Exhibit T-___ (JAW-24T)
Docket Nos. UW-031284/010961/
031596 (consolidated)
Witness: James A. Ward

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. AMERICAN WATER RESOURCES, INC., Respondent.	DOCKET NO. UW-031284 & DOCKET NO. UW-010961 DOCKET NO. UW-031596 (consolidated)

TESTIMONY OF

James A. Ward

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

April 1, 2004

Part 1 – Introduction

Q. Please state your name and business address.

A. My name is James A. Ward. My business address is 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA 98504-7250.

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

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

Q. Have you testified previously in this proceeding?

A. Yes. I submitted testimony and exhibits in this proceeding on December 16, 2003. Those exhibits are Exhibit No. ___ (JAW-1T) through Exhibit No. ___ (JAW-23). I filed a revised Exhibit No. ___ (JAW-1T) on February 4, 2004.

Q. Are you submitting exhibits in addition to your rebuttal testimony?

A. Yes. I am submitting the following documents:

Exhibit No. ___ (JAW-25), Updated Results of Operations

Exhibit No. ___ (JAW-26), AWR's Employee Expenses

Exhibit No. ___ (JAW-27), Letter & Interoffice Memo from Lewis County Public Health Dept

Exhibit No. ___ (JAW-28), AWR's Response to Data Request No. 23

Exhibit No. ___ (JAW-29), AWR's Response to Data Request No. 26

Exhibit No. ___ (JAW-30), NRRI Survey

Exhibit No. ___ (JAW-31), AWR's response to Data Request No. 16.

Exhibit No. ___ (JAW-32), Gain on Sale – View Royal

Exhibit No. ___ (JAW-33), AWR's Response to Data Request No. 21

Exhibit No. ___ (JAW-34), Excerpt from AWR's Water System Plan December 2000

Exhibit No. ___ (JAW-35), Excerpt from AWR's Current Tariff

Exhibit No. ___ (JAW-36), Group B Sampling Document

Exhibit No. ___ (JAW-37), AWR's Depreciation Schedule February 2000

Exhibit No. ___ (JAW-38), Declaration and Documents from WA Department of Ecology

Exhibit No. ___ (JAW-39), Gain on Sale – Birchfield

Exhibit No. ___ (JAW-40), AWR's 2002 Tax Return

Exhibit No. ___ (JAW-41), AWR's 1999 Tax Return

Exhibit No. ___ (JAW-42), AWR's 2000 Tax Return

Exhibit No. ___ (JAW-43), Uniform Systems of Accounts Sections

Exhibit No. ___ (JAW-44), AWR's Quarterly Report Dated January 22, 2004

Exhibit No. ___ (JAW-45), AWR's Capital Structure

Q. Have you reviewed the testimony and exhibits filed on behalf of AWR by Julia Parker and Virgil Fox?

A. Yes.

II. REVENUES

Q. With regard to Staff's Pro Forma Adjustment P-1, Ms. Parker testifies that she agrees with the premise of the adjustment, but proposed a different amount. Exhibit No. ___ (JMP-1T) at 8:9-17. Does Staff agree with the amended amount?

A. Yes. Staff accepts the amount as proposed by Ms. Parker. Pro Forma Adjustment P-1 reduces revenue by $1,104, and is shown in Exhibit No. ___ (JAW-25) at column H, row 8.

Q. With regard to Staff's Pro Forma Adjustment P-2, Ms. Parker testifies that she agrees with the principle of the adjustment, but not how the adjustment was calculated. Exhibit No. ___ (JMP-1T) at 8:18 to 9:3. How does Staff respond?

A. Staff accepts the amount as proposed by Ms. Parker. Pro Forma Adjustment P-2 reduces revenue by $78,976, and is shown in Exhibit No. ___ (JAW-25) at column K, row 8.

III. EXPENSES

Q. With regard to Staff's Restating Adjustment R-3, has Staff reviewed Ms. Parker's recommendation? Exhibit No. ___ (JMP-1T) at 10:10 to 11:17.

A. Yes. Ms. Parker accepts Staff's Restating Adjustment R-3(a), which removes out-of-period expenses for preparation of an annual report and income taxes. Ms. Parker also accepts Staff's Restating Adjustment R-3(b), which removes accounting expenses related to the sale of water systems. Ms. Parker adds AWR's Restating Adjustment R-3(c) to account for a credit recorded on the Company's books that offsets a bill from a prior period. The amount of the credit was $3,596. Staff accepts AWR's Restating Adjustment R-3(c) to add $3,596 back to the Company's accounting expenses. The combined Restating Adjustment R-3 is shown in Exhibit No. ___ (JAW-25) at column E, row 22.

Q. Does Staff agree with the Company's treatment of Pro Forma Adjustment P-3, which deals with employee costs? Exhibit No. ___ (JMP-1T) at 12:7 to 14:15.

A. No. Staff recommends that the Commission set rates based on historical cost adjusted for known and measurable expenses. Therefore, only the amount AWR paid during the test period for the appropriate level of employee expenses should be included in rates. If AWR's employee cost increases, either through increasing employee hours or hiring additional employees, that cost can be included in rates during a future rate case. This is consistent with traditional regulatory theory.

In the alternative, if the Commission believes some adjustment to AWR's employee costs is appropriate, Staff recommends that the Commission include only the full-time compensation amount for AWR's six employees, consisting of one manager, three field employees, and two office employees. Amounts associated with employees not yet hired should <u>not</u> be included in rates.

Q. Please explain Staff's primary recommendation with regard to Pro Forma Adjustment P-3.

A. AWR employed 7.5 employees during the test period, but the level of employees AWR seems to require is six. During the test period, AWR spent $23,842 for its manager's salary; $112,172 for its 4.5 field employees; $56,924 for its two office employees; $29,071 in benefits for all employees; and $25,252 in payroll taxes for all employees. Those amounts adjusted to reflect three field employees are appropriate to be included in rates. The test period amounts adjusted to reflect three field employees are $89,070 in wages, $26,859 in benefits, and $22,006 in taxes.

Q. Please explain Staff's alternative recommendation regarding Pro Forma Adjustment P-3.

A. Full time compensation for the current level of active field employees (3) and office employees (2) should be included in AWR's expenses only if the Commission decides that an adjustment to AWR's employee expenses is warranted. After reviewing Ms. Parker's testimony, Staff requested data on the number of hours each employee worked during the test period. The data indicates that all of AWR's employees worked reduced hours during part of the test period. Exhibit No. ___ (JMP-5). If the Commission allows full time compensation in rates, AWR should be required to employ full time employees used only for AWR work.

Q. Why does Staff recommend the Commission reject AWR's request for costs associated with future employees.

A. Staff does not agree that expenses for future employees should be included in AWR's rates. AWR repeatedly requests rates to cover additional employees. The Commission granted rate increases that included funds to hire additional employees in AWR's last three general rate cases. Each time a rate increase was allowed, AWR failed to hire or maintain the additional employees it said it needed.

