January and June, 1997. The balance, \$202,079, depreciated through the end of the test period, yields the adjusted net, \$200,194.

Staff opposes AWRI's proposed addition of the adjusted net Account 114 balance to rate base. Staff argues the Commission should follow the prevailing rule relating to utility plant acquisitions by requiring acquired systems to be included in rate base at historical booked cost depreciated to the appropriate point in time in each case. In rate accounting terminology, Staff would account "below the line" for acquisition adjustment amounts. Thus, Staff would allow AWRI to include in rate base historical booked costs in cases where AWRI paid less than historical booked cost for a system and require AWRI to include in rate base historical booked costs in cases where AWRI paid more than historical booked cost for a system.

Staff's approach neither penalizes nor unduly rewards AWRI and is the more sound approach in principle. Staff's approach is adopted. Subject to adjustment under used and useful plant principles, and recognizing appropriate depreciation, amortization, and CIAC adjustments from the time of AWRI's acquisition until December 31, 1997, AWRI's rate base will reflect all acquired plant at historical booked costs.

AWRI's brief touches on the point that AWRI and Staff disagreed at various times in this proceeding both on the correct accounting treatment and the appropriate rate base treatment of amounts that reflect differences between what AWRI paid for various systems and the original cost less depreciation values included in the books of the acquired systems. Accounting treatment and rate base treatment of these amounts are distinct issues and are best analyzed separately. Ms. Parker's and Mr. Ward's direct testimonies do not clearly distinguish the two issues and it is fair to observe that this led to significant confusion as reflected by Ms. Parker's rebuttal testimony. Much of the confusion appeared to have been resolved by the close of evidentiary proceedings and the parties' briefs focus on the more salient issue of rate base treatment. Still, to be perfectly clear and to ensure appropriate and accurate rate treatment, it is necessary to discuss both accounting and rate base aspects of acquisition adjustment amounts.

a. Accounting. Ms. Parker presented on rebuttal Exhibit No. 18, "a worksheet which details the contents of account 114 Utility Plant Acquisition Adjustment and the amortization of this account." Exh. T-15 at 15-16. This exhibit shows the amounts by which AWRI's purchase price either exceeds or is less than the original cost less depreciation and

CIAC amounts reflected on the acquired utility's books for the transferred assets. When the acquiring utility pays less than the per books asset value, the Account 114 entry must show a credit amount. Thus, for example, when AWRI purchased S&K Pumps & Drilling for \$17,795 less than the S&K's historical depreciated original cost on the date of purchase, AWRI should have entered a negative \$17,795 in Account 114. Exh. T-15 at 16; Exh. 18. When AWRI purchased View Royal, it paid \$77,085 more than View Royal's historical depreciated original cost on the date of purchase. AWRI should have entered a positive \$77,085 in Account 114 to reflect this transaction. AWRI apparently did make proper Account 114 entries.

Exhibit No. 18 is consistent with the approved Account 114 methodology, accounts for appropriate debits and credits for below-cost and above-cost test period acquisitions respectively, and reflects amortization and remaining balances at various dates. At the end of the test period, AWRI's worksheet (and, presumably, its book Account 114) shows an acquisition adjustment balance of \$200,193.56. It appears from the briefs, and particularly from line 29 of the stipulated rate base calculation attached to Staff's brief, that the parties now agree this amount, rounded to the nearest dollar, is the correct Account 114 balance for AWRI as of December 31, 1997.

This accounting analysis is important not only to confirm the amount at issue, but also for a second reason: it exposes the fact that Staff's proposed rate base treatment of AWRI's bargain purchases and premium purchases rewards AWRI for its acquisition of distressed systems. This reflects an incentive policy that allows AWRI to earn a return not just on the purchase price, but on the higher rate base of certain systems acquired at less than historical depreciated costs. In total, adjusting for depreciation, this amounts to \$35,201 more included in rate base than AWRI paid for certain plant. This exact incentive mechanism has met with success in other jurisdictions where it is supported by utility companies that have a history of purchasing numerous, discrete water systems. Re Acquisition Adjustment Policy, 116 PUR4th 254 (Fla. PSC, 1990). The Florida PSC observes:

Those utilities that are actively acquiring distressed utilities have found that our policy gives them the flexibility to make some purchases at a premium and still receive rate base treatment because of the balancing effect created by purchases made at a discount. In other words, multiple purchases at a discount have created a new incentive to purchase those troubled utilities that can only be purchased at a premium.

Were the Commission to approve the form of "incentive policy" AWRI advocates by allowing AWRI to include in rate base premium payments made for some systems while excluding from rate base depreciated original cost amounts that exceed purchase price on other systems, this would send the entirely inappropriate message that AWRI should avoid purchasing systems at a discount and should always be willing to pay a premium amount so that

rate base might thus be inflated to produce additional return. Although there may be reasons in individual cases to approve additions to rate base from net positive Account 114 balances, that is a separate question, discussed in the following section.

b. Rate base Treatment. In addition to accounting and related incentive policy concerns, the decision about whether to allow AWRI's positive acquisition account balances in rate base is informed by answering the practical question of what, if any, benefit customers derive from AWRI's acquisitions. The parties' arguments on brief elaborated extensively on this point and it will be treated in considerable detail here.

By way of background, the parties variously recommend looking to the New York Public Service Commission's 1994 Statement of Policy On Acquisition Incentive Mechanisms for Small Water Companies (AWRI Brf. at 6 (citing Exh. 32); TR. 435-36 (Ward)), Pennsylvania's policy (TR. 435-36 (Ward)), the Commission's action in Rainier View Water Company, Docket No. WU-941147, the Commission's "water manual" (AWRI Brf. at 7 (citing Exh. 70 and TR. 438 (Ward))), and Matthew Bender Company's looseleaf publication, Accounting for Public Utilities (Staff Brf. at 5-6). Additional sources consulted include Re Acquisition Adjustment Policy, 116 PUR4th 254 (Fla. PSC, 1990), and Leonard Saul Goodman's recent, previously cited, two volume opus, The Process of Ratemaking.

A common theme runs through these authorities: to include all or part of a positive acquisition account balance in rate base, the acquiring utility must show benefits to customers commensurate with the net positive balance proposed. The parties agree the appropriate question is whether the net excess costs AWRI paid for various systems, principally View Royal and H2O, provide "a commensurate benefit to either existing or acquired customers" (AWRI Brf. at 6), or, in Staff's words, whether the excess costs AWRI paid result "in a tangible benefit to the customers, and that the amount of this measurable benefit is commensurate to the amount of the requested adjustment" (Staff Brf. at 5). Staff submits AWRI failed to carry its burden to show the adjustment is appropriate.

AWRI says Ms. Parker's testimony supports the proposed acquisition adjustment and, on brief, quotes her testimony summarizing her belief that the excess amount paid for the H2O and View Royal systems provides "measurable[,] commensurate benefit to the H2O and View Royal customers" (Exh. T-15 at 23), as follows:

1. The assets from the purchase of H2O and View Royal Water Systems are

understated on the books of AWRI, and do not reflect the true cost of the water systems.

2. The customers have had the benefit of using these assets without adequate consideration paid to the prior owners of the water systems.

3. The prior owners were not interested in continuing to provide quality service to the customers on the purchased systems, and therefore sold the systems to AWRI at a price they felt compensated them for their sweat equity.

4. AWRI has increased the level of oversight and general administration to these acquired systems above and beyond what was present prior to the transfer. Although this is not usually a visible benefit, it is a benefit nonetheless.

AWRI Brf. at 6 (citing Exh. T-15, p.23).

These four benefits AWRI alleges to support its proposed acquisition adjustment to rate base are not quantified and, indeed, are somewhat nebulous. Although they are not "measurable" in that sense, this alone does not disqualify them as reasons to approve some adjustment to rate base. Nevertheless, three of the four "summary" rationales stated by Ms. Parker fail absolutely to support the proposed rate base addition for different reasons.

To the extent "[t]he assets from the purchase of H2O and View Royal . . . are understated on the books of AWRI," they must similarly have been understated on the books of the predecessor companies. This is because AWRI was required to record, and assertedly did maintain, the historical cost and depreciation of the plant as recorded on the original companies' books. Exh. T-15 at 13-14. Absent detailed accounting data and analysis from the predecessor companies to show precisely the accounting failures that led to the alleged problems with the books and what would be required to correct them, AWRI's assertions cannot be considered adequately supported to stand as a rationale to allow any amount of acquisition adjustment in rate base. In other words, if AWRI alleges it paid amounts apparently, but not in fact, above historical depreciated costs because of errors in the predecessor companies' books, the alleged errors must be specified and tied to specific assets that the predecessors either failed to record, recorded incorrectly, or depreciated incorrectly over some definite time frame. The Commission requires detailed accounting records to substantiate alleged book errors; here there is nothing more than a witness' general assertion that errors exist. AWRI's frank admission that the books and records of the predecessor companies do not permit such substantiation precludes acceptance of alleged accounting errors as a rationale to support the proposed addition to rate base.

Ms. Parker's assertion that "[t]he customers have had the benefit of

using these assets without adequate consideration paid to the prior owners of the water systems" must be rejected as a rationale for the proposed adjustment to rate base both because the assertion is unsubstantiated by evidence and because it invites retroactive ratemaking. Statements such as "I also assert that the president of VRWC also did not receive adequate wages for his duties as a water purveyor" cannot be considered seriously as evidence; nor can any weight be given to mere speculation about the relationship between the infrequency of rate cases under prior ownership and operating costs recovery. Exh. T-15 at 22-23. Mr. Jorgenson's litany of complaints to the Commission at the time he sold the system (Exh. 20) and Ms. Parker's off-the-cuff analysis of particular elements of a Commission staff results-of-operations statement for H2O Water Company in Docket No. UW-950253 also do not constitute evidence upon which the Commission could rely as providing justification for the proposed acquisition adjustment to rate base. At best, Exhibit 20 is unreliable hearsay. Ms. Parker's testimony lacks important context and includes unsupported speculation.

Even if it is true that the prior owners failed to seek adequate rates or provide adequate support for any proposed rates on a continuing basis, to allow the recovery of alleged inadequate "consideration" via prior rates would be to allow retroactive ratemaking, a practice disfavored to the point of practical prohibition under longstanding utility ratemaking principles. Any attempt to improve on allegedly inadequate rates in effect during some prior period to recover costs incurred during the prior period is an attempt retroactively to charge something other than the tariff rate that was in effect for the prior period and thus violates the Filed Rate Doctrine.

Similarly, turning to Ms. Parker's third point, any failure by the prior owners to timely reflect their continuing labor and management efforts in rates is not a problem that can be, or should be, remedied by inflating rate base, and hence return, now. Ms. Parker's "belief" notwithstanding (Exh. T-15 at 23), there is no actual evidence of unrecovered "sweat equity" investment by the prior owners and not even an assertion of measured or measurable amounts of "sweat equity" that provide some continuing benefit to customers. There is no showing that any time invested by the prior owners would properly have been capitalized rather than expensed via salaries or otherwise. To permit recovery of any amounts for day-to-day management or labor by the prior owners again would violate the prohibition against retroactive rates.

AWRI's fourth assertion based on Ms. Parker's testimony--that its customers benefit from an "increased . . . level of oversight and general administration to these acquired systems"--segues into Ms. Ingram's assertions that AWRI's acquired customers benefit from "increases in

compliance with regulations, planned upgrades to the acquired systems, availability of [AWRI] personnel to address concerns of customers, regionalization of water systems, and economies of scale. Exh. T-30 at 17-18. Thus, four types of benefits are claimed: (1) improved quality of service for AWRI's customers through regulatory compliance, presumably with health regulations; (2) improved physical facilities, presumably to enhance water purity, clarity, and pressure; (3) available personnel, presumably to respond quickly and effectively to customer problems and complaints; and (4) savings via regionalization and economies of scale, presumably to permit lower rates to customers.

There is little to substantiate the claimed quality of service benefits and, as Staff observes, AWRI's customers' testimony:

shows that, although Mr. Fox [AWRI's owner] may believe that he is a better manager of the [H2O and View Royal] systems, and has made or plans to make, substantial improvements, . . . the customers do not perceive substantial improvements in the service they are receiving, or responsiveness of [AWRI] management to their concerns since AWRI acquired the systems. Most of the testimony indicated that the primary effect of AWRI's acquisition of the systems has been increased rates and indifferent management, with no obvious improvements in the quality of service provided to the customers.

Staff Brf. at 7.

Many customers testified at public hearings specially scheduled for their comments that the primary effect they see in AWRI's acquisition is, to quote Staff's pithy summary, "increased rates and indifferent management." Staff Brf. at 7; see e.g., TR. 99-102 (Gross), 504 (Lingren), 560-61 (Bossert), 588-92 (Thompson). Significantly, too, AWRI actually cut back its office staff and field staff just after the test year end and thus actually has fewer personnel to respond to customer needs and, as a direct result of acquisition, larger numbers of customers to whom it must be prepared to respond. Quality of service has actually declined, not improved, in the wake of AWRI's acquisitions.

