WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,

COMPLAINANT,

VS.

AMERICAN WATER RESOURCES, INC.,

RESPONDENT.

DOCKET NOS. UW-031284/UW-010961 (CONSOLIDATED)

DIRECT TESTIMONY

OF JULIA M. PARKER

ON BEHALF OF AMERICAN WATER RESOURCES, INC.

February 19, 2004

I – Introduction of Witness

Q. Please state your name and business address.

A. My name is Julia M. Parker. My business address is 627 South Market Boulevard, PO Box 977, Chehalis, Washington, 98532-0977.

Q. Please briefly describe your educational and professional history.

A. I graduated from St. Martin's College with a Bachelor of Arts in Accounting. I was employed by the Washington Utilities and Transportation Commission (WUTC) for a period of a little over 6 years as a Revenue Requirements Specialist in the water, natural gas, low-level radioactive waste and telecommunications industries. While at the WUTC, I attended the National Association of Regulatory Utility Commissioners' (NARUC) Annual Regulatory Studies Program sponsored by Michigan State University and the Eleventh Annual Western Utility Rate Seminar co-sponsored by NARUC, the Utah Public Service Commission and the Division of Continuing Education, University of Utah. During my employment at the WUTC, I testified in several contested rate filings in the water and low-level radioactive waste industries, to include UW-911041, UW-911512 and UW-930155, Alderton-McMillin Water Supply, Inc.; and TG-920234, US Ecology, Inc.

Since leaving the WUTC in 1996, I have been self-employed as an accountant, operating Lewis County Tax and Bookkeeping Service where I provide income tax and accounting services to various businesses, non-profit organizations and individuals. In addition to general accounting service, I also provide assistance to small water companies in preparing their rate casework papers and financial statements for filing with the WUTC. As a private consultant, I testified before the WUTC on behalf of American Water Resources, Inc. in Dockets UW-980072 and UW-980258, as well as for Rainier View Water Co., Inc. in Docket UW-010877. I hold a certificate from the Washington State Board of Accountancy as a Certified Public Accountant.

Q. In what capacity are you testifying today?

A. I am testifying today on behalf of American Water Resources, Inc. (AWR) as their accountant and regulatory consultant. I will address the use of the test period ended June 30, 2003, the appropriateness of the restating and pro forma adjustments proposed by the staff witness, as well as the level of rate base appropriate for this proceeding.

Q. Would you please summarize your understanding of the purpose of this proceeding?

A. It is my understanding that the purpose of this proceeding is to determine whether AWR's current rates and charges provide the company with an excessive return. If the company is found to be earning an excessive return, then the company will be required to make a new tariff filing reducing rates. Another issue to be discussed in this process is the mitigation of the penalties assessed on Mr. Fox under Docket UW-031596.

Q. Can you please summarize the company's position in this proceeding?

A. Yes. It is the company's position that the WUTC staff's proposal is completely out of touch with reality. RCW 80.01.040(3) requires the WUTC to "regulate in the public interest, as provided by the public services laws, the rates, services, facilities, and practices of all persons engaging within this state in the business of supplying any utility service or commodity to the public for compensation, and related activities; including but not limited to…water companies." The recommendation of staff to reduce the water rates by an additional $10.22 per month is nowhere close to being in the public interest. The staff's tone in their testimony is full of conspiracy, and in their attempt to persuade the reader of conspiracy, the staff made allegations in their testimony that are completely speculation. I believe that years ago staff made some personal judgments with regard to the sole shareholder of the company that distorts their ability to objectively view decisions made by the management of this company.

As part of "regulating in the public interest," the WUTC also holds the responsibility to "fix just, reasonable, and compensatory rates," and rates sufficient to "yield a reasonable compensation for the service rendered." RCW 80.28.020. The rates proposed by staff are <u>not</u> compensatory, let alone yield a reasonable compensation for the service rendered. Without a doubt, if the rates proposed by staff are approved the company will not have adequate resources to operate.

II – Presentation of Exhibits

Q. Did you prepare an exhibit showing the company's test period revenue, expenses, rate base, and adjustments proposed by AWR in this case?

A. Yes. My exhibit is presented as No. _____ (JMP-2), Company Results of Operations.

Q. Do you sponsor any other exhibits in this case?

A. Yes. They are presented as Exhibit___(JMP-3), Updated Financial Statements for the Test Period; Exhibit___(JMP-4), Calculation of Annual Effect of Revenue Reduction, and Calculation of Average Customers for the Test Period; Exhibit___(JMP-5), Salaries & Benefits; Exhibit___(JMP-6), Rate Base; Exhibit___(JMP-7), Amortization of Plant Expenditures from reserve account CIAC-Capital Improvements Account; Exhibit___(JMP-8), Company Monthly Income and Cash Flow Worksheet; Exhibit___(JMP-9), Capital Structure, Weighted Cost of Debt, Cost of Equity, and Rate of Return.

Q. Have you reviewed the test period that the WUTC staff selected for this rate case?

A. Yes, I have, and I do not have any objections with the use of the proposed test period. However, having said this, I would like to point out that as with any test period there are unique circumstances in this test period which need to be addressed in order to make the test period representative of the actual cost of operations. Inherent in using a split test period where half of the test period is in a prior fiscal period which has been adjusted and closed and the other half of the test period is in an open fiscal period which has not been adjusted, there is always the possibility that the information within the chosen test period can change. This possibility is not due to poor accounting practices on the part of the company, but because items are discovered after a reporting date which affect the open period and those items are adjusted by management in the process of ensuring their accounting system is as accurate as possible. This is a standard process employed by all companies that I know of.