For example, in Docket No. UW-980253 (rates effective November 24, 1998), AWR sought rates for additional employees. At that time, the Company had seven employees and wanted to employ nine. Staff did not support including amounts for future employees in rates. However, the Commission granted AWR's request for rates after hearing. After the rate increase, AWR hired more employees for a total of nine, but did not maintain them and was down to eight and one-half employees in May 1999.

In Docket No. UW-991392 (rates effective November 16, 1999), AWR again requested rates for two additional employees. AWR had at that time eight and one-half employees. Staff supported the rate increase, and the Commission granted the increase with no conditions. AWR did hire one additional employee, but did not maintain that level and was down to eight employees by September

2000. AWR continued collecting rates that included the increased employee costs.

In the last rate case, Docket No. UW-010961, AWR had seven employees and requested funds for two additional employees. The Commission approved a rate increase specifically to allow AWR to hire two additional employees. The Commission required AWR to establish a separate account, the Docket 010961 Account, to hold the funds for the additional employees. Establishing the Docket 010961 Account was necessary because AWR had consistently represented to the Commission that it needed additional employees, the Commission consistently granted rate increases to cover additional employees, and AWR consistently failed to hire or maintain those additional positions after the Commission granted the rate increases. After the Order was entered in Docket No. UW-010961, AWR did hire one temporary field helper for four months in 2002; however, the Company has not maintained the additional employees it said it needed.

To avoid a similar situation in this rate case, Staff recommends the Commission follow standard ratemaking principles of setting prospective rates based on historical cost data. Rates should be set on known and measurable costs.

During the test period, AWR operated with 4.5 field employees during the first six months and with three field employees during the last six months. Since January 1, 2003, AWR has operated with six employees. In fact, AWR has operated with six employees for the last 14 months. Rates should be set based on six employees, which consist of one manager, three field workers, and two office personnel. Staff has adjusted the salary cost, benefit costs, and payroll tax cost to reflect what three field employees cost AWR during the test period. AWR's test period amount for field employees was $112,172. Exhibit No. ___ (JAW-1T) at 11:18. As adjusted, AWR's test period amount for three field employees is $89,070.

AWR continued to service its debt while collecting rates that included funds to hire additional employees that AWR did not hire or maintain. Exhibit No. ___ (VRF-1T) at 14:13-22.

Q. What level of costs does Staff propose to include in rates for employee expenses?

A. The following chart shows the test period cost, which Staff recommends the Commission allow in rates, and Staff's alternative recommendation.

Position/(# of Employees)	Adjusted Test Period Costs	Alternative Recommendation	Difference
Manager (1)	$23,842	$24,000	$158
Field (3)	$89,070	$98,703	$9,633
Office (2)	$56,924	$64,002	$7,078
Benefits (6)	$26,859	$26,859	$0
Payroll Tax (6)	$22,006	$24,169	$2,163

Q. What should happen if AWR hires and maintains additional employees?

A. After AWR has operated with additional employees and has incurred the additional expenses, those employee expenses will be included in rates.

Q. With regard to Staff's Pro Forma Adjustment P-4, Ms. Parker testifies that she agrees with the theory of the adjustment, but not the dollar amount. Exhibit No. ___ (JMP-1T) at 14:16 to 15:3. Does Staff agree with the Company's treatment of Adjustment P-4?

A. No. This adjustment is dependent on the final rate base. Ms. Parker bases her adjustment on a rate base of $813,247. Staff's adjustment is based on Staff's calculation of rate base, which results in a rate base of $546,514. This includes the adjustments Staff accepts based on the Company's testimony and updated information. Pro Forma Adjustment P-4 for interest synchronization expense based on Staff's calculation of rate base would reduce AWR's interest expense by

$14,044. Pro Forma Adjustment P-4 is shown in Exhibit No. ___ (JAW-25) at column Q, row 45.

Q. Regarding AWR's Pro Forma Adjustment P-6 sponsored by Ms. Parker (Exhibit No. ___ (JMP-1T) at 15:4-22), does Staff accept the Company's adjustment to increase manager compensation to $60,000?

A. No. Staff does not agree with AWR's Pro Forma Adjustment P-6. Manager compensation was set at $24,000 in Docket No. UW-991392. The reason it was set at $24,000 was a response to poor management, poor customer service, and poor service quality. AWR agreed to the reduced salary amount. Staff believes the manager's compensation should remain near $24,000 because of ongoing management concerns. Because AWR spent $23,842 during the test period, Staff recommends the Commission set rates using that amount.

Mr. Fox quotes his corporate goals to create a financially sound business venture that is large enough to have a scale of economy, employ competent personnel, function professionally, and provide a rate of return incentive for its management and shareholder. Exhibit No. ___ (VRF-1T) at 9:3-6. However, in the last few years AWR has sold 21 of its water systems to Peninsula Light, has sold the View Royal water system to Valley Water District, and has sold the

Birchfield water system to Lewis County Water and Sewer District #5. AWR has been sued by its customers on the Crowder Road water system, with the customers prevailing and obtaining a judgment of approximately $600,000. AWR has not completed updates to its water system plan as required by DOH.

AWR has reduced the hours during which employees are available to address customer concerns. AWR mismanaged the Docket 010961 Account by not fully funding the account and using the money for inappropriate purposes. Each of these items was a direct result of management decisions.

In addition, maintaining a level similar to that set in Docket No. UW-991392 is appropriate because the outside consulting expense continues to increase. Mr. Fox testifies that he does not make significant expenditures or decisions without his advisors' approval. Exhibit No. ___ (VRF-1T) at 22:14-16. Mr. Fox acknowledges that this practice of consultation increases AWR's operating costs. Exhibit No. ___ (VRF-1T) at 22:16-18. The advisor fees have added unnecessarily to AWR's operating cost. Mr. Fox's reliance on outside consultants and the increased costs of this practice justifies maintaining management compensation at $23,842.

Q. With regard to AWR's Pro Forma Adjustment P-7 sponsored by Ms. Parker (Exhibit No. ___ (JMP-1T) at 16:1-10), does Staff accept the adjustment, which adds Pierce County permitting fees of $55 per water system to AWR's expenses?

A. Yes. Water systems are subject to multiple levels of review and regulation, and the cost of that regulation is properly passed through to customers. The Pierce County permitting fees of $55 per water system is an annual fee and is properly passed on to customers. Staff agrees to AWR's Pro Forma Adjustment P-7.

Q. Ms. Parker sponsors AWR's proposed Pro Forma Adjustment P-8 for additional compensation and payroll taxes for site assessments of Group B water systems conducted by local health authorities. Exhibit No. ___ (JMP-12) at 16:11 to 17:3. Does Staff accept the Company's adjustment?

A. No. Ms. Parker calculates that the site assessment cost would apply to all Group B water systems owned by AWR. However, AWR has not provided documentation showing that any county other than Lewis County plans to conduct site assessments. In addition, not all Group B systems will be inspected. The letter from Lewis County Health regarding the site assessments indicates that only one of AWR's 32 Group B water systems located in Lewis County will be visited in 2004. Exhibit No. ___ (VRF-6). That water system is Raubuck/060471.