"Planned upgrades" do not count as current benefits against which to measure a proposed addition to rate base for acquisition adjustment amounts. Unless made expressly in connection with an acquisition, preferably as a condition for approval, and preferably with a definite timetable, planned upgrades are simply too indefinite. Significantly, the one actual improvement AWRI cites, addition of a generator to the View Royal system, was required by the DOH at the time of acquisition and presumably was taken fully into account in negotiating AWRI's purchase offer. That assumption made, it is reasonable to expect AWRI to act prudently and reduce its offering price to reflect the necessity for the generator, not pay a premium for the privilege of purchasing an obvious liability. Moreover, rather than adjusting rate base with acquisition adjustment dollars, it is more appropriate, and the Commission Staff did, in fact, adjust rate base to reflect the actual plant addition during the test year.

Turning to the alleged economic benefits of AWRI's acquisitions, Staff argues there is no basis to approve an acquisition adjustment found in AWRI's assertions that "because it has acquired more customers, the costs of operations will be spread over more customers, resulting in economies of scale;" and that AWRI "will provide more interested dedicated, management than the prior managers of [H2O and View Royal], will do more regular testing, and develop a water system plan." Staff Brf. at 6. According to AWRI, however, "[r]egionalization" through acquisitions includes "having field people nearby and improving buying power." AWRI Brf. at 7 (citing Tr. 342-43 (Fox)).

The benefit to customers arising from "having field people nearby," might be considered the type of benefit that would help support the addition of acquisition adjustment dollars to rate base under some circumstances. In AWRI's case, however, the benefit has not materialized. Mr. Fox described the AWRI system as being in seven counties, consisting largely of six-pack systems that are "kind of spread all over the world." TR. 311, 342. Although AWRI eventually may hire additional personnel, it's staff at the end of the test year, and currently, is inadequate to satisfy existing system maintenance and customer service demands as shown by various witnesses' testimonies. TR. 342-43 (Fox); See also, e.g., TR. 46-50 (Brownell), 72-73 (Huestess), 82-83 (Pickering), 547-48 (Melius), 561, 573-74 (Bossert). Thus, it is clear AWRI's test year acquisitions have not bestowed the benefits allegedly arising from regionalization. Indeed, quite the opposite appears to be true. There is no inherent benefit from regionalization or economies of scale; whether customers actually benefit is a matter of management decisions that may have little or nothing to do with system acquisition per se.

The improved buying power to which Mr. Fox refers is not an artifact of AWRI's acquisitions, but rather "kind of a side benefit" arising from Mr. Fox's ownership of a construction business that "does do a fair amount of dollar buying." TR. 343 (Fox). Thus, it is neither a benefit of "regionalization," as AWRI suggests on brief, or an economy of scale achieved from AWRI's acquisition of new systems.

AWRI cites Ms. Ingram's testimony regarding the New York Public Service Commission's 1994 policy statement on acquisition incentive mechanisms for small water companies and to the Commission's recognition of that policy statement when it approved an acquisition adjustment in Docket No. UW-941147 for Rainier View Water Company when it purchased Indian Springs water system. AWRI Brf. at 6-7. Ms. Ingram's testimony, reiterated in AWRI's brief, is that:

the acquisition adjustment . . . can be the one vehicle that can eliminate long-term problems. [T]here is commensurate benefit which includes increases in compliance with regulations, planned upgrades to the acquired systems, availability of Company personnel to address concerns of



customers, regionalization of waters systems, and economies of scale.

AWRI Brf. at 7, Exh. T-30 at 17-18.

Staff criticizes AWRI's characterization of the Commission's approval of Rainier View's acquisition of Indian Springs as demonstrating that "potential" system integration justifies an acquisition adjustment.

Staff

points out that "the intertie of the Indian Springs system [to Rainier View] was a condition of the sale of the system [and] a condition of the Commission's approval of the sale." Staff Brf. at 8. Ms. Ingram, as Staff relates, acknowledged on cross-examination that the conditional nature of the sale and the Commission's approval "does sound to be accurate." TR. 278. Thus, in Rainier View's case the "planned upgrades" were assured and were the key to actual "regionalization" through the physical interconnection and integration of two water systems. That is materially and significantly different from an apparently elaborate water plan AWRI has developed but the implementation of which is on indefinite hold.

In sum, the evidence does not support a finding that AWRI's acquisitions have bestowed on existing or potential customers benefits commensurate with the acquisition adjustment amount it requests be included in rate base upon which AWRI will earn a return. Indeed, it not only appears that AWRI's aggressive acquisition program does not provide benefits, it appears AWRI's resources have been stretched increasingly thin to the point that it has reduced staff, eliminated routine communication with customers, eliminated convenient means by which customers can contact the company, and has put on hold all repairs not necessary to simply "keep the water flowing." Exh. 1, page 24.

No adjustment to rate base to account for positive Account No. 114 balances at December 31, 1997, is supported by the record. AWRI's proposed rate base addition is rejected.

iii. Used and Useful. AWRI's original case included an adjustment to rate base to account for plant not used and useful in the public service. Staff included no such adjustment in its rate base analysis and says on brief it lacks sufficient data to calculate a used and useful adjustment. AWRI dropped any used and useful adjustment in its rebuttal case. Although AWRI's brief, and the evidence it cites, is equivocal on this point, it appears the rationale is that at least some of "this plant is in service and did have, in many cases, at least one connection." AWRI Brf. At 8. The point in time when these uncertain connections occurred is unclear and AWRI says in a post-hearing filing that it cannot yet confirm that all systems are actively serving at least one customer. What is clear is that some stand-alone systems had "no customers," at the end of the test year, or even at the time AWRI filed for new rates. Exh. T-10 at 8; TR. 229 (Parker).

Although Mr. Ward testified he considers plant used and useful if it is

"available for service," that definition is too broad. AWRI's analogy "to putting in a distribution system to serve customers (whether water, electrical, or telephone) where part of the capacity is not being used because the customers have not hooked up yet," also misses the mark. These six-pack systems are stand-alone facilities; they are not even arguably used and useful until they serve at least one connection. Once the stand-alone system does serve at least one customer, all or part of the required plant can be included in rate base and appropriate adjustments to revenues, expenses, and customer count can be made to account properly for all the variables that must be considered in setting prospective rates. Thus, in the case where there is one active customer connection on a six-pack, it may be appropriate to include the well, the pump, the storage tank, the mains and distribution system, and associated plant in rate base as 100 percent used and useful because the one customer cannot be served without making all that plant operate, albeit not necessarily to its full capacity. In this case, however, some six-packs have no customers on the relevant end-of-period date, and the associated plant need not be operated to serve any customers. The plant is not used and useful and must be excluded from rate base. The amount of this required adjustment is \$15,996, based conservatively on AWRI's as-filed schedules.

In addition to the plant discussed above, AWRI's Exhibit no. 25 shows post-test year in-service dates for other facilities. Consistent with the following discussion regarding post-test year additions to plant not being proper pro forma additions to rate base absent consideration of revenue, expense, and customer count adjustments to match the additional plant, the costs of this plant should be, and are here, removed from rate base. The amount of this required adjustment is \$9,108.

#### iv. 1998 Plant Additions and CIAC

Having achieved an accurate match among relevant factors to determine prospective rates by using end-of-period rate base and customer count, Staff also proposed via Mr. Ward's testimony \$43,780 in additions to rate base to account for post-test year plant additions through June 30, 1998, net of one-half year's depreciation, and \$36,252 net additional CIAC amortization through the same period. Exh. T-60 at 9. Staff proposed no pro forma adjustment to account for additional customers who provided the CIAC and presumably will be served by the additional plant, nor did Staff recommend any offsetting adjustments to revenue or expenses in conjunction with these suggested rate base adjustments. Not surprisingly, AWRI accepted this recommendation without question. Exh. T-15 at 11 (Parker). The record, however, does not support these adjustments to rate base. Indeed, Mr. Ward acknowledged in response to questions from the bench that it was "a mistake on my part to include pro forma adjustments and rate base without considering the full effect of revenue and expenses." Tr.

461. These plant additions and post test period CIAC amounts thus cannot be accepted as valid pro forma adjustments and they are disallowed for purposes of establishing rates in this proceeding.

v. Construction Work in Progress

AWRI and Staff both include in rate base AWRI's per books year end balances for construction work in progress (CWIP). The amount is \$11,903.

Usually, CWIP is not included in rate base. Instead, the company is allowed to capitalize an allowance for funds used during construction (AFUDC) to represent the costs of financing, typically at the authorized rate of return. The Commission, however, "may include the reasonable costs of [CWIP] to the extent the commission (sic) finds that inclusion is

in the public interest." RCW 80.04.250. Here, the projects under construction but not completed at December 31, 1997, all are to improve AWRI's quality, or quantity of service in existing service territories. Accordingly, it is in the public interest to include these costs in rate base and this uncontested treatment is approved.

In light of this treatment, it is important to note AWRI included in its rate base determination \$258 in capitalized interest as AFUDC. Since CWIP is included as a component of rate base and allowed to earn a return that AWRI will recover currently in rates, it is inappropriate for any AFUDC to accrue on CWIP balances or be included in rates as an added cost.

vi. Other Adjustments to Rate Base

a. Vehicle Expense. Small matters sometimes implicate significant principles. Such is the nature of Staff's dispute with AWRI over AWRI expensing or capitalizing costs associated with Mr. Fox's use of his personal vehicle for AWRI business purposes. The total amount in dispute is \$4,455. That the disputed dollars are relatively few cannot be allowed

to trivialize the importance of the principles. Indeed, because AWRI is new to the water utility business and its owner has little experience operating in a pervasively regulated business environment, it is critically important that the Commission scrupulously apply established regulatory principles even when the financial result may seem counter-intuitive to the company and lay observers.

Mr. Fox uses his personal vehicle to conduct AWRI business; this is undisputed. Ms. Parker asserts "Mr. Fox's records [show] that in 1997, he traveled approximately 25,000 miles" on AWRI's behalf. Exh. T-15 at 30-31. At the current state-authorized reimbursement of \$.315 per mile, this amounts to \$7,875. Id. This is significantly more than the dollar amount AWRI proposes to include in rates via this case. Nevertheless, Staff accepts that if AWRI produced documentation to corroborate this asserted business use, a mileage-based reimbursement would be appropriate. Staff Brf. at 9. AWRI, however, neither seeks mileage-based

reimbursement, nor provided to Staff the "log" it asserts exists to substantiate Mr. Fox's business use of his personal vehicle.

Instead of accounting for mileage, AWRI proposes to capitalize and recover over 3 years \$2,867 in repair and replacement part costs and to expense for annual recovery \$1,588 in other costs associated with Mr. Fox's automobile. As Staff points out on brief, to capitalize repair costs for a vehicle AWRI does not own is facially improper. Staff also notes AWRI did not allocate any of the incurred costs to reflect Mr. Fox's personal use; nor is there an allocation to Mr. Fox's other business use even though he operates several businesses in addition to AWRI. It also would be improper to expense costs as AWRI proposes when there is not adequate documentation in the record to support a finding that AWRI has allocated Mr. Fox's automobile related expenses accurately to account for the various uses he makes of his car. Again, despite Staff's formal data request, AWRI did not produce documentation from which appropriate determinations might be made to permit some amount of transportation costs to be included in AWRI's rates to account for Mr. Fox's business use of his personal vehicle.

AWRI alleges Staff would "penalize" AWRI by removing from rates costs associated with Mr. Fox's use of his personal car for AWRI business. Exh.

T-15 at 30. On the contrary, AWRI penalizes itself by insisting on an inappropriate and unacceptable method to account for and recover such costs. The Commission cannot approve a method that fails to differentiate adequately or support by careful records a reasonable allocation of actual expenses incurred when utility owner intermingles his personal affairs with the utility's business and regulatory affairs.

AWRI fails to support its proposed inclusion of transportation/travel expense incurred by AWRI's owner; Staff's adjustments to rate base and expense are accepted to remove the unsupported costs from rates.

b. Reclassified Plant. AWRI proposes to reclassify \$5,110 in plant that, in fact, was expensed during 1996. Given AWRI's 1997 rate case, AWRI already has had its opportunity to recover this \$5,110 in rates whether or not the dollars were accounted for inappropriately at the time of that case. AWRI relies on Ms. Parker's testimony "that the expenses cannot be said to have been recovered in rates because the company operated at a net operating loss." AWRI Brf. at 9 (no citation). The Commission approves rates that provide regulated companies the opportunity to recover costs; there are no guarantees that the companies uniformly will recover 100 percent of their costs every year. Moreover, it cannot realistically be suggested that an overall net operating loss can be tied to a failure to recover some particular cost or even a category of costs. Whether or not AWRI experienced a net operating loss during 1997 simply is beside the point. To include previously expensed costs in rate base upon which prospective rates are determined would be to allow retroactive

ratemaking and that will not be done here. AWRI's proposed reclassification of these expenses is rejected.

c. Contributed Operating Costs. AWRI proposes to include in rate base \$11,555 "to capitalize expenses related to the time and effort of officers in the acquisition of plant." AWRI Brf. at 10 (citing Exh. No. T-10 at 37). According to Ms. Parker's testimony, "AWRI imputes this amount for "time and vehicle costs contributed by member's (sic) of Mr. Fox's family to assist in the operations of the water company." It is unclear from this testimony, the only evidence even arguably on point, that the imputation AWRI suggests has anything at all to do with the "time and effort of officers in the acquisition of plant." No detail is offered with regard to whether the referenced family members actually are officers, what their duties are, what exact contributions they made-- there simply are no facts upon which the claimed capital contribution could be justified even if otherwise allowable. Moreover, there is no accounting justification for the amount claimed.