This test period is also unique in that the WUTC has placed very strict restrictions on AWR as far as the use of a portion of its revenue is concerned. These restrictions were based on a test period in which the company had more than 1,800 customers. Since the last case in which these restrictions were placed on the company, the customer base of the company has decreased by a significant amount without a corresponding decrease in the fixed cost of the company. In order to continue meeting the WUTC's restrictions and continue operations, the company was forced to take measures that would not ordinarily be taken, such as reduce its staff during the months of January – June, 2003. This reduction in force was not due to the company not needing the services of these employees, but instead was a cost saving measure to enable the company to meet its monthly cash flow. I will address the impact this measure has on the expense of the company later in my testimony. This is not to say that the test period selected by staff for this proceeding is inappropriate, only that the individual items within the test period need to be examined to determine whether the test period is representative of the actual cost of operations.

III - Revenues

Q. Did you review the test period income figures used in the WUTC staff's testimony and exhibits?

A. Yes, I have. The figures used are those supplied by me in the company's response to Data Request No. 2. As I stated in the response to this data request, the revenue of the company could be overstated due to problems with the billing system. I have worked with the company to establish procedures to enable the company to reconcile the general ledger to the billing system on a monthly basis. In doing this, I have relied on the company personnel to perform its review of the revenue accrual and have not had the opportunity to thoroughly reconcile the account myself. The company employees have continued working to reconcile the accounts receivable account and has now reduced the overstatement to $1,104.00, affecting some income statement accounts and some balance sheet accounts in the test period. The revised income statement and balance sheet are presented as Exhibit ______ (JMP-3). I will point out changes as they occur in the results of operations. The effect on the test period income accounts is zero.

Q. Do you accept the income figures as presented in the staff's testimony?

A. Yes, I accept the staff's income figures as they represent the income of the company.

Q. Have you reviewed the staff's Restating and Pro Forma adjustments to revenue?

A. Yes, I have.

Q. Beginning with staff's Restating Adjustment R1, do you agree with this adjustment?

A. Yes. This adjustment removes from operating revenue the income from the company's non-regulated Satellite Management Agency (SMA) operations. The company has recorded this income below-the-line and as such does not believe it is appropriately considered in the operating revenue for its regulated operations. I have included this adjustment as R-1 in Exhibit No. ___(JMP-2) at column f, line 44.

Q. Regarding staff's Pro Forma Adjustment P1, do you agree with this adjustment?

A. I agree with the premise of this adjustment, however, I have updated information which affects the amount of this adjustment. This adjustment reduces operating revenue for the overstatement in accounts receivable. As I stated before in my discussion of the use of the test period, the company has continued to reconcile the accounts receivable account and has reduced the overstatement to $1,104 as of June 30, 2003. The correct amount of this pro forma adjustment should reduce revenue by $1,104, as shown as P-1 in Exhibit No. ____(JMP-2) at column i, line 3.

Q. Regarding staff's Pro Forma Adjustment P2, do you agree with this adjustment?

A. As with the preceding adjustment, I agree with the principle of this adjustment, but I do not agree with how it is calculated. I have extracted from company records the number of customers who were actually billed the monthly revenue for each of the months in the test period. I multiplied this information by the $4.40 rate reduction to extract a more accurate revenue reduction for the test period of $78,976. This adjustment is presented as P-2 in Exhibit No.___(JMP-2) at column i, line 3. The calculation of this adjustment is presented as Exhibit No.____(JMP-4).

Q. Do you propose any other adjustments to AWR's revenue?

A. No.

IV - Expenses

Q. Did you review the test period expense figures used in the WUTC staff's testimony and exhibits?

A. Yes, I have. I have discovered some updates to these expense figures that I believe should be incorporated in this case to ensure the accuracy of the information. The total expenses incurred by the company in the test period were $644,990: operating expenses of $559,505, interest expense of $31,469 and federal income tax of $54,016. Federal income tax is split between regulated ($16,652) and non-operating ($37,364) as per the National Association of Regulatory Utility Commissioners, Uniform System of Accounts for Class A Water Utilities, 1996. The federal income tax recorded in the test period is that owed on total corporate net income for 2002.

Q. Do you have adjustments to these test period expenses?

A. I do. In order to make my numbering of the adjustments consistent with staff's numbering, I will first discuss the adjustments proposed by staff and follow with any new proposed adjustment.

Q. Beginning with the Restating Adjustments, have you reviewed staff's R2?

A. Yes, I have, and I believe that the adjustment is appropriate for ratemaking, although, the characterization of the expense that staff makes is completely inappropriate. The account contains late payment penalty assessments, not penalty for "improper income tax calculations" as asserted by staff. While some of the tax due is related to the gain on sale of assets, the entire penalty is not due to that transaction. Having said that, the WUTC staff is correct in that the expense is not appropriately recoverable in rates. The adjustment to reduce expense by $2,597 is included as R-2 in Exhibit No.___(JMP-2) at column f, line 34.

Q. The next Restating Adjustment is R-3, have you reviewed this adjustment?

A. Yes, I have, and the documents behind this adjustment. Again, I must protest the characterization by staff. Staff explains the adjustment as removing "double entries" from the test period. There are no duplicate or double entries in the books and records of AWR. It is true that the test period includes the expense for the preparation of the corporate income tax and the WUTC annual report of two years, both 2001 and 2002. However, this is a function of the split test period and not inappropriate accounting procedure. The expense for accounting was recorded as the bills were received; the 2001 tax return was prepared in September, 2002, while the 2002 tax return was prepared in June, 2003. The removal of $2,500 in expense is appropriate for ratemaking to allow the expense of only one year in Adjustment R-3a.

The other part of staff's proposed adjustment removes the cost of accounting expenses related to the sale of the water systems. I agree that this expense is also not appropriately included in rates. The removal of $4,700 in expense is appropriate for ratemaking Restating Adjustment R-3b.