Ms. Parker notes in her testimony: "As Mr. Fox states, each site assessment is anticipated to take up a day's time for each system." Exhibit No. ___ (JMP-1T) at 16:19-20. However, DOH estimates that the site assessments will take approximately one to two hours, plus driving time. Exhibit No. ___ (DL-1T) at 28:16-17. In addition, many of AWR's water systems are located adjacent to each other, which likely reduces the inspection time. Exhibit No. ___ (DL-1T) at 29:3. For example, Brookhaven #1, #2, and #3; Eastridge #2 and #3; Granite #1 and #2; Hunter #1, #2, #3, and #4; RES #1, #2, and #3; and Taylor Creek #1 and #2 are groups of water systems that are located adjacent to each other. It is unlikely that each water system will require one day to conduct a site assessment when systems are located adjacent to each other.

Additionally, Ms. Parker calculates that the site assessments will be conducted while Company staff is in overtime status. AWR provides no reason why Company staff cannot assist with the site assessments during normal working hours. Staff believes that no adjustment to compensation or payroll taxes is necessary to complete the site assessments.

Staff spoke with officials from Lewis County Health and learned that site assessments for Group B water systems were conducted in 2002. Exhibit No. ___ (JAW-27). In one day, Lewis County Health officials conducted 18 site assessments, which included 28 water systems. Those site assessments were of the same nature and purpose as the site assessments for which AWR seeks $22,848 to be included in rates. Lewis County Health officials also conducted another AWR site assessment visit on another day in 2002, during which AWR personnel were not present. Exhibit No. ___ (JAW-27). AWR allowed the Lewis County Health officials to retrieve the keys from AWR's office and perform the assessments on seven Group B water systems in less than one day without AWR personnel. Because AWR has not demonstrated that the site assessment visits will result in additional costs to the Company, no adjustment to AWR's expenses is needed.

Q. Ms. Parker sponsors AWR's proposed Pro Forma Adjustment P-9, which increases the test period rate case costs. Exhibit No. ___ (JMP-1T) at 17: 4-11. Does Staff accept AWR's Pro Forma Adjustment P-9?

A. No. Ms. Parker estimates that this rate case will cost $41,000, but does not provide backup information to support the estimated cost of Legal ($20,000), Witness ($5,000) and Accounting ($16,000), shown in Exhibit No. ___ (JMP-11). Ms. Parker also fails to acknowledge that some rate case consulting costs are imbedded in accounting and legal expenses already allowed in rates.

Ms. Parker notes that the frequency of AWR's rate case filings has been about two years. Exhibit No. ___ (JMP-1T) at 17:8-10. However, a rate case filing does not always result in a formal hearing, as this case has. AWR has filed seven general rate cases and several surcharges and has completed two formal hearings. The first was in 1998, in the consolidated dockets (Docket Nos. UW-980072, UW-980258, and UW-980265), which dealt with a general rate increase and AWR's Facilities Charge. The second hearing was in Docket No. UW-000405, which dealt with an extension of the critical list surcharge and was dismissed. This case is the third formal hearing resulting from a rate filing.

Staff believes the current amount of $11,000 per year should continue to be used. In 1998, rate case costs were set at $36,000 amortized over three years, resulting in $12,000 being included in rates annually. Docket Nos. UW-980072, UW-980258, and UW-980265 (consolidated). Rate case costs were set at $11,000 per year as part of the settlement in Docket No. UW-010961. The conditions under which rate case costs were established in both the Consolidated 1998

Dockets and Docket No. UW-010961 are similar to the conditions present in this case.

IV. RATE BASE

Q. Ms. Parker sponsors Adjustment R-7, which adds to rate base the unamortized balance of AWR's Miscellaneous Deferred Debit Account 186.3 Regulatory Assets. Exhibit No. ___ (JMP-1T) at 18:9-15. Does Staff agree with this adjustment?

A. Yes. Staff agrees with Adjustment R-7, and $6,467 should be added to rate base. Adjustment R-7 is shown in Exhibit No. ___ (JAW-25) at column Q, row 52.

Q. Ms. Parker sponsors Adjustment R-8, which adds to rate base the average balance of AWR's dedicated checking account for facility charges. Exhibit No. ___ (JMP-1T) at 18:16 to 19:7. Does Staff agree with this adjustment?

A. Yes. Staff agrees with Adjustment R-8, and $36,366 should be added to rate base. Adjustment R-8 is shown in Exhibit No. ___ (JAW-25) at column Q, row 52.

Q. Ms. Parker sponsors Adjustment R-9, which adjusts Contributions In Aid of Construction (CIAC) of the expenditures from the reserve account created in

Docket UW-010417. Exhibit No. ___ (JMP-1T) at 19:8 to 20:11. Does Staff agree with this adjustment?

A. Yes. Adjustment R-9 is appropriate for ratemaking purposes. The total amount expended for this account has been $84,525. 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 to support the capital item, and $18,103 was expended for return of capital as provided in Docket UW-010417. The affect of this adjustment is an increase in CIAC of $63,297 and a decrease in Accumulated Amortization of $3,600 for a cumulative impact on rate base of a $59,515 decrease. Adjustment R-9 is shown in Exhibit No. ___ (JAW-25) at column Q, rows 56 and 57.

Q. Ms. Parker sponsors Adjustment R-11, which provides for an acquisition adjustment to rate base. Exhibit No. ___ (JMP-1T) at 21:7 to 22:17. Does Staff agree with this adjustment?

A. Yes. As Ms. Parker observes, Adjustment R-11 relates to an issue from a previous case with AWR. Exhibit No. ___ (JMP-1T) at 21:8-10. In Docket Nos. UW-980072, UW-980258, and UW-980265 (Consolidated 1998 Dockets), the Commission determined, based on the facts in that case, that AWR's acquired water systems should be recorded in rate base at historical booked cost, depreciated to the appropriate point in time. Fifth Supplemental Order at 10-18; Sixth Supplemental Order at 12. Ms. Parker states that AWR was penalized for purchasing systems at a premium when the Commission applied this approach. Exhibit No. ___ (JMP-1T) at 22:8. This approach does not penalize AWR. Under the facts presented in the Consolidated 1998 Dockets, AWR simply did not justify including the premium amounts in rate base. Even though the premium amounts were not included in rate base, AWR was rewarded for purchasing distressed systems under this approach because water systems purchased for less than book value were included as an offset to the premium.

To understand how AWR was rewarded under the Consolidated 1998 Dockets approach, it is necessary to understand the accounting for the acquisition adjustment. Acquisition adjustment amounts are recorded in Account 114 Utility Plant Acquisition Adjustment. Under the approach used by the Commission in the Consolidated 1998 Dockets, proper accounting requires that when a utility pays less than historical booked cost for an asset, it records the amount of the discount as a negative amount to Account 114. When a utility pays more than historical booked cost for an asset, it records the amount of the premium as a positive amount to Account 114. The balance for Account 114 is the net of these amounts. A negative balance reflects larger discounts than premiums. A positive balance reflects larger premiums than discounts. This approach balances premium and discount purchases, and this balancing rewards AWR.