Finally, even putting aside the absolute lack of supporting evidence, the suggestion to include this adjustment must be rejected because to do so would constitute retroactive ratemaking. Staff Brf. at 10. Contributions of time and effort to AWRI's past operations by Mr. Fox's family--whether they be shareholders, officers, or have no official capacity with the company at all--cannot be included in rates for recovery prospectively. The alleged costs contributed to AWRI's operations during periods Ms. Parker refers to generally as "over the last two years" (Exh. No. T-10 at 36) must be, and are, disallowed.

d. Depreciation/Amortization Reserve Adjustment. Changes in depreciation expense, discussed separately below, require changes to rate base to achieve proper income and rate base relationships and to avoid the company earning a return on the expense. The amount of the required adjustment is \$13,494, derived as discussed below in connection with the depreciation expense adjustment.

e. Allocated Net Common Plant. Staff proposed and AWRI agreed that depreciation of certain common plant should be allocated to SMA activity. This \$1,583 adjustment reflects the allocation of net plant upon which the expense is based.

Consistent with the foregoing discussion, the amount of AWRI's rate base is determined to be \$833,292, as reflected in Table 2.

TABLE 2  
AMERICAN WATER RESOURCES, INC.  
Rate Base Summary  
12 Months Ended December 31, 1997

Description	Amount
Per Books	\$1,053,224
Adjustments:	
RA-12 Deferred Debit Accounts - Capitalized	17,245
PA-18 Capitalized Truck - Net	6,165
RA-13 Capitalized Auto Repairs	(2,708)
PA-20 Net Acquisition Adjustments	(200,194)
Remove CWIP Interest	(258)
Remove plant not in test year service	(25,104)
Depreciation/Amortization Reserve Adj.	(13,494)
Allocated Common Plant (Office Furniture & Equipment)	(1,583)
Total Adjustments	(219,932)
Pro Forma Rate Base	\$833,292

C. Rate of Return. AWRI proposes an overall 13.15 percent rate of return using a hypothetical capital structure including 50 percent debt at 11.31 percent interest and 50 percent equity at 15 percent return. Staff opposes AWRI's proposals and recommends an overall 10.54 percent rate of return using AWRI's adjusted actual capital structure including approximately 94 percent debt at 10.5 percent interest and approximately 6 percent equity at 11.1 percent return. Exh. 51.

1. Capital Structure. AWRI asserts its actual capital structure ought to be "the starting point" in the regulatory equation with due regard taken of the fact that AWRI is financed almost exclusively with "Mr. Fox's money." In fact, AWRI's argument is that the Commission should ignore AWRI's actual capital structure and hypothesize or assume a more ideal capital structure since its all "Mr. Fox's money" anyway. In addition, AWRI proposes blending its actual debt costs at 11.3 percent with a 15.0 percent equity return to produce a 13.2 percent overall return, a return 1.2 percent higher than any Commission-approved water company return mentioned in AWRI's direct case.

Ironically, Staff argues that because AWRI's financing essentially is "Mr. Fox's money," AWRI should be held to the actual capital structure Mr. Fox decided best suits his interests. Staff takes a very pragmatic approach to what AWRI treats as a more theoretical issue. Staff urges reduced debt costs by advocating interest on shareholder loans, which constitute the majority of AWRI's debt, at prime plus two (10.5 percent at end of test year). Actually, it appears from Exhibit No. 51 that Staff uses 10.5 percent for AWRI's overall debt; the practical effect, considering that some of AWRI's third party debt is at 0 percent, 7.5 percent, and 9 percent, is to impute just under 11.2 percent interest to AWRI's shareholder loans. Based on a DCF analysis, Staff urges 11.1 percent return on equity. Using AWRI's actual capital structure, this yields overall return of 10.54 percent.

One indisputable fact is apparent: AWRI's actual capital structure is highly undesirable because it puts the company at high risk of financial failure. In addition, AWRI's extraordinary debt ratio probably makes it impossible for the company to borrow funds in conventional markets or attract equity investment from outsiders. This adds to AWRI's overall business risk. Unfortunately, it is AWRI's customers who must bear the risk; they are the ones most vulnerable in the event AWRI fails financially. The Commission's goal, then, must be to encourage AWRI to change its capital structure to improve the company's financial structure and stability.

Staff argues that using AWRI's actual capital structure in the return equation in this rate case will encourage AWRI to reform its actual capital structure to include more equity which can then be recognized in AWRI's next rate case. Conversely, Staff argues, to apply the hypothetical capital structure AWRI proposes now does nothing to encourage AWRI to actually reform its capital structure. Staff's argument is persuasive.

Staff's argument, indeed, might be thought of as the proverbial "stick" that keeps AWRI's overall return lower by recognizing less than 10 percent of the company's capital for equity return purposes. AWRI might be additionally encouraged to actually reform its capital structure if the proverbial "carrot" is used in equal measure. This can be accomplished by sending an encouraging signal that the Commission does expect AWRI to balance debt and equity and will reward that decision. Adopting a hypothetical capital structure between AWRI's actual debt to equity ratio and the 50/50 ratio it urges on brief serves that end without unduly rewarding AWRI in advance for steps the Commission expects the company to take in the near term. Accordingly, a hypothetical 80/20 debt to equity ratio is adopted for purposes of this Initial Order. Further adjustments in future cases may depend on whether AWRI responds meaningfully to the incentive provided here by imputing a more favorable capital structure than exists in fact.

2. Debt Cost AWRI's actual debt cost is driven largely by \$936,347 in loans from Mr. Fox, nominally paying 12 percent interest. Mr. Fox testified AWRI pays him \$10,000 to \$11,000 per month in interest, yet \$936,347 in principle at 12 percent annual interest ought to pay only \$9,364 per month. Either Mr. Fox testified inaccurately, or AWRI actually is paying Mr. Fox between 12.5 and 13.8 percent interest. AWRI's remaining debt consists of seller financing at 7.5 and 9 percent interest on certain water systems AWRI has acquired and additional small amounts of debt bearing no interest. AWRI says its weighted debt cost is 11.31 percent and proposes to use that rate as its cost of debt in this case. AWRI Brf. at 13; Exh. 11, page 4.

Staff argues that AWRI fails to "directly support the use of the 12% rate" for shareholder loans. Staff Brf. at 14. Staff says the proposed rate reflects self-dealing and irresponsibility toward AWRI's customers whose interests should be balanced against those of AWRI's investors, keeping in mind that Mr. Fox owns 90-plus percent of the outstanding shares.

AWRI failed to present any evidence that 12 percent is a market rate. Indeed, the only evidence AWRI cites on brief is "[t]he testimony from Mr. Fox has been trying to attract investment and find banks that were willing to loan, but he cannot find them." AWRI Brf. at 13 (citing TR. 420). In fact, the cited testimony is Mr. Kermode's acknowledgment, in connection with cross-examination related to the equity component to be included in AWRI's rates, that Mr. Kermode is aware that Mr. Fox has not succeeded in attracting outside investors. There is no mention of banks or loans and the evidence in no way supports AWRI's position on debt.

Staff proposes 10.5 percent interest on AWRI's debt to Mr. Fox, two hundred basis points above the prime rate at the time Mr. Kermode filed his testimony. In support, Staff notes AWRI's non-affiliated debt is between 7 and 9 percent, argues that AWRI's risk profile is an artifact of self-dealing that necessarily suits the lender but necessarily, too, is uncritically accepted by AWRI, and the need to provide an incentive to AWRI to reduce its debt in favor of equity.

Staff's arguments highlight the point that AWRI failed to present any objective evidence to justify the interest rate on shareholder debt it proposes to include in AWRI's capitalization. Under the circumstances, Staff's proposed 10.50 percent interest for notes payable to AWRI's owner is reasonable and is accepted as the appropriate rate. Considering AWRI's debt structure as reflected in Exhibit 11 at page 4, and applying the indicated costs of non-shareholder debt, yields a 9.91 percent overall weighted cost of debt and that figure is accepted.

3. Equity Return. AWRI recommends a 15 percent return on equity because the company is small and because, AWRI claims, the Commission has allowed that same level for other small water companies in the past. Neither point is developed on brief beyond observing that small companies typically are more risky than large, publicly traded companies. AWRI focuses its argument not on any evidence that might affirmatively carry its burden to support a 15 percent return on equity, but rather on why Staff's reliance on discounted cash flow (DCF) analysis to recommend an 11.1 percent return on equity is flawed.

Staff points directly to AWRI's only evidence regarding return on equity, Ms. Parker's brief testimony that she relied on a hypothetical capital structure analysis sometimes used by Commission staff in cases where no information exists regarding a company's actual capital structure



(Exh. T-10 at 52-53 and T-15 at 44). Ms. Parker says this approach yields a "hypothetical 12% rate of return" including a 14% return on equity to which she added "a 1% premium . . . to reflect the extreme risk of investment . . . due to this being a start-up company in an extreme period of growth." As Staff says, AWRI does not tie Commission staff's past use of this hypothetical approach to the circumstances of this case and thus fails to demonstrate why it would be appropriate to rely on the approach here. AWRI's brief cites no precedent in which the Commission relies upon this hypothetical analysis and although Ms. Parker identifies several cases on rebuttal the record includes no information from which it might be ascertained whether the assumed 14 percent equity return used in those cases already is adjusted for risk. Moreover, in the cited cases, it appears Commission staff and the companies negotiated hypothetical capital structures in the context of overall settlement agreements. Those negotiated results, as related by Ms. Parker, included interest on debt between 8 and 10 percent and return on equity at 14 percent. Yet, here AWRI proposes to blend what it claims is its actual debt cost, 11.31 percent including substantial loans from AWRI's owner at 12 percent, with a 15 percent return on equity ungrounded by conventional approaches to equity return analysis.

Staff relies on Mr. Kermode's DCF analysis to propose an 11.1 percent return on equity. Exh. T-50 at 21-23; Exh. 52. AWRI mounts no challenge to the analysis per se, but criticizes the approach as inappropriate to determine equity return in small water company cases. AWRI Brf. at 14. Indeed, it is accepted generally, and Mr. Kermode accepts, that DCF analysis involving larger, publicly traded companies usually is no more than a starting point; typically, the resulting return figure is adjusted upward to account for the higher return investors demand when purchasing shares in higher risk ventures. Mr. Kermode testified: "[n]ormally, I would use [DCF computed return] as the base and adjust by one point to recognize the difference between national and small water companies." Exh. T-50 at 22-23. He declined to make that adjustment here because he believes "the company should earn at the reduced level until such time the Staff determines that the company accounting and reporting functions have improved to the level expected from a company of this size." Exh. T-50 at 23.

The evidence shows AWRI's accounting and other records remain less than fully satisfactory in many areas and more seriously deficient in some important regards. Exh. T-15 at 3-5 (Parker); Exh. T-50 at 23 (Kermode); Tr. 154-56, 211 (Parker). AWRI, however, appears to be making conscientious efforts to improve this situation, including hiring personnel with appropriate experience to manage the company and improve its records keeping function. Mr. Kermode recommends the Commission require AWRI to submit quarterly financial reports that Staff can review for proper accounting procedure, methodology, and timeliness. Exh. T-50

at 23-24. Although AWRI resists this idea, it appears it would benefit the company and improve its focus on the advantages of cooperation and compliance in a fully regulated environment. The reporting will be required.

It is desirable to allow AWRI a sufficient return on equity to encourage the company to move toward a balanced capital structure. That not only will benefit AWRI and its customers by establishing a more stable company, it will make AWRI more attractive to third party investors and will assist AWRI to secure outside debt financing at favorable rates. AWRI must achieve these goals in the near term if it truly wishes to be a viable company over the long term.

Balancing the pertinent facts and the Commission's policy goals, and considering Staff's DCF analysis the best starting point, a 12.6 percent return on equity is appropriate for AWRI at this time. This 150 basis point upward adjustment to the return indicated by Mr. Kermodé's DCF analysis of larger, publicly held water companies recognizes the inherently higher risk posed by a small, growing company, but does not reward the even higher risk posed by AWRI's decision to heavily weight its actual capital structure with debt.

Table 3 summarizes the return authorized in accordance with the preceding analysis and discussion.