In staff's review of the accounting expense, there is an out-of-period credit that reduces the test period expense for a credit in the amount of $3,596 given by Moss Adams LLP for accounting services performed in 2000 and 2001. Just as it is inappropriate for costs from prior years to be included in the test period, it is inappropriate to include in the test period credits for services provided in prior years. This credit, dated 3/27/2003, is shown in Exhibit No.___(JAW-9), sponsored by staff witness, Mr. Ward. The company adds $3,596 back to this account, since removal of an amount for a credit recorded to offset a bill in a prior period is inappropriate, and would understate the expense in the test period. See Restating Adjustment R-3c.

In total, Restating Adjustments R-3a, R-3b and R-3c reduce the test period expense by $3,604. This is shown in Exhibit No.___(JMP-2) at column f, line 21. Restating Adjustments R-3a, R-3b and R-3c result in a restated test period accounting expense of $15,428, as shown in Exhibit No.___(JMP-2) at column g, line 21.

Q. The next Restating Adjustment is R4, have you reviewed this adjustment?

A. Yes, I have. I agree that legal expenses related to the sale of water systems are not proper for determining rates for ongoing operations. The adjustment of $2,902 in legal expenses to arrive at restated normal, recurring test period legal expenses is appropriate. This adjustment is shown in Exhibit No.___(JMP-2) at column f, line 22 as R-4.

Q. The next Restating Adjustment is R5, have you reviewed this adjustment?

A. Yes, I have. This proposed adjustment removes out-of-period income tax expense from the results of regulated operations. The company supports this adjustment; in fact, the company did not record this as an expense of its regulated operations. I have included a corresponding adjustment as R-5 in Exhibit No.___(JMP-2) at column f, line 45.

Q. Moving on to staff's Pro Forma Adjustment P3, affecting salaries, benefits and payroll taxes, do you agree that the adjustment proposed by staff adjusts the expense to reflect amounts appropriate for ratemaking?

A. No, I do not. Staff's proposal is to reduce the expense level for employee salaries, benefits and payroll taxes based on the premise that the level of employees decreased in January, 2003 and continued through the present. The staff's analysis of the payroll costs did not look at the number of hours worked by the employees during the test year, or whether the number of hours worked increased after the end of the test period. Also, the staff never inquired as to the reason the company operated with six employees, if that was a temporary staffing level, or if the position was eliminated entirely. The staff's adjustment is to remove from the test period an amount that is equal to one full field staff salary, benefits and payroll tax. There are a number of reasons why this adjustment is inappropriate.

I have prepared Exhibit ___(JMP-5) to show the details of the test period salary expense. You can see by this exhibit that the total hours worked during the test period are all less than full time. As I state later in my testimony, throughout 2002 the company had a full staff of 7+ employees: a manager, two office staff, four field technicians and one temporary field staff helper. In order to meet the lower cash flow in the winter of 2003, all personnel were asked to temporarily cut their hours back to either 30 or 32 hours a week, effective January 1, 2003. In other words, the lower level that staff uses was a temporary reduction that lasted approximately 6 months and does not reflect current operations. When revenues increased in the summer months, the hours were re-established at full time. At the same time, because of an unrelated employment issue, one of the field technicians was terminated. This position has not been eliminated, it just remains unfilled until it is apparent that the cash flow from operations will support all 7 full-time positions.

Prior to cutting back employee hours in January, 2003, we attempted to discuss with staff the issue of the rates generated by the lower level of remaining customers not being adequate to fund the base line 7 employees that were required before the funds in the Docket 010961 Account could be accessed. We pointed out that with the reduction of customers, revenue was going to be reduced by approximately $280,000 and thus the overall expense levels would have to be adjusted accordingly, including salaries. We specifically asked that given the differences between the test period for the settlement and the number of customers remaining after the sale of View Royal, the base line employee level should be adjusted to match the remaining customers. The staff told us that they would oppose any such approach.

The inadequate pro forma level of finding for field staff that the staff has allowed ($77,156) will not pay the salaries of the three current field staff at the level of pay they received in the test period. The removal of a full position when the test period only had the cost of the position for a partial year reduces the amount available to pay the other employees. It appears to be staff's belief that the company has determined it does not need that fourth field staff person. This is simply not true. The company has 4 field staff positions and maintains that those 4 positions are needed to serve the number of customers it currently has. It is precisely because of staff's overly restrictive reading of the Docket account that caused the need to cut back staff hours.

The worksheet presented in Exhibit ___(JMP-5) re-calculates the salaries of the employees to full time status for the whole year. The result of this calculation is a pro forma adjustment to increase salaries, benefits and payroll to reflect a full year of operating costs at the current level of service. The effect of this adjustment is a pro forma increase in employee salaries of $32,099, payroll tax increases by $9,819 and benefits increase by $5,915. This pro forma adjustment is shown as PA-3 in Exhibit ___(JMP-2), page 2, column i, lines 9, 11, and 33.

Q. Have you reviewed the staff's pro forma adjustment P4 relating to interest and federal income tax synchronization?

A. Yes, I have, and while I agree with the theory of the adjustments, I do not agree with the dollar amount of the adjustments because they rely on other contested adjustments. I have recalculated the adjustment as follows: I propose interest expense be adjusted by $16,707, to synchronize the interest expense of $14,762 to rate base of $636,273. This adjustment is shown as P-4 in Exhibit ___(JMP-2), page 2, column i, line 42. This adjustment results in zero taxable interest. Therefore, an adjustment to remove the test period federal income tax expense is appropriate for ratemaking in this proceeding. This adjustment is shown as P-4 in Exhibit ___(JMP-2), page 2, column i, line 43.