The effect of the acquisition adjustment on rate base depends on the facts of each case. AWR acquired water systems over time both at discounts and at premiums. In the Consolidated 1998 Dockets, AWR had purchased water systems at premiums and discounts, and the premium purchases outweighed the discount purchases. The Commission allowed in rate base the historical cost amount because AWR did not show a benefit to customers commensurate with the amount AWR proposed to include in rate base with regard to the premium purchases.

Since that time, AWR's acquisitions and sales has changed the balance in Account 114. AWR sold View Royal, one of the premium purchases from the Consolidated 1998 Dockets, and purchased six water systems at bargain discounts. View Royal had a premium of $164,808 over rate base. The total purchase price for the six systems purchased at a discount was $4, and those six systems had a total historical book cost of $99,362. Exhibit No. ___ (JAW-28); Exhibit No. ___ (JAW-29). As a result of AWR's acquisitions and sales, Account

114 now carries a negative balance of $176,974, which reflects more discount payments than premium payments. Exhibit No. ___ (JMP-1T) at 22:4; Exhibit No. ___ (JMP-6). The Commission must now determine how to treat AWR's acquisition adjustments in this case.

AWR argues that it is entitled to add the amount of the negative acquisition adjustment to its rate base. AWR suggests that the Commission established that AWR is entitled to the higher historical cost when it purchases water systems at a discount. Exhibit No. ___ (JMP-1T) at 21:17-19. To the contrary, Staff believes that the Commission's Sixth Supplemental Order issued in the Consolidated 1998 Dockets states very clearly that the Commission did not create an entitlement to use the balancing approach. Sixth Supplemental Order at 12.

If AWR's position today is that including the negative balance of Account 114 in rate base now will complete the balancing process that began in 1998, Staff agrees, but with two important conditions. First, customers should receive a portion of the gain from the View Royal sale equal to the debt in AWR's capital structure as I describe in my direct testimony. Exhibit No. __ (JAW-1T) at 21:9-15. If the proceeds belong to Mr. Fox as the sole shareholder, as AWR argues, there is no need to provide a balancing of the premium and discount purchases.

The balancing only makes sense if the gain on sale is shared between the shareholder and the ratepayers. I discuss the treatment of the gain on sale resulting from the sale of View Royal more fully in my direct testimony at Exhibit No. ___ (JAW-1T) at 20:6 to 24:9, and in my rebuttal testimony under Section V, below.

Second, AWR's acquisition adjustment will be reviewed in every rate case on a stand-alone basis. Clearly, there are circumstances in which a balancing is not needed.

Adjustment R-11 is shown in Exhibit No. ___ (JAW-25) at column Q, rows 55 and 57.

V. GAIN ON SALE

Q. Do water companies regularly buy and sell plant assets for gain?

A. No. Windfalls in excess of historical cost are not ordinary in the water industry. Normally, water companies do not continually buy and sell water systems. Water companies typically purchase water systems and hold them for long periods of time to provide water service. Because the nature of the water business is to provide service over time, buying and selling (trafficking) of water systems is very rare. However, during the last eight years, AWR has repeatedly bought and sold water systems.

In March 2001, AWR sold 21 water systems to Peninsula Light for a gain on sale of $110,856. In January 2002, AWR sold the View Royal water system to the Valley Water District for a gain on sale of $335,550. AWR sold the Birchfield water system in 2002. Mr. Fox testified that he purchased the Country Water system in 1998 for $190,000. He explains that he "defied" Commission Staff by purchasing the stock, and he later sold the water system for $420,000 in 1999. Exhibit No. ___ (VRF-1T) at 18 – 19. Additionally, AWR recently attempted to sell water systems to Washington Water Service, Trident Utilities, and The Water Company of Washington.

Q. With regard to the water industry, how should the sale of assets be treated generally?

A. When a company purchases assets for use in the business, the customers in fact pay for those assets through CIAC or their monthly rates. Normally these assets are held until the end of their useful life or retired for economic reasons. When plant assets are retired or are no longer used and useful, a gain or loss may result. This gain or loss is normally passed through to the ratepayers through changes to the monthly water rates. Gains and losses from sales should be treated in the same manner.

Q. How do other states handle gain on sales?

A. According to a 1994 National Regulatory Research Institute (NRRI) survey of states regarding gain on sale of assets, most states allocate the gain to ratepayers, followed by splitting the gain between shareholders and ratepayers, and then gain to shareholders. Exhibit No. ___ (JAW-30). The study notes that gain on sale transactions occur most frequently in the electric industry followed by telecommunications, gas and finally water. *Id.* at 2-3. Washington State is noted as having a generic policy on gain on sale transactions. *Id.* at 4. The generic policy quoted in the survey spilt the gain on sale between shareholders and ratepayers. *Id.* at 5. The method of allocation varies, as does the implementation used by different states.

View Royal

Q. Did AWR realize a gain on sale when it sold the View Royal water system?

A. Yes, AWR sold View Royal for $335,550 more than rate base.

Q. What did the Company do with the proceeds of this sale?

A. AWR applied all of the proceeds toward paying off debt AWR owed to Mr. Fox.

Q. Was the gain on sale adequate to pay off all the debt?

A. No. AWR borrowed $50,219 from its line of credit to pay the amount of debt the gain on sale did not cover. Mr. Fox's debt was paid off in March 2002.

Q. Does Staff believe that paying off all shareholder debt was in the best interest of the Company and customers?

A. No. First, AWR would have had proceeds of the sale available to use for Company purposes. AWR continually states that funds are not available to pay expenses, complete capital projects, or reduce current payables. The funds from the sale could have been used for many purposes, including work under the capital improvement plan, reducing the accounts payable, and paying operating expenses. In addition, AWR should have used the funds from the sale to pay the resulting capital gains tax.

Second, all the debt was converted to equity. By converting all debt to equity, AWR changed the capital structure to now include a much higher return on equity cost. In the past, AWR had a capital structure that was too heavily reliant on debt. The goal is to obtain a capital structure that is balanced. According to Ms Parker, the current capital structure is 35% debt and 65% equity. Exhibit No. ___ (JMP-9).

Q. How should AWR have used the proceeds from the gain on the View Royal sale to benefit both the Company and the customers?

A. First, AWR should have paid any expenses associated with the sale due at the time of sale, and funds should have been retained to pay any future expenses, such as taxes or escrow fees. Second, AWR should have paid off any debt associated with View Royal. Third, AWR should have evaluated its critical needs.

Q. Does Staff believe borrowing on the line of credit to pay off shareholder debt was in the best interest of the Company and customers?

A. No. AWR used short-term debt to pay off long-term debt. Short-term debt is normally for short-term uses and is repaid as funds become available from operations. Exhibit No. ___ (JAW-31) at 11. Interest rates on long-term debt are normally lower than short-term debt. In addition, AWR could have used the line of credit to pay for work under the capital improvement plan, reduce the accounts payable, and pay for operating expenses.