TABLE 3  
AMERICAN WATER RESOURCES, INC.  
Rate of Return Summary

Description	Ratio	Cost Rate	Weighted Debt	80.00%
Equity	9.91% 7.93%	12.60%	2.52%	
TOTAL	100.00%	10.45%		

D. Operations and Maintenance Expense

Table 4 summarizes AWRI's and Staff's positions with regard to revenues, and operations and maintenance expenses. The table reflects contested and uncontested adjustments to the per books amounts and shows the differences that separate AWRI and Staff. The uncontested adjustments are found to be supported by the record and these should be approved.

TABLE 4  
AMERICAN WATER RESOURCES, INC.  
Comparison of Company and Staff Positions  
Operating Revenues, Expenses and Income for the 12 months Ended December

31, 1997

Line No.	Description	Amount	Staff
1	Difference		
2	Per Books Operating Revenues:	\$392,637	\$392,637 0
3	Uncontested Adjustments (Proforma less Per Books):		
4	PA-1 Annualize revenue at current rates	187,845	187,845 0
5	PA-2 Annualize fireflow & misc. Revenue	14,748	14,748 0
6	Total Adjustments	202,593 202,593 0	
7	Total Pro Forma Revenue at Present Rates		595,230 595,230 0
8			
9	Per Books Operating Expenses before FIT (Bench Req. 3):	432,703	432,703 0
10	Uncontested Adjustments (Proforma less Per books):		
11	Chemicals & Testing	5,974 5,974 0	
12	Materials & Supplies	(750) (750) 0	
13	Repairs & Maintenance	526 526 0	
14	Engineering (3,579)	(3,579) 0	
15	Legal (2,007)	(2,007) 0	
16	Postage	7,480 7,480 0	
17	Telephone	250 250 0	
18	Transportation-fuel/other	2,523 2,523 0	
19	Transportation-RM	1,134 1,134 0	
20	Regulatory Commission Expense	943 943 0	
21	Bad Debt Expense	595 595 0	
22	Property Tax	(16,710) (16,710) 0	
	DOCKET NOS. UW-980072, -980258, -980265 (consolidated) and UW-980076		
23	Sub-Total Uncontested Adjustments:	(3,621) (3,621) 0	
24	Contested Adjustments (Proforma less Per Books):		
25	Salaries & Wages	65,111 46,994 18,117	
26	Purchased Power	9,772 7,900 1,872	
27	Accounting (5,615)	(11,615) 6,000	
28	Janitorial	(24) 24	
29	Rent	1,595 (181) 1,776	
30	Insurance	1,498 1,366 132	
31	Education/Dues	(37) 37	
32	Meals/Entertainment	(1,313) 1,313	
33	Meetings & Seminars	(84) (727) 643	
34	Other (43) (48) 5		
35	Travel	(927) 927	
36	Office Expense	(9,499) (12,694) 3,195	
37	Printing	1,767 1,630 137	
38	Excise Tax	30,633 29,934 699	
39	Depreciation Expense	23,868 12,951 10,917	
40	Amortization-Def. Exp.	1,582 1,028 554	
41	Rate Case Expense	54,417 7,417 47,000	
42	Payroll Tax	3,261 1,830 1,431	
43	Sub-Total Contested Adjustments	178,263 83,484 94,779	
44	Total Adjustments	174,642 79,863 94,779	
45	Pro Forma Operating Expenses Before FIT	607,345 512,566	94,779

46	Pro Forma Operating Income Before FIT	(12,115)	82,664
	(94,779)		
47	Less: Federal Income Tax Expense	(6,303)	694 (6,997)
48	Pro Forma Net Operating Income	(\$5,812)	\$81,970 (\$87,782)

1. Salaries and Wages. According to the parties' jointly prepared post-hearing list of contested amounts for various operating expenses, AWRI advocates \$226,096 and Staff \$207,979 for salaries and wages. AWRI includes salaries and wages for eight employees; Staff's analysis includes six employees. The difference in number of employees reasonably required to serve 1,730 customers on approximately 150 systems is attributable to an apparent misunderstanding between Mr. Fox and Mr. Kermode regarding the "minimal" number of employees versus the "optimal" number of employees. The source of the miscommunication is unimportant. Staff's goal is to allow adequate salary and wages in AWRI's rates to permit adequate or "optimal" staffing to ensure good customer service, adequate systems maintenance, and a well-run, efficient water company generally. Exh. T-50 at 12-13 (Kermode). AWRI says it needs \$226,096 to employ adequate personnel to meet those objectives. Considering the two additional employees AWRI says are necessary, the \$18,117 difference between AWRI's and Staff's bottom lines disappears.

AWRI's proposed amount for salary and wages is approved. How AWRI allocates these dollars among individual employees is something AWRI management will decide being mindful of its duty to staff its operations adequately to provide improved quality of service to its customers and to conduct its operations, including accounting and records keeping functions, in accordance with the Commission's regulatory requirements. The Commission, of course, will have opportunities in future rate cases to consider the prudence and reasonableness of AWRI's decisions.

A contentious issue at hearing is the appropriate amount of salary to be paid Mr. Fox. The Commission allowed \$41,000 for Mr. Fox's annual salary in AWRI's last rate case, yet AWRI paid Mr. Fox \$60,000 during the test year. This robs revenue from functions or facilities that might benefit customers more directly than the activities Mr. Fox performs. Insofar as Mr. Fox's experience operating a public utility is concerned, it is very limited. Much of Mr. Fox's time appears to be spent analyzing and negotiating investment prospects rather than in day-to-day company operations. TR. 309-310, 326 (Fox). Roughly half of the money he has invested in AWRI via loans or otherwise has been used for acquisitions. TR. 337 (Fox). Mr. Fox's activities in connection with AWRI business clearly have as much, or more, to do with protecting and ensuring a return on Mr. Fox's significant loans to AWRI as they do with the company's operation in the public interest. During the next rate cycle, as AWRI decides how to actually spend the revenues allowed through this rate case, AWRI would do well to be particularly careful in decisions regarding who

is compensated to do what. Staff's suggestion that \$30,000 be allowed in rates does not denigrate Mr. Fox's business acumen, or suggest that he should not be compensated for his work. It does suggest that Mr. Fox as AWRI's chief executive officer must recognize that much of the 40 hours, or 60 hours, or 80 hours a week he spends "playing business" (TR. 338 (Fox)) is for the benefit of Mr. Fox as private investor, not for the benefit of AWRI and its ratepayers. He is compensated not by salary, but in other ways, for his financial interests in AWRI.

2. SMA Allocations. AWRI says it allocated expenses to its Satellite Management Agency (SMA) activities and adjusted the "per books" amounts presented in its various ratemaking schedules. Exh. T-15 at 37 (Parker). In other words, AWRI removed SMA costs before it addressed the company's operations via Ms. Parker's testimony. AWRI Brf. at 20. Ms. Parker explained in detail AWRI's two types of SMA activities and the detailed procedure followed to allocate costs to those activities. Exh. T-15 at 37-44. AWRI's methodology includes direct allocations of some expenses (e.g., utilities, chemicals, repair and maintenance), allocation based on percent of employee hours for some expenses (i.e., wages-field, wages-office (partial)), and allocation based on percent of customers for other expenses (e.g., wages-office (partial), rent, insurance). Ms. Parker acknowledged on rebuttal that she failed inadvertently to allocate meetings and seminars and depreciation accounts for office equipment and one vehicle.

Staff mistrusts AWRI's SMA allocations principally because Staff felt it was not provided data in a form permitting audit. Staff Brf. at 20. Still, Staff apparently was able to back out AWRI's SMA allocations and then apply its own method, using a single allocation factor based on customer ratios to all relevant expenses. Staff also asserts AWRI failed to allocate insurance, rent, and several other expense categories. Id. Ms. Parker's testimony, however, shows that she did allocate in these categories, though some difference remains between AWRI and Staff on appropriate amounts for insurance (\$132), janitorial (\$24), education/dues (\$37), meals/entertainment (amount not segregated), meetings/seminars (amount not segregated), other (\$5), travel (amount not segregated), office expense (amount not segregated), and printing (\$137). Exh. T-15 at 40-43; post-hearing stipulation re amounts that remain in dispute.

On this issue, as on several others, principles are as important, perhaps more important, than the relatively few dollars at issue. The controlling principle here is that AWRI's more detailed analysis is preferred over Staff's workable, but less detailed approach. The Commission's interest in allocation methodology when a company's operations include both regulated and unregulated activities is heightened during this period of deregulation in several utility sectors. Generally, there should be a preference for more precise methodologies and measures. Where costs can be directly assigned, that should be done. Where allocation factors must be used, these should relate to the nature of the cost incurrence. In furtherance of these principles, AWRI's SMA

allocation methodology and results are accepted for purposes of this case. The parties' stipulated results reflect in AWRI's column appropriate allocations for the two overlooked depreciation categories and the meetings/seminars category.

3. Rate Case Expense. Originally, Ms. Parker testified the company estimated total rate case expense incurred in this case at \$25,000. She described this amount as one that "may seem high," as, indeed, it does. Ms. Parker testifies the high cost is attributable to the joint hearing of "four contested dockets" and what she considers the "burdens" placed on the company by Staff's data requests and other inquiries. Ms. Parker goes on for five pages in her prefiled direct testimony detailing the discovery process and concludes "we have all been a victim of the regulatory process." This unfortunate characterization of the Commission's performance is not supported by objective evidence.

Six weeks later, two weeks after Staff filed its testimony, AWRI filed rebuttal testimony and revised its current rate case expense figure by doubling it to \$50,000. Ms. Parker testified "[t]his increase is mainly caused by the contentiousness, and the punitive nature of staff's testimony." Exh. T-15 at 37. This is the only "support" AWRI offered at the time for its proposed doubling of rate case expense. AWRI's characterization of Staff's case again is inapt.

After the hearing, AWRI submitted, with Staff's apparent acquiescence, a schedule purporting to show actual rate case expenses incurred through September 30, 1998, totaling \$40,230. AWRI says it anticipates another \$9,500 to complete this case through the administrative review process. Since both AWRI and Staff refer to this late-filed data, it will be considered, but its probative value is diminished by its unaudited nature and by the fact that there was no opportunity for inquiry regarding specific costs. The one cost item that can be audited in a rough sense is discovery. Staff relates on brief that the company reported \$2,612 in actual costs to respond to Staff's data requests, yet includes \$7,932 in accounting costs in the discovery category of its late-filed rate case expense schedule. Staff says on brief it "is at a loss to imagine where the remaining \$5,200 of costs was incurred for this category of expense."

AWRI not only doubled the amount it requests be included in rates for rate case expense, it also proposes the full amount for recovery in one year, in addition to its presently approved rate case expense allowance of \$4,417. This contrasts to AWRI's original proposal to amortize rate case expense over three years. AWRI's rationale for this request is that "[t]he recommendations of staff force the company to plan for annual rate proceeding[s]."

"Staff's position is that the hearing in this case, including the necessity of preparing and filing testimony, would have been avoided [if]

the company's records were reasonably organized and kept in a fashion that allowed audit with a reasonable amount of effort." Staff Brf. at 21. Staff points to the confused state of AWRI's books, including significant modifications AWRI continued to make for six months following its rate filing.

It appears AWRI incurred in the range of \$35,000 to \$40,000 in rate case expense through the evidentiary phase; AWRI may or may not incur additional costs before the Commission's final order. Although less contentiousness and better records might have reduced these costs, contentiousness typically is the product of less than fully cooperative behavior and strong personalities on both sides of litigated matters, and there usually is room for legitimate debate regarding the adequacy of records for various purposes. Parties who must appear before the Commission must not be discouraged from exercising their full panoply of due process rights. Accordingly, AWRI should be allowed the opportunity to recover in rates its duly incurred costs to the extent fully supported by the record. Taking into account the untested nature of AWRI's late-filed rate case expense schedule and the appearance of inflated amounts in at least one category, and being unwilling to accept AWRI's speculation that the company may incur yet another nearly \$10,000 in rate case expense, the amount allowed is \$36,000 to be amortized over three years with no rate base treatment for the unamortized balance.

#### 4. Other Disputed Expense Categories

a. Purchase Power. Both AWRI and Staff based their purchase power expense calculations on the last three months of the test year. AWRI annualized the expense in its initial testimony but adjusted for seasonality on rebuttal, nominally responding to Mr. Kermode's expressed concern that there might be some seasonal factor. Staff annualized the expense but made no adjustment for seasonality. The result is a \$1,872 difference: AWRI asks for \$43,194 while Staff insists on \$41,322.

Mr. Kermode did express concern Staff's approach might underestimate AWRI's power costs, but stuck with his methodology when comparisons to another water company's annual expense showed no significant seasonal variation. Exh. T-50 at 14; TR. 388. AWRI says the company Mr. Kermode compared is not representative because one system examined serves over 100 customers and the other over 300 customers. AWRI Brf. at 25 (citing TR. 410 (Kermode)) AWRI, by contrast, serves its customers through a mix of several larger systems and numerous small systems. AWRI asserts its small systems' pumps run almost continuously during the summer months, raising AWRI's purchase power costs relative to larger systems.