Q. Do you have additional adjustments to test period expense to propose?

A. Yes, I have four. Beginning with my pro forma adjustment P-6, I would like to propose that the salary for Mr. Fox be increased to a level consistent with the work he is performing. In the last contested rate filing for AWR, the salary for Mr. Fox was reduced to $24,000 and it was suggested that AWR hire a manager. As a result, Mr. Fox hired Herta Ingram to take over the management of AWR and a salary of $60,000 per year was established and placed in rates. In the year 2000, Mitch Meyers was hired to replace Ms. Ingram as the operations manager for AWR at a similar salary. Mr. Meyers was terminated by AWR in February, 2001 and Mr. Fox took over the duties of operations manager. In the last case, staff removed from test period expense all costs associated with the operations manager as Mr. Fox temporarily filled the position.

It is unfair to Mr. Fox to expect that he fill the operation manager position for a salary that is lower than every other employee of the company. In the last contested case before the WUTC, the staff established the pay for the operations manager at the market rate of $60,000. Exhibit ___(JMP-10) calculates the increase from the test period this salary represents. Adjustment P-6 shown in Exhibit ___(JMP-2), page 2, column i, lines 10 and 33 increases officer salary by $36,158 and the related payroll taxes by $2,766.

Q. What is your next adjustment to test period expense?

A. That would be P-7, Pro Forma Pierce County Permit Costs. This adjustment adds to the test period a new requirement on group B water systems in Pierce County. In October 2003 the Tacoma-Pierce County Health Department instituted a requirement that all group B water systems have a monitoring permit. The monitoring permit comes at a cost of $55 per system and is applicable to the 38 Pierce County group B systems the company operates for a total annual cost of $2,090. A copy of the notice from the Tacoma-Pierce County Health Department is included in Mr. Fox's testimony as Exhibit___(VRF-5). The increased cost is shown as adjustment P-7, in Exhibit___(JMP-2), page 2, column i, line 34.

Q. Please describe your next adjustment to test period expense.

A. My next adjustment, calculated in Exhibit___(JMP-12), increases the test period expense by the cost to the company for the county site assessments of group B public water systems. Mr. Fox has included in this testimony as Exhibit___(VRF-6) a letter from Lewis County Health and Social Services, which announces Lewis County's intention to conduct site visits on systems within their jurisdiction. We anticipate that all of the counties we operate in will follow the Washington State Department of Health's directive and announce their intention to do the same. As Mr. Fox states, each site assessment is anticipated to take up a day's time for each system. In Exhibit___(JMP-12) the average hourly cost of a field technician of $17.00 per hour is presented and it is assumed that this assessment would be done in addition to the field technicians regular duties at their overtime rate of $25.50 per hour. The total employee cost of the site assessment is expected to be $22,848, presented in Exhibit___(JMP-2) as adjustment P-8 in column i, line 9. The associated payroll taxes on this overtime is $2,530, presented in column i, line 33 also noted as adjustment P-8.

Q. What is your final adjustment to test period expense?

A. My last adjustment set forth in Exhibit ___(JMP-11) is to increase the test period rate case costs by the estimated costs of this proceeding. In this exhibit we have estimated that the total accounting, witness and legal costs associated with this proceeding will be $41,000. The frequency of AWR's rate case filings has been about two years, therefore we propose that the costs be amortized over a two year period. The annual rate case expense would be $20,500, an increase of $9,500 as reflected as adjustment P-9 in Exhibit ___(JMP-2), column i, line 23.

V – Rate Base

Q. Have you prepared an exhibit presenting the company position regarding rate base in this proceeding?

A. Yes, I have. Exhibit ____(JMP-6) presents the company position on rate base.

Q. Please explain what this exhibit shows.

A. In looking at my Exhibit ____(JMP-6), lines 1-5 present the account balances as shown on the company's financial statement (Exhibit ___(JMP-3)) on June 30, 2002 and on June 30, 2003. This exhibit calculates the beginning/end of year average (BEOY) account balances of the investment accounts used in calculating rate base. The use of BEOY average is appropriate in ratemaking as it matches the rate base of the test period to the number of customers in the test period to the events (income and expense) of the test period. The WUTC has long used the BEOY average in calculating rate base. Line 6 of my Exhibit ____(JMP-6) is a subtotal of these accounts and the company's net unadjusted rate base is shown in column e. I have presented this unadjusted figure in my Exhibit ____(JMP-2) as lines 50-55, column d. Lines 8-17 of my Exhibit ____(JMP-6) present the company's adjustments to rate base, which I will describe in detail later in my testimony, and line 17 presents the company's final position on net rate base at $813,247.

Q. Please describe your adjustment to rate base identified as R-7.

A. This adjustment adds to rate base the unamortized balance of the Miscellaneous Deferred Debit Account 186.3 Regulatory Assets. There are three regulatory assets that have been capitalized in the past and amortized; these regulatory assets were related to litigation, purchases, and major line repairs. This adjustment to rate base was proposed and accepted as appropriate in the WUTC's Fifth Supplemental Order in Dockets UW-980072, UW-980258 and UW-980265 (consolidated).

Q. Please describe your adjustment to rate base identified as R-8.

A. This adjustment adds to rate base the average balance of the company's dedicated checking account for facility charges. The balance of this account entitled "136.4 FCB – FACILITY CHARGES" can be seen on the company's balance sheet presented in Exhibit ___(JMP-3). When facility charges are collected they are deposited into this dedicated account and recorded as Contributions in Aid of Construction in account 271.1 Facility Charges. The funds are held in the dedicated account until such time as they are spent on capital improvements, which are capitalized as Utility Plant In Service. Contributions in Aid of Construction represent the amount of Utility Plant that was placed in service using customer or other non-shareholder invested funds. Without making this adjustment for the funds held in the dedicated cash account, Contributions in Aid of Construction is overstated in the rate base calculation. The adjustment R-8 restates Contributions in Aid of Construction by $36,366 so that the balance represents the amount of Utility Plant that is actually constructed and in service.