Q. How does Staff recommend the Commission treat the gain on sale resulting from the sale of View Royal?

A. Staff recommends that the gain on sale should be shared between the shareholder and ratepayers. This split of gain on sale should follow the same allocation used in the Peninsula Light case based on a four-year averaging of AWR's capital structure. This is the same recommendation I make in my direct testimony. Exhibit No. ___ (JAW-1T) at 21:9-15 and 24:3-9.

Q. How would this allocation work?

A. The net gain on sale is calculated using the sale documents and known expenses of the sale. The net gain is allocated to shareholders and ratepayers based on a four-year averaging of AWR's capital structure. In the case of View Royal, AWR has used all proceeds to pay down shareholder debt and no cash exists. Staff recommends that the allocation be given effect by reducing the rate base by the amount allocated to the ratepayers, thus benefiting customers through lower monthly bills. This reduction occurs when the Commission reclassifies the customers' portion by reducing equity and increasing CIAC in the amount of the customer allocation. This would more fairly allocate the customers' share as if plant had been purchased with these funds and not recovered through rate base treatment. Staff recommends that this same approach be used for the gain on sale resulting from the sale of the Birchfield water system, discussed below.

Q. Why does Staff believe there should be a split or sharing of the gain on sale of View Royal?

A. The ratepayers have, over time, paid for the water system assets through their monthly rates. The historical cost of the View Royal system when originally purchased by AWR was $267,753. The corresponding rate base at the time of purchase was $10,192. At the time of AWR's sale of the View Royal, system the historical cost was $621,737 and the corresponding rate base was $164,450 supported by ratepayers.

Q. Have the numbers you recommended be used for the allocation of the gain on View Royal changed since you filed your direct testimony?

A. Yes. Staff received updated numbers from AWR. Based on the updated information, Staff calculates the net gain on sale to be $221,009 available after taxes. Exhibit No. ___ (JAW-32). The four-year averaging of AWR's capital structure results in 97.9% debt and 2.1% equity. The amount of gain allocated to the shareholder is $4,660 and the amount of gain allocated to the ratepayers is $216,350. *Id.* Staff recommends the Commission reclassify equity to CIAC in the amount of $216,350.

Q. Does Staff have an alternative recommendation with regard to the allocation of the gain on the View Royal Sale?

A. Yes. Symmetry of risk is another way to allocate the gain on sale. Symmetry of risk attempts to share the burden and benefit of each transaction. Staff's alternative shares the gain on sale based on the burden and benefit of who was responsible for the cost of the property sold.

Mr. Fox testifies that when he purchased View Royal, $164,808 was placed in AWR's Account 114 for acquisition adjustments and that rates did not cover the burden of the purchase. Since the purchase, View Royal has grown from 207 customers to 404 customers at the time of sale. The rate base the Commission has allowed in rates has grown from $10,192 to $164,450 at time of sale. This rate base is the burden the ratepayers carry as they pay the amount through monthly rates to the Company.

The shareholder's burden at the time of sale was $164,808, which is the amount not included in rate base. The ratepayers' burden at the time of sale was 164,450, which reflects the amount that was included in rate base for View Royal. Using a burden split, the portion allocated to the shareholder is 50.05%, and the portion allocated to the ratepayers is 49.95%. Staff believes that an alternative would be to split the gain on sale following the burden / benefit analyses. Staff calculates the gain on sale to be $287,265 after rate base recovery, paying sale expenses, and capital gains tax. The burden / benefit analyses would split this gain at $143,788 to shareholders and $143,467 to ratepayers. Staff provides this split as an alternative to the debt-to-equity burden analysis used in Peninsula Light gain on sale transaction.

Birchfield sale

Q. AWR claims that the sale of the Birchfield water system consisted of two transfers to the Lewis County Water and Sewer District #5 (LCWSD), one from AWR and one from Mr. Fox and his wife. What is Staff's understanding of who owned Birchfield prior to the sale and transfer?

A. Staff has always understood that Birchfield consisted of one water system, and that AWR owned the entire system. Because of Mr. Fox's and Ms. Parker's testimony to the contrary, Staff asked for clarification and documentation to support that there were two separate water systems and that one was funded and owned by Mr. Fox. AWR responded to Staff's request for data by objecting, saying that gathering such data would be overly burdensome. Exhibit No. ___ (JAW-33). In addition, AWR claimed that the documents requested were those of an affiliated company, and that records dating back to 1997, 1998, and 1999 were old and hard to "reconstruct." *Id.* In a supplemental response, AWR provided agreements for engineering services between Mr. Fox and Howard Godat & Associates, P.S., Inc. *Id.* Those contracts are not conclusive with regard to ownership because they are dated before Mr. Fox transferred Birchfield to AWR. Once again, as in prior rate cases with this Company, records of historical cost just don't seem to exist. For example, in the Consolidated 1998 Dockets, records were unacceptable to the Commission, and Docket No. UW-000405 was dismissed because AWR did not produce the documentation supporting its request to extend its surcharge.

Q. Did Staff review any documents regarding Birchfield that indicated who owned the water system?

A. Yes. Staff reviewed records submitted by AWR and its predecessor, Lewis County Utility Corporation, to the Commission, the Washington Department of Health (DOH), and the Washington Department of Ecology (DOE). Commission records indicate that Birchfield has been regulated under the ownership of AWR or its predecessor since 1996. Commission records indicate one water system with three wells. Exhibit No. ___ (JAW-34); Exhibit No. ___ (JAW-35); Exhibit No. ___ (JAW-36).

From DOH, Staff reviewed Water System Plans (WSP) and Water Facilities Inventory (WFI) forms for Birchfield. AWR is required to submit a WFI form to DOH annually for each of its water systems. DOH assigns each water system a unique identification number, and the identification number for Birchfield is 003157. AWR reported to DOH that Birchfield was one water system consisting of three wells. Exhibit No. ___ (DL-15). For example, the WFI form dated September 9, 2002, shows Birchfield Water System as having three wells. Exhibit No. (DL-15). In addition, Mr. Fox submitted as exhibits in this case letters from DOH approving increased number of connections to Birchfield. Exhibit No. ___ (VRF-11); Exhibit No. ___ (VRF-13); Exhibit No. ___ (VRF-14); Exhibit No. ___ (VRF-15). Those letters address only one Birchfield Water System ID# 003157.

From DOE, Staff reviewed Water Right Applications & Permits and correspondence involving the Birchfield water system. Mr. Fox has represented to DOE that Birchfield is one water system with three wells owned by AWR and its predecessors. For example, the Report of Examination form dated January 7, 1992, discusses Birchfield well number 3. Exhibit No. ___ (JAW-38), Attachment A. The report notes that Mr. Fox filed a companion application for "the first phase of the project." *Id.* The report does not indicate that Birchfield consisted of multiple projects. *Id.* Rather, statements such as "The expanded Birchfield water system will include three wells which will be interconnected to serve the development" indicate that all three wells were a part of a single Birchfield project. *Id.*

In addition, the water rights for all three wells were transferred from Mr. Fox to Lewis County Utility Corporation, AWR's predecessor. Exhibit No. ___ (JAW-38), Attachment B, Attachment C, Attachment D. Each application for assignment lists Birchfield as the water system. Id. Also, copies of correspondence between DOE and Mr. Fox, Lewis County Utility Corporation, AWR, or LCWSD show a history of the wells starting with Mr. Fox and being transferred to Lewis County Utility Corporation. Lewis County Utility Corporation transferred the wells to AWR, and AWR recently transferred the system to Lewis County Water and Sewer District #5. Exhibit No. ___ (JAW-38), Attachments E through K.