AWRI tested the seasonality concept by reviewing its actual experience during the first eight months of 1998. Ms. Parker testified on rebuttal that she found a seasonal variation in power consumption. She adjusted AWRI's power costs, however, by using the actual experience in 1998, reflecting \$4,066 in average costs per month, roughly the same amount she

reported for July and August, 1998. These amounts may reflect seasonality, but they also may reflect higher customer counts and an atypically dry summer. Thus, the amount of AWRI's seasonality adjustment is not adequately supported.

On balance, Staff's purchased power amount based on AWRI's actual experience during the last three months of the test year is the better supported amount. A better substantiated seasonal affect, if any, may be recognized in a future proceeding. In this case, Staff's amount, \$41,322, is accepted.

b. Accounting Services. AWRI advocates including outside accounting expense in prospective rates at the level Staff says actually were incurred and properly expensed during the test year, \$10,642. AWRI Brf. at 25; Exh. T-50 at 6-7 (Kermode). Staff, however, advocates a pro forma adjustment to reduce this by \$6,000 on the theory that the addition of Ms.

Ingram to AWRI's staff will reduce the need for outside accounting services. There is no testimony or other evidence, however, to support either the theory or amount of Staff's proposed adjustment. The only hard

fact on this point is what AWRI actually incurred in the test year and accounted for during that period in the fashion Staff advocates. AWRI proposes no prospective increase in outside accounting costs. AWRI's outside accounting expense figure is reasonable and is allowed.

c. Rent. The rent issue involves yet another affiliated transaction and thus requires special scrutiny. AWRI pays rent to Birchfield Ranch, Mr. Fox's home where he maintains an office. During the first half of 1997, AWRI paid \$300 per month for the space at Birchfield Ranch. During the second half of 1997, this doubled to \$600 per month and now AWRI proposes that \$700 per month be included in rates to reflect this expense. AWRI suggests these increases are justified by the facts that a warehouse and machine shop at Birchfield Ranch also are available for AWRI'

s use, but there is no indication that these facilities became available for the first time in mid-1997, or later, in consideration of increased rent. AWRI characterizes its proposed rent as "very reasonable" on its face and describes the proposed increase as "modest." It really is not possible to judge from the evidence presented whether the proposed rent is

facially reasonable or not; there simply is not adequate detail regarding the space in Mr. Fox's home, warehouse, and machine shop or the proportionate use of these spaces for AWRI business relative to Mr. Fox's use of the space for his other businesses or for personal interests.

Ms. Parker testified the local market for office space in the nearest town is \$13.50 per square foot. Exh. T-10 at 39. Mr. Kermode testified that AWRI's space at Birchfield Ranch works out to \$10.29 per square foot at the test-year-end rate of \$600 per month, but notes the actual office is not in town, it is in a remote location. By objective measures such as present rates of inflation, AWRI's proposed 17 percent pro forma increase in rent hardly seems "modest." This description seems particularly



inappropriate when the 100 percent increase in rent in mid-year 1997 is considered. Absent a showing that the proposed \$100 increase represents the addition of space or intensified use by AWRI of existing, shared space, the increase is unsubstantiated and is disallowed. AWRI is allowed

\$600 per month for its office space. The need for an additional \$600 annual amount for the use of Mr. Fox's private home office is unsubstantiated and is disallowed.

d. Meals/Entertainment, Meetings/Seminars, Transportation/Travel, Other (miscellaneous). AWRI proposes to include in expenses \$1,473 it claims are actual meals and entertainment expenses incurred during the conduct of AWRI's business. AWRI offered no supporting records.

Although

it may be true, as AWRI maintains, that the IRS does not require receipts for individual expenditures under \$25, the Commission requires some record

to support every expenditure; Staff suggests standardized expense reports "requir[ed] to be used by all employees." Staff Brf. at 25. Staff argues that absent supporting records, meals and entertainment expenses should be

disallowed. Staff finds \$177 (before adjustment for SMA allocation) in such expenses adequately supported.

No one suggests AWRI "[throws] lavish parties [or wastes] ratepayers' money on meals and entertainment." AWRI Brf. at 27. Yet, AWRI is a closely held business; it virtually is a one-man operation in terms of decision making authority and expenditure control. AWRI's record keeping demonstrates a lack of care in distinguishing between Mr. Fox's personal affairs, Mr. Fox's other business affairs, and AWRI's business affairs. AWRI claimed documentation to reflect Mr. Fox's day-to-day activities exists, but it was not produced. Exh. T-15 at 28. Under such circumstances the Commission must adhere strictly to policies that ensure AWRI pays only expenses adequately confirmed by records to relate to AWRI's

business conducted for the benefit of its customers. Staff's adjustment

to AWRI's proposed level of meals and entertainment expense is adopted with SMA reallocation based on AWRI's allocation factor.

The same arguments and principles apply to AWRI's claimed expenses for

meetings and seminars, and "other" expense. AWRI claims \$910 for meetings

and seminars, but provided support satisfactory to Staff for only \$295 (before adjustment for SMA allocation). Staff's adjustment to AWRI's proposed level of meetings and seminars expense is adopted with SMA

reallocation based on AWRI's allocation factor. AWRI claims \$463 for "other." Staff does not dispute the figure except for the SMA allocation factor.

The following pro forma levels are allowed: meals and entertainment, \$162; meetings and seminars, \$270; travel, \$138; and "other," \$463. These amounts reflect Staff's adjustments with SMA reallocation based on AWRI's

allocation factor.

The expense part of AWRI's claimed transportation costs is discussed above under rate base. It is sufficient to note again here that AWRI must keep adequate records to support all categories of expense if it proposes to recover such expenses in rates. AWRI failed to maintain such records in the transportation category.

e. Office Expense. AWRI proposes to include its test year, per books, office expense, \$12,727, including \$2,600 paid for part-time secretarial expense. If, as AWRI claims, this is not a non-recurring expense because the services will be required on an ongoing basis, the proper treatment is to include the expense in salaries and wages. Staff says "the adjustment to wages includes the additional cost of office personnel. It is unclear whether Staff means included under its proposed wages, under AWRI's proposed wages, or both. In any event, this order accepts AWRI's salaries and wages and Ms. Parker's testimony establishes that AWRI does include the cost in that category. Exh. T-15 at 28, 32. Accordingly, Staff's adjustment to remove this cost from office expense is appropriate and is adopted subject to SMA reallocation.

f. Excise Tax. AWRI and Staff agree the company should recover from customers the amount of any excise tax related to facilities charges and service connections. AWRI advocates including these one-time per customer charges in monthly rates. Staff advocates the tax should be collected as a separate line item charged to individual customers at the time they pay the associated fee.

The amount involved, \$699, does not justify a substantial change in tariff authority that would be required to implement Staff's recommendation. AWRI's approach falls within generally accepted accounting and ratemaking procedures and is accepted as the better approach at this time.

g. Depreciation. Although the parties remain approximately \$11,000 apart on depreciation expense, much of the difference is accounted for by acquisition adjustment amortization (\$5,774), contributed operating costs (\$2,174), and capitalized costs for repairs to Mr. Fox's automobile (\$956), all issues previously decided. Because none of these costs should be included in rate base, the associated depreciation expense (\$8,904 according to AWRI) is excluded.

The remaining difference between AWRI and Staff results from the parties' different approaches to SMA allocation and different approaches to calculating depreciation. As previously discussed, AWRI's SMA allocation method is accepted for purpose here. Staff proposes a composite depreciation rate. AWRI's more detailed approach to

depreciation, considering individual lives of particular assets is preferred over Staff's composite approach. AWRI's methodology is adopted.

The allowed pro forma depreciation expense is calculated using the annualized depreciation per Exhibit no. 25, as revised in response to Bench Request 1, adjusted by the following: (1) decrease by \$543 for plant not used or useful during the test year; (2) increase by \$1,370 for truck depreciation; (3) decrease by \$434 for SMA allocation of common plant; (4) decrease by \$956 for disallowed capitalized repairs. There also is an offsetting adjustment to account for CIAC amortization. The resulting pro forma level is \$47,995. Compared to per books depreciation, \$33,816, the required adjustment is \$14,179.

This adjustment is reflected in rate base through the depreciation/amortization reserve account. There is a \$685 difference because the addition to rate base for AWRI's new truck is net of one-half year depreciation.

h. Amortization. AWRI says the \$554 difference between the parties on amortization expense includes \$134 related to Staff's objection to AWRI's proposed reclassification of plant. Since that reclassification is disapproved, AWRI's amortization expense should be reduced by that amount. The balance, \$419, reflects the difference between AWRI's proposal to amortize legal and accounting costs associated with facilities acquisition over 10 years while Staff proposes a 30 year amortization period. Staff's proposal matches capitalized legal and accounting expenses to the life of the associated plant. This sound accounting policy and practice is adopted. AWRI's amortization expense should be reduced another \$419 to reflect Staff's adjustment.

Table 5 portrays the pro forma results of operations allowed in accordance with the foregoing discussion.

TABLE 5  
 AMERICAN WATER RESOURCES, INC.  
 Results of Operations Summary for the 12 months Ended December 31, 1997

Line No.	Description	Amount
1		
2	Per Books Operating Revenues:	\$392,637
3	Uncontested Adjustments:	
4	PA-1 Annualize revenue at current rates	187,845
5	PA-2 Annualize fireflow & misc. Revenue	14,748
6	Total Adjustments	202,593
7	Total Pro Forma Revenue at Present Rates	595,230
8		
9	Per Books Operating Expenses before FIT (Bench Req. 3):	432,703
10	Uncontested Adjustments:	
11	Chemicals & Testing	5,974

12	Materials & Supplies	(750)
13	Repairs & Maintenance	526
14	Engineering	(3,579)
15	Legal	(2,007)
16	Postage	7,480
17	Telephone	250
18	Transportation-fuel/other	2,523
19	Transportation-RM	1,134
20	Regulatory Commission Expense	943
21	Bad Debt Expense	595
22	Property Tax	(16,710)
23	Sub-Total Uncontested Adjustments:	(3,621)
24	Contested Adjustments:	
25	Salaries & Wages	65,111
26	Purchased Power	7,900
27	Accounting	(5,615)
28	Janitorial	0
29	Rent*	(103)
30	Insurance*	1,281
31	Education/Dues	0
32	Meals/Entertainment*	(1,311)
33	Meetings & Seminars*	(724)
34	Other*	(43)
35	Travel*	(925)
36	Office Expense*	(12,580)
37	Printing*	1,623
38	Excise Tax	30,633
39	Depreciation Expense	14,179
40	Amortization-Def. Exp.	1,028
41	Rate Case Expense	16,417
42	Payroll Tax	3,261
43	Sub-Total Contested Adjustments	120,132
44	Total Adjustments	116,511
45	Pro Forma Operating Expenses Before FIT	549,214
46	Pro Forma Operating Income Before FIT	46,016
47	Less: Federal Income Tax Expense**	(3,006)
48	Pro Forma Net Operating Income	\$49,022

\*SMA portion based on Company allocation factor

\*\* Federal Income tax calculated based on income before FIT less pro forma interest from authorized weighted cost of debt applied to allowed rate base.

E. Revenue Requirement. Based on the above determinations of rate base, results of operations, and rate of return, AWRI has the following revenue requirement:

TABLE 6	
AMERICAN WATER RESOURCES, INC.	
Revenue Requirement Calculation	
Pro Forma Rate Base	\$833,292
Authorized Rate of Return	10.45%
Net Operating Income Requirement	87,057
Pro Forma Net Operating Income	49,022
Net Operating Income Deficiency	\$38,035

Conversion Factor\* 0.80475  
Revenue Requirement Deficiency \$47,263

\*Conversion Factor Calculation:

Revenue 1.00000  
Expenses:  
WUTC Fee 0.00200  
Uncollectibles 0.00100  
Public Utility Tax @5.029% of Rev. Less Uncollectibles 0.05024  
Sub-Total Expenses 0.05324  
Revenue Less Expenses 0.94676  
Federal Income Tax @ 15% 0.14201  
Conversion Factor 0.80475

F. Rate Design. AWRI and Staff agree in principle to an inverted block rate design, but their proposals are very different in implementation and with respect to other important principles. AWRI proposes to maintain its existing rate design which includes a base rate for up to 400 cubic feet (2,992 gallons) and consumption rates per 100 cubic feet that ratchet up at 800 cubic feet (5,984 gallons) and 1,500 cubic feet (11,220 gallons). The basis for this rate design is unclear. Although it does reflect generally the sound policy of encouraging water conservation, there is no evidence that the proposed blocks are based on any study of usage patterns or otherwise have any rational basis in fact. Moreover, since customers' bills only show the base charge plus a single line indicating "overage," the increasing block rates at 800 cubic feet and 1,500 cubic feet send no specific price signal to those who might be influenced to conserve if they could avoid charges in the next higher block without sacrificing too much consumption during the following rate period.