Q. Please describe your adjustment to rate base identified as R-9.

A. Adjustment R-9 is a regulatory adjustment that adjusts Contributions in Aid of Construction of the expenditures from the reserve account created by WUTC order in Docket UW-010417. While the company does not believe this adjustment is appropriate for ratemaking, the company does offer this adjustment in this proceeding in compliance with the WUTC's Order Granting Application for Sale and Transfer of Assets and Tariff Adoption in Docket UW-010417. The figures for this ratemaking adjustment are calculated in Exhibit ___(JMP-7). The second page of Exhibit ___(JMP-7) is a transaction report from AWR's accounting records that reflects the activity of the reserve account since it was established in July, 2001. The transactions from this report have been extracted to the first page of Exhibit ___(JMP-7), which calculates the imputed amortization of this regulatory adjustment as well as sets forth the balances needed for the average rate base calculation. Since the account was established there has been a total of $84,524.81 expended from the account. Of this amount, $63,297 was expended for capital improvements that were capitalized and are being depreciated, $3,125 was expended for legal and accounting expense incurred in support of the capital improvements, and $18,103 was expended as a return of capital to the company in compliance with the WUTC's First Supplemental Order in Docket UW-010417, Modifying Order Approving Sale and Transfer of Assets. Amortization was calculated using straight line and allowing a half-year for the first year the plant is in service. Because the test period is split between calendar years, the accumulated amortization was calculated for the June end test period. Exhibit ___(JMP-6) takes the end of test period numbers calculated on Exhibit ___(JMP-7) and figures the BEOY average for adjustment P-9. The affect of adjustment R-9 is an increase in Contributions In Aid of Construction of $63,297 and a decrease in Accumulated Amortization of $3,600 for a cumulative impact on rate base of a $59,515 decrease.

Q. Please describe your adjustment to rate base identified as R-10.

A. Adjustment R-10 is a regulatory adjustment that is the same as that proposed by staff as adjustment RB2. As discussed by staff, the company is collecting a capital surcharge in the amount of $4.54 per month from all customers on the system. The surcharge expires on December 31, 2006 or upon repayment of $410,956 of principal, whichever occurs first. The funds collected from this surcharge are placed in a reserve account dedicated to the repayment of principal, interest and taxes. In accordance with RCW 80.28.022 and WAC 480-110-455(2)(c), the company has recorded and treated all funds collected through this surcharge as Contributions In Aid of Construction in account 271.6 CIAC – CIP SURCHARGE. The company recorded all assets constructed with funds from the surcharge loan capital assets and as such, properly includes them in the asset listing and book depreciation schedules. The balance of account 271.6 CIAC – CIP SURCHARGE reflects the total of the surcharge collections applied to the principal of the surcharge loan. Because the surcharge is a dedicated income for the repayment of principal and interest on the loan balance, it is appropriate to adjust rate base for the balance of the loan. Adjustment R-10 increases CIAC and decreases rate base by $267,661.

Q. Please describe your adjustment to rate base identified as R-11.

A. Adjustment R-11 is an adjustment for acquisition adjustment that relates back to the last contested rate filing in Docket Nos. UW-980072, UW-980258, and UW-980265 (consolidated). In that case, AWR proposed that rate base be increased above historical cost in the amount of the premium the company paid for the View Royal Company and the H2O Company systems. AWR argued in that case that all of the customers benefited from the purchase of these two systems because of the increase in the number of customers and therefore the higher purchase price should be allowed in rates. The staff argued that the higher purchase price did not benefit the customers and therefore the rate base should remain at original booked cost less depreciation. The staff stated in their testimony of that case that if the company were to purchase systems for less than the historical booked cost of the system, they would allow the historical book cost to be included in rate base.

In the years following the last contested case, AWR has done just that. In 1998 and 1999, AWR acquired a number of systems that were purchased for less than the historical booked cost. These systems were all added to the company's plant records at their historical cost as ordered in Dockets UW-980072, UW-980258, and UW-980265 (consolidated). The result of this was to take the Utility Plant Acquisition Account #114 from a debit balance on 12/31/1997 of $200,193, reflecting the premium paid and the level of investment that the company was not allowed a return on to the average credit balance of $176,974, reflecting the bargain purchases the company has made. By including this account in the rate base calculation, rate base is adjusted below historical cost and the company is denied a return on that bargain purchase. It would be a case of double jeopardy. The company in 1998 was penalized for investing more than historical cost in its plant, and then later when its bargain purchases far outweighed the premium purchases.

In this case, the company only asks that the treatment of plant be consistent. If plant is to be placed in rate base at original historical cost, then the Utility Plant Acquisition Adjustment Account should be removed from the rate base calculation. Adjustment R-11 shown on Exhibit ___(JMP-6), adds back the $176,974 from the Acquisition Adjustment. This adjustment is also shown in Exhibit___(JMP-2) in column f, line 52. Consistent with this adjustment is the addition of the associated amortization of acquisition adjustment which is shown in column f, line 30 as $5,091.

Q. The staff has proposed adjustments to rate base for the gain on the sale of the View Royal water system. Do you agree that the adjustment is appropriate?

A. No, I do not. I believe the circumstances surrounding the sale of the View Royal Water System do not warrant the penalizing adjustments proposed by staff.

Q. Please explain.

A. The View Royal water system was purchased in 1997 for $175,000. Rate base of the system at the time of purchase was $97,915; acquisition adjustment was recorded in the amount of $77,085 to reflect the difference between the purchase price and the established rate base. The company went through a rate case in 1998 where it was repeatedly criticized for purchasing the system for more than the established rate base. The company was told that the customers received no benefit for the purchase of the View Royal system.[1] Because the company purchased the system with funds it borrowed from the sole shareholder, Mr. Fox, the company was further chastised for carrying debt above the established rate base.[2] According to the WUTC order, the higher debt cost put too much of a drain on the ratepayers. The company requested an adjustment to rate base to allow a return on the additional investment above the recognized rate base, and was denied.[3] No return of or return on the higher investment was allowed.