Nowhere in the documents reviewed by Staff does it show two separate systems, one owned by AWR and one owned by Mr. Fox.

Q. How does Staff respond to AWR's claim that the sales agreement for Birchfield conclusively establishes that two separate properties were transferred to LCWSD?

A. The sales agreement states that the portion allegedly owned by AWR was sold for rate base of $57,500, and that the portion allegedly owned by Mr. Fox was sold for $256,500. Exhibit No. ___ (JMP-1T) at 26:9-12. Exhibit A of the sales agreement purports to transfer the three wells from Mr. Fox as an individual to LCWSD. Exhibit No. ___ (JAW-17) at 12. Those are the same three wells that Mr. Fox and AWR reported to the Commission, the Department of Health, and the Department of Ecology that AWR owned. Those wells were included in rate base by the Commission in rate setting proceedings. DOH has records of AWR owning three wells. DOE has records of AWR owning three wells. It is not likely that two distinct systems, with the same name, were owned by two distinct entities (Mr. Fox and AWR).

Q. How should the Commission allocate the gain on sale for Birchfield?

A. As I stated in my direct testimony, Staff recommends that the Commission allocate the net gain on sale based on a four-year averaging of AWR's capital structure. The net gain on sale should be allocated between the shareholder and ratepayers. Staff recommends that the Commission effect the allocation by reducing the rate base by the amount of the ratepayers' share of the gain, thus benefiting customers through lower monthly bills. This reduction can occur by the Commission reducing AWR's equity and increasing CIAC by the amount allocated to the ratepayers. This would fairly allocate the customers' share as if plant had been purchased with these funds and not recovered through rate base treatment.

AWR provided Staff with updated numbers, which affects the amounts allocated to the shareholder and the ratepayers. Based on the updated numbers, the net gain on sale is $218,025. Exhibit No. ___ (JAW-39). The four-year averaging of AWR's capital structure results in 94.5% debt and 5.5% equity. The amount of gain allocated to the shareholder is $11,950, and the amount of gain allocated to the ratepayers is $206,075. Staff recommends the Commission reclassify equity to CIAC in the amount of $206,075.

VI. DOCKET ACCOUNT UW-010961

Q. Ms. Parker testifies about the Company's decision not to hire additional employees after the sale of the View Royal water system. Exhibit No. ___ (JMP-1T) at 30:5 to 32:2. Please respond.

A. Ms. Parker testifies that after AWR sold View Royal, the Company experienced cash flow problems. The sale resulted in AWR's monthly revenue decreasing by approximately $15,000. Exhibit No. ___ (JMP-1T) at 30:21; Exhibit No. ___ (JAW-31) at 1. Because she was not certain what the complete impact of the sale would be, Ms. Parker could only estimate that AWR's monthly expenses decreased by approximately $2,000 to $3,000. Exhibit No. ___ (JMP-1T) at 30:23 to 31:1; Exhibit No. ___ (JAW-31) at 1-2. The sale of View Royal resulted in a net reduction to AWR's revenue of approximately $12,000 to $13,000 a month. Exhibit No. ___ (JMP-1T) at 30:20 to 30:1; Exhibit No. ___ (JAW-31) at 1-2.

Ms. Parker created a spreadsheet to track monthly revenue and expenses. Exhibit No. ___ (JAW-31) at 2. Each month, with the exception of June, July, and September 2002, the Company knew there was not enough revenue to cover expenses. At the end of September 2002, AWR was notified that its bank required payments to be made on the Company's line of credit. Exhibit No. ___

(JAW-31) at 2. AWR developed a plan to reduce employee hours in December 2002, almost a year after it sold View Royal. Exhibit No. ___ (JAW-31) at 2-3. The Company implemented the plan January 2003, after Ms. Parker was able to quantify the plan into dollars.

AWR significantly changed its structure when it sold View Royal. As a practical matter, that meant AWR would not hire additional employees, and the funds in the Docket 010961 Account would not be spent. AWR argues that the sale of View Royal resulted in a $12,000 to $13,000 net decrease in revenue, so its revenue was no longer sufficient to pay its operating expenses. If that was the case, AWR should have filed a petition with the Commission to amend the Order Accepting Settlement Agreement that established the Docket 010961 Account. The other choice AWR had was to file a rate case. Because AWR had alternate means to address its problems, there was no Catch 22 as Ms. Parker suggests. Exhibit No. ___ (JMP-1T) at 31:7.

Q. Ms. Parker testifies that the sale of View Royal did not result in eliminating the need for the additional employees anticipated by the Commission's Order Approving Settlement Agreement in Docket No. UW-010961 (dated December 18, 2001). Exhibit No. ___ (JMP-1T) at 31:12-15. Please respond.

A. Ms. Parker focuses on AWR's revenues and not the purpose of the Commission's Order. The Order Approving Settlement Agreement provided the Company with a mechanism to fund nine employees, with money being set aside in a separate account for costs associated with employees in addition to the seven it already employed. In other words, the Order Approving Settlement Agreement provided funding for AWR's eighth and ninth employees, who were not yet hired and for whom AWR was not incurring expenses.

However, AWR did not need the level of employees contemplated by the Order Approving Settlement Agreement as a result of the sale of View Royal because AWR did not need nine employees after the sale. Whether the sale resulted in AWR not having sufficient cash flow to pay operating expenses, including employee costs for seven employees, after the set aside amount was deposited is a different question. If that was the case, the Company should have petitioned for the Commission to cancel the set aside requirement and adjust rates to reflect the Company's operations after the sale of View Royal.

Q. Ms. Parker discusses the tax obligation resulting from the accumulation of funds in the Docket 010961 Account. Exhibit No. ___ (JMP-1T) at 33:3-19. Please respond.

A. AWR would not have incurred a tax liability if it had spent the money in the Docket 010961 Account the way the money was intended to be spent. There was no provision in the Settlement Agreement or the Order Approving Settlement Agreement for a tax liability because none was needed. Federal income taxes are based on net income of a business calculated by subtracting the expenses necessary to operate the business from gross income. Expenses include such items as electric power cost, building rents, employee wages and benefits and transportation costs. Had AWR hired additional employees and spent the money in the account, it would have used the funds and claimed a corresponding expense in determining whether the Company had any taxable income. The Docket 010961 Account was not the cause of the taxes AWR incurred; the taxes occurred because AWR failed to spend the funds for the reasons the Docket 010961 Account was created.