One thing clear from the customers' testimonies is that they do not like, indeed they resent, having to pay a base rate that includes the cost of 400 cubic feet of water. TR. 47, 49-50 (Brownell), 62 (Walker), 113-14 (Tompson), 499 (Oniel), 537 (Pettit). Again and again, customers complained that it is impossible for anyone to live on a 400 cubic feet per month level of water consumption no matter how conservation minded. These customers apparently would prefer a base rate reflecting consumption at a level that reasonably reflects what a conservation minded user might reasonably require, not at a level clearly below the minimum consumption necessary to meet even basic needs. That, of course, would mean a relatively higher base rate for all customers. Customers who wish to conserve and pay less do not have that option and effectively subsidize other customers who do not choose to conserve or simply have higher water demands due to family size or particular needs. Customers on fixed incomes who need most to control monthly expenditures are hardest hit by high base charges that include costs associated with higher levels of consumption that may bear no relationship to individual needs.

Staff recognized this dilemma and proposes a base rate for zero consumption with a per 100 cubic foot charge that ratchets up only once, at 1,500 cubic feet. Staff says there is not sufficient data to support multiple blocks. Staff's rationale for its proposal is that customers on fixed incomes who elect to conserve or leave their homes for periods of time will thereby benefit by paying a reduced base charge relative to a base charge that includes 400 cubic feet, or some other base amount before the consumption rate kicks in.

Staff's proposal has merit in that it gives customers the ability to control through their consumption decisions the amount of their bill above a relatively modest base charge. A zero consumption base rate rewards those who conserve. The zero consumption rate design sends a clear signal that what a customer pays depends directly on what the customer consumes, beginning with the first cubic foot. The rate design thus recognizes quality of service problems; customers who find AWRI's water unfit to drink or to prepare food and who purchase bottled water for those uses will see their AWRI bills match more closely their remaining consumption for bathing, clothes washing, and other uses. Beyond quality of service driven decisions to use less water, the zero consumption base charge rate design promotes conservation generally in a more positive way. The simple message "use less, pay less" is easily understood, yet customers are not put under the impression that they should meet an unrealistically low consumption volume (i.e., 400 cubic feet per month). Finally, it is important for customers to recognize that water cannot be delivered without cost, and costs should be borne by those who cause it to be incurred. Those who use more should pay more; those who elect to install water intensive landscaping, irrigate gardens, maintain farm animals, or engage in other activities that require large volumes of water must bear the costs. Including volumes more or less arbitrarily in base charges shifts some costs from higher volume users to lower volume users creating a cross-subsidy the effects of which cannot be measured and corrected absent accurate and detailed data upon which a more sophisticated rate design depends. Such data are not presently available.

Staff's proposal includes an increased consumption rate for amounts over 1,500 cubic feet per month. Given the paucity of data, a lack Staff notes in its brief, it is impossible to know what impact a higher block rate might have on AWRI's revenues. Accordingly, the proposal is rejected. Average consumption multiplied by number of customers yields total consumption. A single consumption billing rate based on that simple algebra best matches rates to revenue requirements. Data should be developed for future cases that will permit more detailed rate design analysis.

Two additional points require brief discussion. First, AWRI's practice

is to bill in 100 cubic foot increments, rounding up to the next 100 cubic feet at 101 cubic feet, 201 cubic feet, and so forth. A customer who uses 401 cubic feet of water (2,992 gallons) should not have to pay for 500 cubic feet (3,740 gallons). AWRI's "rounding up" practice is unacceptable. AWRI is required to change its billing practices. Customers' bills are to be based on actual consumption to the nearest ten cubic feet, or cubic foot, whichever is the smallest unit that can be read from individual meters. If 100 cubic feet is the smallest measurable increment, AWRI still is required to round to the nearest 100 cubic feet (i.e., 1 - 149 cubic feet consumed equals 100 cubic feet billed; 150 - 249 cubic feet consumed equals 200 cubic feet billed, and so forth).

Second, some witnesses suggested AWRI may not read their meters and bill on a regular 30 or 31 day cycle to coincide with calendar months. Instead, at least on some occasions, AWRI recorded consumption over longer periods. This inflates the volume upon which a customer's bill is based, perhaps even pushing the bill into the next higher inverted block. By moving to a zero consumption base charge with no inverted blocks, any problems associated with tardy meter reading disappear; customers will pay the same for all consumption regardless of the particular billing period during which the consumption takes place. Nevertheless, AWRI still should read all meters on a monthly basis so that customers know with a fair degree of accuracy how much water they consume; this promotes conservation. Regular meter reading also helps to ensure relatively stable bills from month to month.

The evidence shows the average consumer on AWRI's systems uses 1,063 cubic feet per month. AWRI's fixed charge for unmetered customers will include 1,100 cubic feet per month at the consumption rate plus the base rate. Table 7 shows AWRI's rates calculated in accordance with the prescribed rate design following the methodology reflected in Exhibit No. 67.

TABLE 7  
AMERICAN WATER RESOURCES, INC.  
Revised Rates Schedule  
Flat Rate-Unmetered (per month)      \$29,40

Monthly Metered Base Charge with zero usage allowance:  
5/8"-3/4" meter      \$17.30  
1" meter      \$28.90  
1-1/2" meter      \$57.62  
2" meter      \$92.23

4" meter \$288.44

Usage Charge per 100cf \$1.10

Facilities Charge \$1,860.00

II. Docket Nos. UW-980072 and UW-980265 (Systems Additions)

Docket Nos. UW-980072 and UW-980265 present a fundamental policy issue: what rate should apply when AWRI takes over the operation of an existing utility? There are two basic scenarios to consider, one where the existing

utility already is subject to Commission jurisdiction and charges Commission-approved rates, and one where the existing utility is not subject to Commission jurisdiction. The first case is not squarely presented in these dockets. It is sufficient to answer for now that under

RCW 80.28.060, AWRI must adopt as its own the acquired utility's tariff and continue to charge the acquired customers under that tariff (RCW 80.28.080) unless and until AWRI shows by affirmative evidence it is appropriate to bring the acquired utility within AWRI's existing rate structure, or make the acquired system subject to new rates along with AWRI's broader customer base in a general rate case proceeding.

The second scenario is presented here; the systems AWRI acquired were not

previously within the Commission's jurisdiction. Docket No. UW-980072 involves AWRI's acquisition of nine systems, two of which had approximately 70 customers total at the time of AWRI's purchase; the other

seven systems had no customers at the time AWRI filed in Docket No. UW-980072 and AWRI presented no evidence to show whether there are customers present on those systems even at the time of the evidentiary proceedings. Docket No. UW-980265 involves AWRI's acquisition of 54 systems. Exh. T-10 at 7 (Parker). This set includes numerous six-packs and several larger systems (e.g., five systems with 122 customers). Exh. T-10 at 8-9 (Parker).

Many of the acquired six-pack systems in this group had no customers at the time AWRI filed the docket and, again, AWRI presented no definitive evidence to show whether the systems serve customers even today. In response to bench interest and inquiry, AWRI filed a statement after the close of evidence to say it could not confirm the existence of even a single customer on any of the systems Ms. Parker testified had no customers, though it believed at least one customer is served by some of the systems. As dubious as that sounds, it is accepted as accurate and so

the systems are found here to be unused and, as previously analyzed, not used and useful for purposes of rate base determination.

As to systems where no customers existed at the time AWRI took over, the solution is straightforward enough. Future customers on those systems, or



customers who connected subsequent to AWRI's takeover, will be charged AWRI's generally applicable rates as determined here in the consolidated rate case proceeding, Docket No. UW-980258.

Existing customers on acquired systems, who paid fixed rates as low as \$17 per month when AWRI took over, present a different problem. An increase in rates from \$17 to the \$30-plus range per month is almost certain to produce significant rate shock. Indeed, several customers came forward in this case and expressed their dismay, outrage, or similar response to seeing their rates nearly double from one day to the next, a matter exacerbated for them by AWRI's present request to increase rates even more just a few months after acquiring these new systems. TR. 46 (Brownell); TR. 55 (Failey); TR. 96 (Livengood); TR. 113 (Thompson). AWRI

contends it must charge these customers AWRI's generally applicable rates from the moment AWRI takes over. That simply is incorrect. There are means by which AWRI can adopt special tariff sheets to preserve an acquired system's rates; other water companies have done so in parallel circumstances. Staff Brf. at 34.

Even-handed treatment of all AWRI's "acquired" customers, whether AWRI purchases a previously regulated or previously unregulated company, is the best policy. Accordingly, in the future when AWRI acquires a new system it must continue to charge the acquired customers the rates then in effect; the Commission easily can approve new tariff sheets to permit such charges at least on a temporary basis. AWRI then may request to bring the new customers within its generally applicable tariff upon showing this will not produce excessive revenue over recovery and upon showing the quality of service on the newly acquired system is acceptable, or that AWRI has concrete plans to improve the system through increased oversight and maintenance, plant upgrades or additions, or otherwise as necessary to deliver an acceptable quality of service. If AWRI's rates that would apply, however, exceed by a considerable amount (e.g., more than 50 percent higher than the customers' rates at the time of acquisition), the Commission should consider a phase in schedule for the new, higher rates rather than allowing AWRI to implement the substantially higher rates in a single step. An appropriate schedule can be determined in individual cases and may be tied to AWRI's schedule for implementation of any needed quality of service improvements.

Under the facts and circumstances present in Docket Nos. UW-980072 and UW-980265, it is too late to implement these policies and procedures. The Commission suspended these dockets, but approved AWRI's generally applicable rates on a temporary basis subject to change in light of whatever rates come out of this consolidated proceeding. Since the rates here depend on a different rate design, they are not easily compared. It must be considered that approval of a higher revenue requirement here

represents a slight rate increase insofar as the refund question is concerned. Customers who use average volumes or above-average volumes will pay slightly more on a monthly basis than under present rates. Prospectively, AWRI will charge customers on these acquired systems the generally applicable rates determined in these consolidated dockets.

### III. Docket No. UW-980076 (Facilities Charge)

AWRI filed in this docket Second Revision Sheet No. 25 canceling First Revision Sheet No. 25, to reflect a decrease in Facilities Charges from \$3,500 to \$2,500 and to redefine to whom the charge applies. Both issues pose significant and difficult questions, including the fundamental question of the appropriate conceptual framework for a facilities charge.

Conceptually, AWRI's position is quite clear. AWRI argues "the facilities charge was designed to help facilitate the replacement of infrastructure and other system [up]grades, not only for new construction, to meet the requirement to provide safe and reliable drinking water." AWRI Brf. at 34 (citing Exh. T-30 at 4 (Ingram)). In AWRI's conceptualization, the facilities charge is tied to growth only in the sense that it is collected from new customers.

Staff articulated a markedly different facilities charge concept. Staff Brf. at 30-34. Staff's concept focuses on facilities charges as a source of capital to fund future growth of existing systems to meet demands imposed by new customers, but not as a source of capital to upgrade or replace existing infrastructure for existing customers. Exh. T-60 at 31-37 (Ward).

Concepts aside, AWRI says the present tariff language is unclear in defining to whom the charge applies. AWRI Brf. at 38. AWRI's First Revision Sheet No. 25, however, actually is perfectly straightforward. The tariff simply requires all new residential customers to pay facilities charges, as follows:

[AWRI's facilities charge] [a]pplies to residential customer applicants requesting water service from the company.

AWRI proposed far more complicated tariff language via Ms. Parker's testimony; examination by the bench, however, established that AWRI had no clear idea who should pay facilities charges and how various proposed exemptions might apply prospectively. TR. 182-190. The tariff language Ms. Parker proposed appears to be unworkable. Id.; and see Exh. T-10 at 6-7. AWRI proposed yet different language on brief. AWRI Brf. at 38-39.

Staff also proposes specific tariff language. Staff is closer to the mark, though its proposal also creates ambiguity because of uncertainty regarding the definition of "Commission Service Area" as a term of art proposed to be included in Second Revised Sheet No. 25.

Mr. Williams' brief generally supports Staff's positions, but articulates a very narrow view of applicability that probably would eliminate collection of facilities charges by AWRI in the foreseeable future.

A. Applicability. The term "facilities charge" or "facility charge" is one of several used to describe a required, up-front capital contribution from new customers to fund growth that provides no direct benefit (e.g., reduced operating costs, enhanced system reliability, improved quality of service) to existing customers. Other, comparable terms are "plant investment fee", "impact fee" and "system-development charge." Water Rates and Related Charges, AWWA Manual M26, First Edition, American Water Works Association, Denver (1986). Such charges are appropriate to ensure fairness consistent with principles of cost incurrence. Existing customers, for example, should not experience rate increases to underwrite additional debt financing to permit the utility to expand into new service territories or to acquire plant required to serve new load in existing service areas. Yet, this is precisely what has occurred on AWRI.