In that case and also since that case, the company continued to be criticized for what is seen as an unwillingness of the company to invest more equity into its plant. The management of the company took much of this criticism to heart and actively pursued ways to infuse more equity into the business. At that point in time, Mr. Fox, the sole shareholder, had invested $310,125 in the equity and had loaned the company over $850,000. Being unable to invest more of his own funds in the company, Mr. Fox went looking for additional investors to add to the capital of the

[1] Fifth Supplemental Order, UW-980072, et al., page 17.
[2] Fifth Supplemental Order, UW-980072, et al., Staff Testimony, Staff Brief.

company and did not find anyone willing to invest equity capital. Since one of the biggest criticisms was that the debt incurred up until 1998 was all from Mr. Fox, the sole shareholder, making it appear as though Mr. Fox was unduly benefiting from the interest paid on the loan, the company pursued a course to replace the shareholder loan with a commercial bank loan. In 1999, the company was able to obtain a commercial loan and replaced roughly half of the shareholder note with third party financing.

After four years of hearing about how he made a poor decision when he purchased the View Royal system, Mr. Fox began searching for another way to reduce the amount of debt the company has. From his prior business experience he knew that there are only two ways besides equity infusion to decrease the amount of debt a company has: you can pay down that debt by increased revenues, or you can sell assets and pay down the debt with the proceeds from the sale of assets. As the company is regulated, an increase in the water rates of the company was not going to be sufficient to pay down the loan to the degree that was required. The company's non-regulated SMA activity was not going to generate the increased revenue to pay down the loan and the company had no other income stream to look towards. Mr. Fox then looked at the only other means available, the sale of company assets.

I found it very curious, and unfair, that the staff in its adjustment for View Royal criticizes the company heavily for carrying the large amount of debt from the purchase of the system above rate base, then on the same page, criticizes the

---

[3] Fifth and Sixth Supplemental Order, UW-980072, et al.

company for paying down that debt. When View Royal was purchased, the company argued that all customers benefited from the purchase because the added customers would bring economies of scale and keep the rates lower. The staff disagreed to this statement and insisted that the purchase was a detriment to the rate payers because they had the burden of carrying the large debt associated with View Royal. Now that the system was sold and all of the proceeds reinvested with the company through the repayment of the debt, the company continues to be criticized as making the wrong decisions.

Q. The staff has proposed adjustments to rate base for the sale of the Birchfield water system. Do you agree that the adjustment is appropriate?

A. No, I do not. The transaction is completely misrepresented and mischaracterized in the staff testimony. The Utility Plant in Service owned by AWR was sold by AWR for rate base; no further adjustment of rate base is necessary or appropriate.

Q. Please explain.

A. Let's look at the Agreement for Transfer of Property that was included in the staff's testimony as Exhibit ___(JAW-17). The agreement is a joint agreement between AWR and Virgil and Carol Fox to sell their separate properties in what is commonly referred to as the Birchfield water system to Lewis County Water and Sewer District No. 5. The Birchfield water system is located in Lewis County on a piece of property owned by Virgil and Carol Fox. As a long-term project, Mr. Fox has been developing this 1,290 acre piece of property into what is known as the Birchfield Master Planned Community (BMPC). The original water system was developed in 1994-1996 to serve the small mobile home park of 20 connections, nine of which are in use and currently located on the property. That is the portion that was incorporated into AWR in exchange for common stock and a note payable to Mr. Fox. AWR has operated this system plant as part of its regulated operations. As part of the development costs of the BMPC, Mr. Fox has installed additional facilities to serve the planned residents of the BMPC. These facilities are separate from those that were built for the mobile home park and are not owned by AWR. They are facilities constructed with Mr. Fox's separate funds, not AWR funds, and are held by Mr. Fox for future use and have never been used and useful properties of the water company.

AWR sold its property, described in Exhibit B of the document as the water system and pump house that was in service to the 9 active and 20 approved customers, for the rate base value of $57,500. Virgil and Carol Fox sold their interest in the additional facilities listed in Exhibit A for $256,500.

Q. Did the sale of the Birchfield system benefit AWR's customers?

A. Yes, I believe that the sale of the Birchfield system benefited AWR's customers a great deal. Birchfield is one of those small systems that was costly to install due to the rural nature of the system. There were only 6 active customers for most of the period since 1996 (up to 9 today) and the monthly revenue from these 6 customers was about $168. Monthly testing is $13, the average electric bill is about $85, and depreciation on the used and useful plant is $183. This means the system generates a minimum net loss of <$113> each month, costs that are borne by the other ratepayers.

Q. What about the lost facility charges on the unsold connections?

A. According to the Department of Health records, the system has recently been approved for 37 connections, up from 20. In fact, the engineering costs assumed by Lewis County Water & Sewer District No. 5 as part of the sales contract, were in part system plan revisions in order to increase the approved connections from 20 to 37. It is true that each new connection would bring $1,860 in facility charge. However, there is a hitch to adding additional customers to the system. Development in the BMPC has been under moratorium until Lewis County has approved the community plan under the Growth Management Act. Until that approval is obtained, there can be no new construction or sale of lots. The approval of the BMPC has been delayed indefinitely and there is no guarantee that those lots will be sold in the near future.

Q. Staff has proposed an adjustment to rate base to reflect the allocation of gain from the sale of the Birchfield system. Is this adjustment appropriate?

A. No. Allocation of gain between the ratepayer and the shareholders in this case is completely inappropriate. There simply is no gain on the sale to allocate. The Birchfield water system was sold for rate base. The plant accounts have been adjusted to remove the system and reflect the sale. No further adjustment is appropriate.