Because AWR incurred the tax liability due to the poor decisions made by the Company's management, the Company's shareholder should bear the liability, not its ratepayers. AWR's management sold its largest water system, View Royal, after telling the Commission that it needed funds to hire additional employees. AWR continued to collect the set aside amount even after it determined that it would not hire the additional employees. Because AWR did not need the additional employees, it did not incur the level of employee expenses necessary to access the money in the Docket 010961 Account, and AWR incurred the tax liability. Although tax liabilities are typically appropriate for ratepayers to bear, tax liabilities that result from imprudent management are appropriately borne by shareholders.

It is likely that AWR does not owe tax for the Docket 010961 Account funds. Staff understands that by booking the revenue as a regulatory liability, AWR should not incur a revenue tax liability until the money is spent. That is, the tax consequence follows the expense of the funds, not the collection of the funds. Staff believes that AWR should not have paid taxes on the set aside amount if it was booked correctly as a regulatory liability, and that AWR should file the appropriate amended tax returns. This would result in all the funds collected from the set aside being available for the purpose intended. As the funds are spent there would be no tax liability because all the money will be spent for the intended purposes of employee cost, and AWR will be able to deduct the expense.

Q. Were other taxes paid from the Docket 010961 Account funds?

A. Yes, AWR used the Docket 010961 Account funds to pay taxes owed for the gain from the sale of View Royal.

Q. Have you reviewed the gain on sale for View Royal and the tax issues associated with that sale?

A. Yes. According to the tax return filed in 2002, the Company had taxable income of $181,453. Exhibit No. ___ (JAW-40). Of course, a company's financial information with regards to its regulated operations may be different from the company's financial information used for tax purposes. In any event, the taxable income shown on AWR's tax return was created by a couple of items. The first item is taxable income on AWR's operations, in this case the sale of water. The second item causing taxable income in AWR's case was the gain on sale of the View Royal water system. This type of transaction rarely occurs in the water utility businesses.

Q. Please explain.

A. According to the tax return for 2002, there was $46,871 of gain based on View Royal assets held short term. There was $250,323 of gain based on View Royal assets held long term. The total taxable income for the Company was $344,572, which is subject to various tax brackets. Removing the capital gains from the sale of View Royal assets leaves a taxable operating income of $47,378, which, by itself, is subject to a tax rate of 15% (corporate tax on $0-$50,000 at 15%), or a tax expense of $7,107.

Because operating income is regularly incurred, tax on this amount should be calculated first so the lower tax bracket applies. In this case, tax on operating income should be $7,107. Gain on sale is an extraordinary item added onto the ordinary income, and it is appropriately taxed at the higher tax rates. In this case, tax on the gain on sale should be $46,910 (total tax of $54,017 minus $7,107 tax on operating income).

The total tax expense for 2002 was $54,017; however, only $7,107 was due to normal operating income. The difference of $46,910, due to the gain on sale transaction of View Royal assets, should be treated as a cost of the sale and paid from the sale proceeds. Staff believes that ratepayers should not subsidize an extraordinary item through normal operating taxes. Allocating taxes based on percentage of revenue or anything different is not representative of normal business practices.

Q. How was the taxable income calculated by AWR?

A. According to the tax return, AWR had a net operating loss (NOL) being carried forward from prior years. Exhibit No. ___ (JAW-40). This NOL from 2001 was $163,199 and was used to offset or reduce taxable income in 2002, by that amount. AWR's taxable income of $344,572 was reduced by $163,199 to provide a net taxable income of $181,453, as shown on the Company's tax return for 2002. Using the corporate tax brackets, a tax expense of $54,017 was calculated on the total amount of $181,453.

Q. The Company paid this tax expense with Docket 010961 Account funds. Was this appropriate?

A. No. The tax liabilities paid with Docket 010961 Account funds were due to decisions made by AWR's management and could have been avoided. The tax liability also resulted from improper accounting. In addition, the Docket 010961 Account funds were not intended to be used to pay tax liabilities. Rather, AWR was to hire additional employees and use the Docket 010961 Account funds for the resulting employee expenses.

Ms. Parker calculated in Pro Forma Adjustment 2 that AWR's annual revenue from the set aside was $78,976 per year. Exhibit No. ___ (JMP-1T) at

9:25; Exhibit No. ___ (JMP-4). Staff accepts this amount. The result of setting the money aside, not using it for the purposes intended, and not properly accounting for the money resulted in taxable income from operations of $47,378. Without the set aside funds, it appears that AWR would have had an operating loss for tax purposes of $31,598. AWR's decisions to not hire additional employees, to continue to collect money from the customers, and to not characterize the Docket 010961 Account as a regulatory liability in its books, caused the tax expenses. These actions were the result of poor management decisions.

Even if AWR failed to characterize the Docket 010961 Account as a regulatory liability, it would have avoided tax liability if it had hired the employees for which the money was provided. Spending this money on employees would have provided an offset to the revenue being collected because AWR could deduct the expenses when calculating its taxes.

In addition, the tax from gain on sale resulted from Mr. Fox selling View Royal. This tax should have been paid from the sale proceeds. However, AWR's management used the entire proceeds from the sale to pay down debt owed to Mr. Fox. This was not a prudent decision.

Q. Mr. Fox notes in his testimony that he discussed the View Royal Water sale with his accountant and they determined no gain on sale would result. Was this a reasonable conclusion?

A. No.

Q. Please explain.

A. According to data available to Staff, the only information that would have been available to AWR on the date of the sale (January 16, 2002) was the 1999 and 2000 tax returns. Exhibit No. ___ (JAW-41); Exhibit No. ___ (JAW-42). The 1999 tax return was signed June 2, 2000, and showed a Net Operating Loss (NOL) going forward of $115,144. Exhibit No. ___ (JAW-41). The 2000 tax return was signed June 13, 2001, and showed a NOL going forward of $147,323. Exhibit No. ___ (JAW-42). This return was later amended and showed a NOL of $128,743. Both of the tax returns available on January 16, 2002, showed a NOL carry forward of $115,144 and operating loss of $147,323 for a total offset of $243,887. Exhibit No. ___ (JAW-41); Exhibit No. ___ (JAW-42). This total carry forward loss was not enough to offset the gain on sale ($297,194 according to the 2002 tax return) and provisions should have been made to provide for some amount of tax liability.

Q. The Company also prepaid 2003 taxes from the Docket 010961 Account. Was this appropriate?

A. No. Ms. Parker testifies that her recommendation was to not hire any additional employees after the sale of View Royal Water. Exhibit No. ___ (JMP-1T) at 29:10-11. This recommendation appears to have occurred in January 2002. The net operating income for 2002 was a result of revenues in excess of expenses. Staff believes this occurred due to AWR following Ms. Parker's recommendation to not hire additional employees, plus improper accounting. Had AWR hired additional employees, an offsetting expense would have occurred, and Staff believes that no taxable income would have resulted from normal operations of the company.

After AWR decided to not hire additional employees and the 2002 tax return was completed, the Company continued collecting Docket 010961 Account money. This continued revenue collection with no offsetting expense resulted in additional taxable income and higher tax expense. Staff believes that the ratepayers should not pay for imprudent decisions of management.