Increased rates to cover the costs of financing debt AWRI incurs to grow via purchase of additional systems definitely is a problem for AWRI's customers. Mr. Fox testified approximately one-half of the nearly one million dollars he has loaned AWRI has been used to acquire systems during the past two and one-half years. TR. 337. Existing customers bear the very significant costs of that half-million dollar debt yet see no direct, and little or no indirect, benefit from capital expended to purchase the additional systems, some of which require significant upgrades and thus burden AWRI with yet additional costs which AWRI then seeks to embed in uniform rates to all customers. Several customers articulated this problem, observing that AWRI is buying new systems all the time, some of which require significant additional investment, yet existing systems remain in less than satisfactory condition. TR. 97 (Livengood), 498 (Oniel), 590 (Thompson). Rates to all customers go steadily up, but quality of service remains inadequate for many customers.

Looking to the future, a facilities charge applicable to new customers is one way to fund AWRI's continued expansion via system acquisitions, or otherwise, without impacting existing customers' rates. AWRI, however, conceives of the facilities charge differently and in a fashion that might serve to restore balance to the inequitable situation that has materialized via excessive debt financing of aggressive plant acquisitions during the past two and one-half years. Although AWRI would require most new customers to pay its facilities charge, it does not consider the capital thus acquired as limited to expenditures for new growth. AWRI says the Commission has approved facilities charges, including AWRI's facilities charge as reflected in its First Revision Sheet No. 25, as a

practical source of funds to underwrite infrastructure replacement, system upgrades, and new construction "to provide safe and reliable drinking water." AWRI Brf. At 34 (citing Exh. T-30 at 4 (Ingram)). Ms. Ingram testified on rebuttal "[i]n the past, a facilities charge has been an alternative to what is termed a "6446" surcharge, which Mr. Ward poses as an alternative to the facilities charge proposed by the company." Exh. T-30 at 6.

Mr. Ward, in fact, distinguished the two types of charges, as follows:

The company's [facilities] charge is levied in an attempt to assist with replacing plant and upgrades. Such a cost is separate and independent from a Facilities Charge. Should the company wish to assess such a charge, it must do so by applying to the Commission for a change in its tariff through a separate request. This request is described elsewhere in my testimony as a 6446 surcharge.

Exh. T-60 at 37. Mr. Ward expresses Staff's view that a facilities charge is not an appropriate mechanism to fund future upgrades and retrofit costs but rather should be applied only to customers whose addition to AWRI precipitates a need to expand system capacity so that adequate capacity continues to be available for future customers within existing service territories when they are ready to connect to the system. Staff suggests tariff language that captures the concept:

[AWRI's facilities charge] [applies to all new applicants for properties not currently served and not within the Commission Service Area (as defined in the utility's tariff) for the utility only when surplus source capacity is available and a direct connection can be made to an existing main that has adequate hydraulic capacity.

What exactly is captured by the phrase "Commission Service Area . . . for the utility" is unclear. "Commission Service Area" is a defined term in the Commission's regulations (WAC 480-110-021) and its meaning should not vary from one utility to another. If not inherently ambiguous, the term may suffer at least from latent ambiguity. Staff's proposed tariff language captures the term's potentially inconsistent use as illustrated by Mr. Ward's testimony that the term sometimes encompasses the entire platted area filed by a water utility as part of its tariff to delimit its service territory, yet, in other cases may include only existing customer connections within the utility's functional reach. TR. 445-50 (Ward).

Mr. Williams agrees with Staff that any facilities charge allowed in AWRI's rates should be limited conceptually and in application along the lines Staff advocates, but he takes the most narrow view. Mr. Williams focuses on a definition of Commission Service Area that would exempt all new customers who connect to any existing system unless their connection required a main extension into territory not originally contemplated for service. Mr. Williams is concerned particularly with the situation when AWRI expands by acquisition of existing systems that may or may not have

facilities charges as part of their regulated or unregulated rate structure. Mr. Williams urges the Commission to recognize that when AWRI acquires an existing utility, none of the unserved customers in the acquired utility's "Commission Service Area," or the equivalent of that area in the case of an unregulated utility, should be subject to AWRI's facilities charge when they eventually apply for service.

AWRI is not a central facility utility; it does not serve its 1,730 customers from a single plant or set of interconnected facilities. AWRI owns and operates several small central systems such as the former H2O Water Company systems and View Royal, but these are stand-alone facilities. AWRI also owns and operates more than one hundred small systems, including numerous six-packs, that bear no resemblance at all to a central plant facility. AWRI's many, geographically dispersed water systems are not interconnected, nor apparently are there plans for interconnection except perhaps on a very minor scale. It is unlikely many, if any, of these systems will grow except by the addition of so-called infill customers. There is no reason to believe AWRI's further growth will not follow the pattern of the last two and one-half years: growth via acquisition of new six-packs and larger systems that may not be

fully subscribed but which are designed to serve specific properties in defined areas. Under that scenario, and Mr. Williams proposed application, there would be few, if any, customers to whom the facilities charge would apply. Staff's approach to application might result in more customers paying the charge, but the funds could not be used under Staff's facilities charge concept to finance the sort of growth that historically has prevailed on AWRI. Indeed, under the view Staff and Mr. Williams share, "the [facilities charge] concept is not appropriate" to AWRI's circumstances. Williams Brf. at 2.

The facilities charge concept to be enforced ultimately reduces to a policy decision informed by what is fair to customers consistent with traditional principles of cost incurrence. Those customers who benefit from cost incurrence should bear the costs. Most importantly, any facilities charge must be tailored to meet the AWRI's specific circumstances. Facilities charges, by their very nature, must be tailored

to meet the needs of individual utilities; it is a mistake to think any "one size fits all" approach will yield useful results.

If history is any guide, it appears AWRI will continue to grow principally by acquiring existing, small water utility companies, and by building new systems, principally six-pack systems to serve new development. Such growth requires capital. AWRI's pattern has been to obtain the necessary capital via shareholder loans. This is expensive to ratepayers, yet confers no direct benefits to, and may even disadvantage, existing customers by delaying AWRI's spending on much needed upgrades and replacements. AWRI's existing customer should not be required to underwrite new growth by ever higher rates especially where existing infrastructure is inadequate to deliver a reasonable quality of service.

Indisputably, AWRI needs funds to finance infrastructure replacement and facility upgrades to improve quality of service for existing customers. Existing customers continue to pay the price for AWRI's expansion through rates laden with excessive debt costs without reaping any benefits. This situation has prevailed for too long. It is appropriate now that new customers contribute capital via facilities charges and that the Commission require AWRI to use that capital to improve existing plant through replacements and upgrades that materially enhance quality of service, precisely as AWRI requests here. As stated at the outset, AWRI's concept for a facilities charge offers an opportunity to restore balance to the inequitable situation that has materialized via excessive debt financing of aggressive plant acquisitions during the past two and one-half years.

Exhibit 11 lists 17 "critical projects" projected to cost \$340,800. These and any similar, unlisted projects must be AWRI's first priorities. Facilities charge revenues can finance all, or a significant part of the needed plant replacements and upgrades. There should be no need for rate increases or surcharges to finance the necessary capital improvements; facilities charge revenues from the numerous new customers AWRI connects to its presently unutilized or underutilized plant (e.g., the 36 new six-packs on which there were no customers as of December 31, 1997) should provide funds adequate to AWRI's capital needs for infrastructure improvements.

The facilities charge issue no doubt will need to be revisited in the future. A time will come, presumably soon, when balance is restored between rates and benefits as AWRI moves quickly to implement its proposal, approved here, to collect facilities charges from virtually all new customers and use those capital contributions to fund needed infrastructure replacements and upgrades to deliver higher quality of service to existing customers. Then, it will be important to consider whether a more narrowly conceived facilities charge, or any facilities charge at all, is an appropriate charge in AWRI's tariff. To ensure the Commission has the information it will need for future evaluation, AWRI is required to account separately for facilities charge collections and report quarterly via a schedule similar to Exhibit no. 11 the company's progress and planned completion dates for critical projects and other projects included in its Water Plan as filed with the Washington State Department of Health as that plan is revised from time to time.

The fairest approach under this analysis is to continue to require all new customers who apply for a connection to a previously unserved property to pay the facilities charge. Accordingly, the appropriate applicability language to be included in AWRI's tariff is:

[AWRI's facilities charge] [applies to all new residential customer applicants for properties not currently served for the utility only when

surplus source capacity is available and a direct connection can be made to an existing main that has adequate hydraulic capacity.

In other respects, the tariff language (but not the amount) AWRI includes in proposed Second Revision Sheet No. 25 is acceptable. AWRI should check the meter sizes indicated in the proposed definition of "residential customer." More inclusive language such as "standard meter less than 1 inch" might be better. Any exceptions to the facilities charge to recognize preexisting contractual arrangements, or for other reasons, are best handled on a case-by-case basis.

B. Rate. AWRI recommends a facilities charge of \$2,500. Staff recommends \$804. Mr. Williams supports Staff's analysis and result.

There again is a conceptual difference between AWRI and Staff that explains much of the significant difference in the two parties' proposed facilities charge. Staff conceives of AWRI as if it were, in fact, a central facility utility and determines a per customer connection cost by simply adding all actual and estimated costs reported by AWRI for eight systems ranging in size from 6 to 300 customers and dividing by the total number of customers. The result is Staff's "impact cost per customer" of \$1,149. Staff would reduce that amount by 30 percent to require "company investment." The result is a facilities charge of \$804.

AWRI, by contrast, proposed a \$2,500 facilities charge more or less arbitrarily based on "institutional knowledge" (Exh. T-10 at 3) and then rationalized the figure by applying an average of averages approach to certain engineering estimates presented via her rebuttal testimony. Exh. T-10 at 4; Exh. 13; Exh. 21. Ms. Parker emphasizes that Staff's approach places too much weight on the 300 customer system included in its analysis and too little weight on the much higher per customer costs of AWRI's numerous six-pack systems by including the costs and customers from only a few small systems. Exh. T-15 at 48. Ms. Parker asserts her analysis corrects this improper weighting by calculating the average actual and estimated per customer cost for each of several systems (one 300 connection, one 40 connection, and 10 six connection systems) and then averaging the averages which weights the analysis more in favor of the smaller systems. Exh. T-15 at 49. Ms. Parker describes her analysis as "very conservative" and says it supports AWRI's proposed facilities charge as being "not unreasonable." Id.

Finally, Ms. Parker presents what she describes as "a more appropriate analysis" which includes consideration of "all the company's systems." Id.; Exh. 21. This analysis, performed for AWRI by HGA Engineers and Surveyors, yields at bottom an average cost per connection of \$2,663. Although Staff attacks the study as "unreliable," Staff nevertheless suggests that if it is considered, it supports a facilities charge of only \$1,863 when adjusted to account for 30 percent required company investment. Staff Brf. at 32.

Yet another facilities charge figure is suggested by applying AWRI's average of averages method to the data Staff apparently does consider reliable, as presented by Mr. Ward in Exhibit no. 68. The result is \$2,158.

Staff's analysis treating AWRI as if it were a central utility yields a facilities charge (\$804) that is too low if the goal is to require capital contributions from new customers that bear a reasonable relationship to the average per connection cost based on AWRI's present facilities mix. AWRI's proposal (\$2,500) is not supported by the evidence, particularly considering that the study Ms. Parker considers to be the strongest analysis supports substantially less than what AWRI proposes. Exhibit 21 is accepted as the best evidence that reasonably ties the facilities charge amount to average per connection costs on AWRI's existing system. The facilities charge best supported by the record is \$1,860 per new connection.

C. Refunds. The Commission's suspension order in Docket No. UW-980076 allowed AWRI to implement a \$2,500 facilities charge effective March 1, 1998, subject to refund. The final facility charge approved here is \$1,860. AWRI is required to refund the difference, \$640, to all customers who paid facilities charges between March 1, 1998, and the effective date of the \$1,860 facilities charge filed in compliance with the Commission's final order in Docket No. UW-980076.

Since the facilities charge is a one time payment, AWRI is required to make refunds via a one time cash payment to all affected customers. Refunds will include annual interest at 9.91 percent calculated from the date the customer paid the facilities charge until the refund date. This interest rate corresponds to the debt component allowance in AWRI's approved return. AWRI must make all refunds within 30 days, and file a complete report of facility charge refunds within 45 days, after the effective date of the \$1,860 facilities charge filed in compliance with the Commission's final order in Docket No. UW-980076.

#### FINDINGS OF FACT

Based on the foregoing discussion, including various underlying fact determinations not reiterated here, the following findings of fact are supported by substantial competent evidence of record:

1. AWRI's quality of service is inadequate to meet the legitimate needs of its customers.
2. AWRI's accounting and records practices are inadequate to meet the Commission's needs in performing its regulatory oversight functions on an ongoing basis.
3. The twelve month period ending December 31, 1997, is an appropriate test year to examine for ratemaking purposes in these proceedings.



4. The parties' stipulation to remove from AWRI's proposed rate base \$340,800 (\$335,931 net of proposed depreciation) attributed to plant improvement projects is supported by evidence that shows the projects either were not initiated or were not completed during the test year. The stipulation should be approved.