Q. Do you propose any further adjustment to the rate base of AWR?

A. No.

VI - Docket 010961 Account

Q. What is the Docket 010961 Account?

A. I believe staff adequately described the Docket 010961 account. It is a dedicated fund created by the WUTC's Order Accepting Settlement Agreement in Docket No. UW-010961. In this order, the WUTC authorized a $3.47 increase in AWR's tariff and required $4.40 of each monthly payment to be placed into the account. The authorized use of this fund was to:

> "(c) cover only those expenses for employees hired in addition to existing employee positions, the related benefits, payroll tax, and transportation expense, and outside business consulting that exceed the average monthly amount spent during the test period, calculated as follows:
>
> | Expense | Monthly Average |
> |---|---|
> | Salary | $17,447 |
> | Transportation | 2,787 |
> | Payroll Tax & Benefits | 4,662 |
> | Business consulting | 917 |
>
> (d) Not pay expenses for any change in position or increase in expenses for existing employee positions from the separate account.
>
> (e) Obtain the vehicles to be used by the two additional field employees from an independent company, i.e. one with no ties to the Company, or to Mr. Fox, by purchase or lease."[4]

Q. What happened after the last tariff increase was granted?

A. The tariff pages were filed and approved December 18, 2001. The company and I had several discussions about the implementation of the order. I had the company prepare job announcements for the new positions. We planned to bill the first

[4] Order Approving Settlement Agreement, Docket UW-010961.

month with the new rates on about the 26th of the month, collect the revenue and make the required deposit into the Docket 010961 account. After the money was collected and deposited, we would begin the recruitment process, place advertisements in the local paper and hire employees. We had, in the months just prior to this, established a relationship with Pinnacle Capital, LLC, a leasing company in University Place, WA, to establish credit for an operating lease to obtain vehicles for the new employees as well as replace the existing service vehicles.

I received a call from Mr. Fox on about January 16, 2002 that he had reached an agreement with Valley Water District to sell the View Royal water system. At this point in time I told the company to hold off on the recruitment process for the new employees as the sale would significantly impact the company's operations and we would need to reevaluate the revenue and expenses of the company without the View Royal customers. If you have to point a finger at someone for making the decision not to hire employees, then you'll have to blame me.

Q. Were you aware of negotiations to sell View Royal before this time?

A. I have known for years that Valley Water District was interested in buying View Royal water system. View Royal Water Company, Inc., the prior owners of the View Royal water system, were in negotiations to sell to the Valley Water District in 1997, but were unable to make the deal work. Later, after AWR purchased the View Royal system and operated for a couple of years, I was told that AWR had off and on discussions with Valley Water District regarding the potential sale of View Royal. I was not aware that the discussions had progressed to the point of an agreed upon sales price. I was also aware of other discussions regarding the sale of water systems, however as none of the discussions had ever resulted in a sale, I did not believe any were going to occur. I was definitely surprised when the sale of the View Royal water system was announced.

Q. Why did you instruct the company not to proceed with the recruitment and hiring of employees?

A. Quite frankly, I did not have a complete picture of what impact the sale was going to have on the monthly revenue and expense of the company. It became extremely important that cash flow was to be tracked monthly because of the restrictions placed on company operations in Docket UW-010961. I prepared a spreadsheet on which I could compare the company's revenue and expenses to the "budgeted" amounts that were stipulated in the order, the spreadsheet has been marked Exhibit ___(JMP-9). I found that in January, total billed revenue was $66,011.71 (including the $4.40 per month that was restricted) and total accrued operating expenses for the month was $64,291.97, for a net operating income of $1,719.74. When this income was collected, the company was required by order to place $8,254.40 into the Docket 010961 account, creating a net operating loss of <$6,534.66>. I realized that even though the company received an increase in rates, it did not do anything to help the monthly cash flow of the company. I estimated that with the sale of View Royal, revenue was going to decrease by approximately $14,988 monthly on average, but I did not know the extent of the decrease in related expenses. I could figure what the reduction in depreciation/amortization costs was ($2,228.44), estimate the cut in power costs ($800-$1000), but that was it. I did not know the impact the sale was going to have on expenses. More cuts had to be made. I looked at the wages expense. The order appeared to require that the wages had to exceed the average $17,447 to use the restricted funds; January wage costs were just $16,352 because the bi-weekly payroll only had 28 paid days in January. Technically, the company would not have been able to use the funds for the hiring of additional employees until the payroll of the existing employees exceeded $17,447. It appeared to be a catch-22 situation.

The situation was further compromised in that somehow the company was going to have to cut its expenses to be able to continue operating with reduced revenue.

Q. The staff's testimony states that the sale of View Royal eliminated the need for additional employees at the level anticipated by the WUTC's order in Docket UW-010961. Do you agree that this statement is accurate?

A. I do not believe the statement is accurate. After the sale of View Royal, it became apparent that the rates generated by the remaining customers, after the $4.40 was deposited into the separate account, did not support the level of employees that were currently employed by AWR. If the company did not maintain the 7 employees it had, then there was no way the company could use the funds in the Docket 010961 account. In an effort to maintain the 7 employees and keep a consistent level of service for the customers, the company did not take action to reduce employees for many months. The company needs the 7 employees, in addition to the manager, to provide an adequate level of service. It does not need to add additional employees, above the 7, at this time.

Q. What is the staffing level of the company?

A. Throughout 2002 the company had a manager, two office staff, four field personnel, and one temporary field staff person throughout the summer. In order to meet the lower cash flow in the winter, all personnel were asked to temporarily cut their hours back to either 30 or 32 hours a week, effective January 1, 2003. At the same time, because of an unrelated issue, one of the field staff was terminated. When revenues resumed to levels that would support a full time staff, all staff members resumed full time hours. The terminated position was not eliminated and just remains unfilled.

As I stated before, we attempted to discuss with staff the issue of the rates generated by the lower level of remaining customers not being adequate to fund the base line 7 employees that were required before the funds in the Docket 010961 account could be accessed. We specifically asked that the differences between the test period for the settlement and the number of customers remaining after the sale of View Royal be examined and that the conditions over the Docket 010961 account be modified. The staff told us that they would oppose any such approach.

Q. Did the Company fund the Docket 010961 Account as ordered by the Commission?

A. The company made every attempt it could to fund the account, however there were months where the operating expenses and other legal obligations of the company were such that the company was unable to make the required deposits. Currently there is $5,290 that remains to be deposited.

Q. Would you like to discuss the use of the Docket 010961 funds for the payment of taxes?

A. The company has made its tax payment from this account as they are a legal obligation of the company and normally would be included as a part of rates. There was no provision made in rates for the payment of income taxes owed from regulated operations. The rates approved by the WUTC in Docket 010961 and set aside by mandatory deposits created taxable income which translates to income tax that needs to be paid. The $18,494 was paid for the 2002 taxes. The $10,400 was paid for 2003 estimated taxes. The staff is incorrect in its testimony that this is a requirement just on "AWR to prepay its taxes each quarter because AWR failed to pay the taxes due for the View Royal gain on sale and the amounts deposited into the Docket 010961 Account." According to IRS Code Section 6655, which applies to all for-profit corporations in the United States, "A corporation that anticipates a tax bill of $500 or more must estimate its income tax liability of the current tax year and pay four quarterly estimated tax installments (with form 8109) during the year. Any underpayment of a required installment results in an addition to tax on the amount of the underpayment of the period of underpayment."

Q. What is the proper accounting of the funds involved with the Docket 010961 Account?

A. The rate increase approved under Docket 010961 was a general rate increase. Nowhere in the discussions between the company and staff prior to the settlement agreement, nor in the Order Approving Settlement Agreement, is the distinction made that the revenue generated by these rates is anything other than Metered or Unmetered Water Revenue. The rate is not separately stated on the tariff page as part of the monthly water rate. The charge is correctly characterized as Water Revenue. To adopt staff's position and recognize the funds as a regulatory liability would be retroactive ratemaking.

Q. Do you agree with the staff's recommended adjustments related to Docket 010961?

A. No, I do not. Staff's adjustments unduly penalize the company for attempting to comply with the order and finding that there wasn't enough resources within the company to comply fully. The company attempted to request relief from the WUTC in its request for a modification of the Order Approving Settlement Agreement that was filed in November, 2002. That request was ignored by the WUTC and the staff, and later withdrawn by the company per the request of staff. If the WUTC approves the adjustments proposed by the staff in R6, P5, and RB5, the company will not have adequate revenue to operate.

Staff's adjustment does not recognize that the revenue collected and set aside in the mandatory account is directly responsible for federal income tax that, regardless of any action by the WUTC, is still a legal obligation of the company. We have already pointed out that the 2002 obligation was $18,494. My current calculation of the tax liability for 2003 is $23,700, of which $15,600 has been paid in estimated tax deposits, leaving an outstanding estimated obligation of $8,100. Both of these obligations of the company have been completely ignored by staff in their testimony.

What I would recommend is that the company be allowed to use the funds left in the Docket 010961 account to pay the current income tax liability and the past due accounts payable and go forward from here with a new rate structure designed to recover the costs of operation and provide a reasonable return on investment. The company could then focus on its obligation to provide reasonable service to its customers for a reasonable price and not spend any more time struggling to meet its past due obligations.

VII - Capital Structure

Q. What is the company's capital structure?

A. I prepared Exhibit ___(JMP-9) to calculate the company's capital structure. Page 1 of Exhibit ___(JMP-9) calculates the capital structure of the company at 35% debt and 65% equity. This calculation includes only the long-term debt of the company. Short-term debt or accounts payable are not included as they represent the working capital of the company. The staff's calculation includes the short-term debt and accounts payable as a component of the capital structure to arrive at the 50/50 split of debt and equity. The staff has misrepresented the cost of the debt in their calculation; therefore I have presented on pages 2 and 3 a more accurate calculation using the staff's methodology.

Q. Please describe the company's cost of debt calculation.

A. The company has $273,543 in long-term debt. The weighted cost of this debt is 6.56%. See Exhibit ___(JMP-9). Please note that Mr. Fox has worked very hard to obtain more favorable interest rates over the past few years. I am sure staff will either not recognize those efforts or find a way to criticize him for those efforts.

Q. Please describe the company's cost of equity calculation.

A. The company has $499,605 in equity, as shown in Exhibit ___(JMP-9). The company accepts the return on equity of 12% as proposed by staff.

Q. What is the average weighted cost of capital of AWR?

A. I have calculated the average weighted cost of capital or rate of return of AWR at 10.07% as shown in Exhibit ___(JMP-9).

VIII - Customer Count and Rate Design

Q. What is the company's customer count for the test period?

A. According to the billing records, the company's average billed monthly customer count was 1,495 during the test period. This was calculated by averaging the number of active customers billed each month. The number of customers billed monthly is presented in Exhibit ___(JMP-4).

Q. What rate design do you propose for setting AWR's rates in this case?

A. I would propose that the rate change be applied equally to the base charge of all customers. This was deemed appropriate in the last rate case and I do not see any reason to deviate from this methodology in this proceeding. The company has determined that it has a net operating income deficiency of $193,237 at the current rate level. Using the monthly average number of customers, this results in an increase in rates of $10.76. The rates proposed by the company are as follows:

	Current	Proposed	Difference
Flat Service	$33.04	$43.83	$10.79
Meter Service Base	$16.77	$27.56	$10.79
0 – 500 cubic feet	$0.0121	$0.0121	-0.00-
>500 cubic feet	$0.0175	$0.0175	-0.00-

Q. Does this conclude your testimony at this time?

A. Yes.