5. Agreed accounting adjustments to include \$17,245 in deferred debit accounts and \$6,165 as net capitalized cost attributed to a previously unaccounted for vehicle are supported adequately by undisputed evidence and should be accepted as adjustments to rate base.

6. The parties' joint proposal to use end of test period rate base and customer count will more closely match rate base, expenses, and revenues; and will produce more reasonable rates for the immediate future period during which rates established here will be effective. The end of test period method should be used establish rates in this proceeding.

7. The evidence does not support a finding that AWRI's acquisitions of operating utilities have bestowed on its existing, acquired, or potential customers benefits commensurate with the \$200,194 acquisition adjustment amount AWRI proposes to include in rate base. The proposed adjustment to rate base should be disallowed.

8. AWRI stand-alone systems (i.e., six-pack systems) with no customers at December 31, 1997, should not be considered used and useful and should be excluded from rate base.

9. Facilities placed in service after December 31, 1997, should be excluded from rate base as plant not used and useful as of the end of the test period.

10. Post-test-period plant additions and contributions in aid of construction (CIAC) are not valid pro forma adjustments to rate base when there are no adjustments to account for additional customers and no analysis is made of potentially offsetting adjustments to revenue and expenses.

11. The parties agreed inclusion in rate base of \$11,903 to account for construction work in progress (CWIP) is in the public interest; it is inappropriate therefore for any allowance for funds used during construction (AFUDC) to accrue on CWIP balances or be included in rates as an added cost.

12. Repair costs to a vehicle not owned by AWRI cannot properly be capitalized and AWRI's proposal to include such costs in rate base should be rejected.

13. AWRI failed to support through appropriate records claimed expense reimbursements for company use of AWRI's principal shareholder's personal vehicle and the expense amounts should be disallowed.

14. AWRI's proposed reclassification and inclusion in rate base of plant previously expensed violates the prohibition against retroactive ratemaking and should be rejected.

15. Alleged contributions by shareholders and others of time and effort to AWRI's past operations were not adequately documented; to include such costs incurred during past periods would constitute retroactive ratemaking and should be rejected.

16. AWRI's rate base supported by this record is \$833,292.

17. AWRI's actual capital structure includes more than 90 percent debt, largely in the form of shareholder loans. A hypothetical capital structure reflecting 80 percent debt and 20 percent equity should be adopted to encourage AWRI to reform its actual capital structure to a more balanced debt to equity ratio such as 50 percent debt, 50 percent equity.

18. Interest on shareholder loans should be imputed at 10.50 percent (two hundred basis points above the prevailing prime interest rate during the relevant period) to provide for reasonable interest and to encourage AWRI to reform its capital structure to include significantly more equity and less debt.

19. AWRI's return on equity should be 12.60 percent to reflect a one hundred and fifty basis point addition to the level indicated by discounted cash flow analysis to recognize AWRI's inherent risk and to encourage AWRI to reform its capital structure to include significantly more equity and less debt.

20. AWRI's rate of return on rate base supported by this record is 10.45 percent.

21. An allowance of \$226,096 for wages and salaries provides for optimal staffing of AWRI's operations to provide adequate quality of service for AWRI's customers.

22. AWRI's analysis of costs that should be allocated to the company's unregulated Satellite Management Agency operations reflects sound methodology and is adequately supported in detail.

23. AWRI's rate case expense in the amount of \$36,000 is adequately supported by the record and should be allowed; the amount should be amortized over three years with no rate base inclusion for the unamortized balance.

24. AWRI's proposed adjustment to purchased power expense to reflect alleged but inadequately substantiated seasonal variations should be rejected.

25. There is not evidence to support an adjustment to AWRI's proposed outside accounting expense at the test year level of \$10,642.

26. AWRI should be allowed \$600 per month rent to reflect its use of offices and ancillary facilities at the home of its principal shareholder.

27. Meals and entertainment, meetings and seminars, transportation and travel expense, and "other" expense should be allowed only to the extent supported adequately by appropriate records; the amounts are \$162, \$270, \$138, and \$463, respectively.

28. AWRI's proposed office expense, \$12,727, should be reduced by \$2,600 to reflect proper treatment of wage expense for part-time secretarial support.

29. AWRI should recover excise taxes on facilities charges and service connection charges as an expense component in generally applicable rates.

30. Depreciation based on individual lives of particular assets is preferable to a composite depreciation rate approach when, as here, adequate data are presented to support the more detailed approach.

31. Capitalized legal and accounting expenses attributed to facilities acquisitions should be amortized over the life of the associated plant.

32. A deficiency exists in AWRI's adjusted test period gross annual revenues at present rates. The amount is \$47,263. AWRI's revenue requirement supported by the record is \$642,493.

33. A zero-base-volume rate design promotes conservation, allows customers to control a more significant part of their monthly water costs, and most closely matches rates to revenues; data presently available do not support more elaborate rate designs, such as inverted block rates.

34. AWRI should be required to bill customers in increments that reflect the smallest units that can be read from customer's meters to more closely match actual consumption to billed amounts. AWRI should be required to read meters on a month-to-month cycle to coincide with monthly billing.

35. Customers on systems AWRI acquires in the future all should be treated the same regardless of whether they previously paid Commission-approved rates or unregulated rates; rates in effect at the time a system is acquired should remain in effect, via special tariff filing in appropriate circumstances, pending Commission review in each case to consider whether AWRI's generally applicable rates are fair, just, reasonable, and adequate for the acquired customers and whether such rates

should be phased in to avoid rate shock.

36. AWRI has incurred substantial debt to finance its growth via systems' acquisitions; existing customers are burdened by higher rates that result from AWRI's extraordinary debt incurred to acquire new customers.

37. Facilities charges to new customers will provide substantial capital to AWRI that can be used to benefit existing customers who have borne, and continue to bear, the costs of AWRI's explosive growth over the past two and one-half years.

38. Using facilities charges AWRI collects prospectively to make needed improvements to existing facilities will help restore a degree of balance to the inequitable cost/benefit situation that has resulted from AWRI's excessive debt financing of aggressive plant acquisition during the past two and one-half years.

39. All customers who request a new connection to AWRI facilities should pay a facilities charge; this is consistent with a facilities charge concept grounded in cost incurrence principles that require new customers to bear the costs of AWRI's expansion rather than continuing to burden existing customers with those costs.

40. AWRI's facilities charge should reflect the average cost of facilities required to serve one new connection, adjusted to require 30 percent investment by AWRI; the amount supported by the record is \$1,860.

41. AWRI's rate schedule 10, Fire Flow Rate, should apply to "commercial customers," and not to "all customers."

#### CONCLUSIONS OF LAW

1. The Washington Utilities and Transportation Commission has jurisdiction over the parties to, and the subject matter of, this proceeding. RCW 80.01.040; Chapter 80.04 RCW; Chapter 80.28 RCW.

2. The rates and charges included in, or made effective by, AWRI's tariff WN U-1, First Revision Sheet No. 1, First Revision Sheet No. 15, Original Sheet No. 15.1; Original Sheet No. 15.3; Original Sheet No. 15.4; Original Sheet No. 15.5; Original Sheet No. 15.6; Original Sheet No. 15.7; Original Sheet No. 15.8; Original Sheet No. 15.9; and Original Sheet No. 15.10, Third Revision Sheet No. 17, Second Revision of Sheet No. 18, Original Sheet No. 18.6, First Revision Sheet No. 25, and Original Sheet No. 27, are unjust, unreasonable, unjustly discriminatory, or unduly preferential, and fail to yield reasonable compensation for the services rendered.

3. AWRI's proposed tariff sheets filed in Docket Nos. UW-980072, UW-980076, UW-980258, and UW-980265, including Second Revision of Sheet No. 1 canceling First Revision Sheet No. 1; Second Revision Sheet No. 15 canceling First Revision Sheet No. 15; First Revision Sheet No. 15.1 Canceling Original Sheet No. 15.1; Original Sheet No. 15.3; Original Sheet No. 15.4; Original Sheet No. 15.5; Original Sheet No. 15.6; Original Sheet No. 15.7; Original Sheet No. 15.8; Original Sheet No. 15.9; and Original Sheet No. 15.10; Fourth Revision of Sheet No. 17 canceling Third Revision Sheet No. 17; Third Revision of Sheet No. 18 canceling Second Revision of Sheet No. 18 and Original Sheet No. 18.6; Second Revision Sheet No. 25 canceling First Revision Sheet No. 25; and First Revision Sheet No. 27 canceling Original Revision Sheet No. 27, have not been shown to be just, reasonable, or sufficient, or otherwise to conform fully to the requirements of law.

4. Rates, terms, and practices determined in accordance with the findings and conclusions in this Initial Order, including separately stated Findings of Fact and Conclusions of Law, and the foregoing analysis and discussion of the record, support Commission determined rates, charges, and practices that should be fixed by order as the just, reasonable, and sufficient rates, charges, and practices that AWRI should observe and put in force in accordance with the terms of this Initial Order.

5. AWRI's accounting and records practices are inadequate to meet the Commission's requirements for information necessary to the Commission's regulatory oversight function. AWRI accordingly is required to conform its practices to ensure the Commission receives adequate and accurate information on a regular basis as provided in the fourth ordering paragraph, below. RCW 80.04.090.

ORDER

IT IS ORDERED That:

1. The proposed tariff revisions filed by American Water Resources, Inc., on January 16, 1998, in Docket No. UW-980072; January 20, 1998, in Docket No. UW-980076; February 27, 1998, in Docket No. UW-980258; and March 2, 1998, in Docket No. UW-980265, now suspended by Commission orders, are rejected.

2. American Water Resources, Inc. is authorized and required to file revised tariff sheets to its Tariff WN U-1, to conform to the requirements of this Order. The authorized and required tariff sheets must bear an appropriate effective date to allow the Commission at least five (5) business days after filing to review the tariff sheets and determine whether they conform in all respects to the requirements of this Order. Each tariff sheet filed must bear a notation that states: "By Authority of Order of the Washington Utilities and Transportation Commission, Docket

No. [insert docket number UW-980072, UW-980076, UW-980258, or UW-980265, as appropriate].

3. American Water Resources, Inc. is required to account separately for all revenues collected via Facilities Charges; the proceeds generated by such charges are required to be used by American Water Resources, Inc., to effect upgrades and improvements to its facilities to provide enhanced service quality to customers. American Water Resources, Inc., is required to report quarterly to the Commission, in writing, its progress in completing and projected completion date for each project listed in Appendix A to this Order, and other such projects as may be reflected in the company's Water Plan as filed with the Washington State Department of Health and as revised from time to time.

4. American Water Resources, Inc. is required to submit to the Commission quarterly reports to be reviewed for proper accounting procedure, methodology, and timeliness; the reports must include an Income Statement, a Balance Sheet, and a Cash Flow Statement. American Water Resources, Inc., should cooperate with Commission staff to sustain a dialogue regarding the company's budget, customer count, and other information that will assist the company in its ongoing operations and assist the staff in its ongoing regulatory oversight responsibilities.

5. American Water Resources, Inc., is required to modify its billing practices to reflect monthly charges calculated on the basis of the smallest billing increment capable of being read from customers' meters (e.g., nearest cubic foot, ten cubic feet, 100 cubic feet), rounded up or down as provided in the body of this Order.

6. American Water Resources, Inc., is required to provide an explanatory notice to customers via a form of notice preapproved by the Commission to be included in customer bills in the first billing period rates that conform to the requirements of this order are effective.

DATED at Olympia, Washington and effective this 24th day of November 1998.

DENNIS J. MOSS  
Administrative Law Judge

NOTICE TO PARTIES:

This is an Initial Order. The action proposed in this Initial Order is not effective until entry of a final order by the Utilities and Transportation Commission. If you disagree with this Initial Order and want the Commission to consider your comments, you must take specific action within the time limits outlined below.

WAC 480-09-780(2) provides that any party to this proceeding has twenty (20) days after the service date of this Initial Order to file a Petition for Administrative Review. What must be included in any Petition and other requirements for a Petition are stated in WAC 480-09-780(3). WAC 480-09-780(4) states that an Answer to any Petition for review may be filed by any party within ten (10) days after service of the Petition.

WAC 480-09-820(2) provides that before entry of a Final Order any party may file a Petition To Reopen a contested proceeding to permit receipt of evidence essential to a decision, but unavailable and not reasonably discoverable at the time of hearing, or for other good and sufficient cause. No Answer to a Petition To Reopen will be accepted for filing absent express notice by the Commission calling for such Answer.

One copy of any Petition or Answer filed must be served on each party of record, with proof of service as required by WAC 480-09-120(2).

An original and three copies of any Petition or Answer must be filed by mail delivery to:

Office of the Secretary  
Washington Utilities and Transportation Commission  
P.O. Box 47250  
Olympia, WA 98504-7250

or, by hand delivery to:

Office of the Secretary  
Washington Utilities and Transportation Commission  
1300 South Evergreen Park Drive, S.W.  
Olympia, WA 9850