Q. Did AWR seek to stop the collection of the set aside requirement?

A. No. Staff reopened Docket No. UW-010961 on August 13, 2003, to amend the Order Approving Settlement Agreement to stop collections and impose a refund obligation on AWR. Staff also initiated Docket No. UW-031284 to investigate the Company's rates. The two Dockets were consolidated. AWR and Staff entered into a Settlement Agreement that AWR would stop collecting the set aside amount, AWR cancelled the set aside obligation. AWR provided partial refunds to customers for the month October and a full refund for the set aside amount collected for November.

Q. Ms. Parker testifies that AWR properly characterized the set aside amount as "Water Revenue" and that Staff's characterization of the set aside amount, as a "regulatory liability" constitutes retroactive ratemaking. Exhibit No. ___ (JMP-1T) at 33:22 to 34:6. Please respond.

A. The National Association of Regulatory Commissioners (NARUC) Uniform System of Accounts (USoA) definition # 27 defines Regulatory Assets and Liabilities as assets and liabilities that result from rate actions of regulatory agencies. Exhibit No. ___ (JAW-43) is a copy of the USoA sections on regulatory assets and liabilities. Regulatory assets and liabilities arise from specific revenues, expenses, gains or losses that would have been included in determination of net income in one period under the general requirement of the USoA but for it being probable that: 1) such items will be included in a different period(s) for purposes of developing the rates the utility is authorized to charge for its utility service, or 2) in the case of regulatory liabilities, that refunds to customers, not provided for in other accounts, will be required. *Id*. The USoA # 253 Other Deferred Credits establishes the sub-account # 253.1 Regulatory Liabilities and states, in brief, that the account shall include the amounts of regulatory liabilities not included in others accounts, imposed on the utility by the ratemaking actions of regulatory agencies. *Id*.

A regulatory liability was created when the Commission approved the settlement agreement between AWR and Commission Staff in Docket No. UW-010961, so there is nothing retroactive about the accounting treatment. However, the question of retroactive ratemaking is a legal question.

Q. What is the current status of the Docket 010961 Account?

A. As of December 31, 2003, the balance of the Docket 010961 Account is $51,762. The balance is different from the balance I provided in my direct testimony, (Exhibit No. ___ (JAW-1T) at 34:4), because AWR had not completed collecting revenue or providing credits under the Docket 010961 Account. AWR filed a quarterly report ending December 31, 2003, showing updated information regarding the Docket 010961 Account. Exhibit No. ___ (JAW-44). I am using the updated information shown in Exhibit No. ___ (JAW-44) in this testimony.

The total amount of Docket 010961 Account funds that needs to be dealt with in this case is $125,113: (1) the account balance of $51,762, (2) the amount the Company still owes to the Account, $5,290, and (3) the amount the Company improperly spent from the Account, $68,061.

Q. What is Staff's recommendation for the use of the Docket 010961 Account funds?

A. Staff still recommends that the funds be treated in the same manner as set out in my direct testimony, Exhibit No. ___ (JAW-1T) at 36 to 39. Staff recommends that these funds be used for the purpose for which they were originally collected: employee expenses. Because AWR will not incur the level of employee expenses necessary to access the Docket 010961 Account money, Staff recommends that the funds be used to offset the Company's employee expenses over a two-year period because the funds were collected over two years. To accomplish this, Staff recommends one-half of the total, $125,113, be used each year. This timing difference of collection and spending coincides with accounting theory on deferred liabilities and regulatory theory of Regulatory Liabilities. Because AWR has already spent a portion of the funds, the imputed amount and the available amount used per year would be reduced.

Q. How would this work?

A. The Company would set up a regulatory liability for $125,113, which is the Docket 010961 Account amount, to properly record and track future transactions. The Company's revenue requirement to pay employee expenses is reduced because part of the expenses would be paid from the regulatory liability account. Because the amount from the Docket 010961 Account consists of cash amounts and non-cash amounts (funds either not deposited or improperly spent), AWR would allocate annually $36,675 from non-cash amounts (imputed) and $25,881 from cash amounts. The cash amounts would be withdrawn directly from the Docket 010961 Account. At the end of two years, the regulatory liability account would be fully amortized, and the Docket 010961 Account fully depleted.

Q. Would AWR be penalized if the Commission adopts Staff's recommendation?

A. No. Staff's recommendation ensures that funds in the Docket 010961 Account will be used for the purpose intended; it does not penalize AWR. AWR would not be free to use the funds for whatever purpose it wants, but using the funds for employee expenses is both consistent with the Commission's Order Approving Settlement Agreement and beneficial to the Company and customers.

VII. CAPITAL STRUCTURE

Q. Does Staff have any adjustments to AWR's capital structure?

A. Yes. Staff adjusts AWR's capital structure to reflect Staff's recommended treatment of the Docket 010961 Account funds. Staff's recommended treatment of the Docket 010961 Account funds reduces equity by $125,113. This results in a capital structure of42.2% debt and 57.8% equity. Exhibit No. ___ (JAW-45).

Q. Please describe AWR's debt.

A. AWR has $273,477 in debt due to bank loans outstanding. The return on debt is weighted at 7.53%. Exhibit No. ___ (JAW-45). This debt calculation does not include an outstanding bank loan of $267,661 that is repayable by a separate surcharge not part of this rate case.

Q. Please describe AWR's equity.

A. AWR has $374,557 in equity. The return on equity is 12.0%. Exhibit No. ___ (JAW-45). Staff's calculation of AWR's equity includes Staff's recommended treatment of the Docket 010961 Account funds, which reduces equity by $125,113.

Q. What is the overall weighted rate of return for AWR?

A. The overall weighted cost of capital or rate of return for AWR is 10.11%. Exhibit No. ___ (JAW-45).

VIII. CUSTOMER COUNT AND RATE DESIGN

Q. Does Staff have any changes to AWR's customer count for the test period?

A. No. The average beginning of year, end of year customer count is 1,502.

Q. Are there any adjustments to Staff's calculation of monthly rates?

A. Yes.

Q. What was AWR's rate structure during the test period?

A. As shown in the Company's tariff:

Flat rate is $37.47

Meter base is $21.17

Usage is 0 – 500 cubic feet at .0121 per cubic foot

Over 500 cubic feet at .0175 per cubic foot

Capital Improvement Surcharge is $4.54

AWR reduced the Meter Base Rate and Flat Rate pursuant to a partial settlement agreement between Staff and AWR that the Commission approved in this Docket on October 1, 2003. The new Flat Rate is $33.07 and Meter Base Rate is $16.77. Exhibit No. ___ (JAW-4).

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

A. For Flat Rate service, Staff recommends the full reduction in the monthly rate.

For Metered Rates, Staff proposes an equal amount of reduction for the base charge and usage charge for metered customers. Metered rates are designed to produce the same average monthly revenue as flat rates. During the test period, the average monthly consumption of water was 1,023 cubic feet.

Based on Staff's adjustments to revenue and expenses and rate base, Staff proposes the annual revenue requirement from monthly rates is $485,011. This equates to monthly average revenue of $40,418. The customer count used is 1,502 customers for the test period. This results in monthly average revenue of $26.91 per customer.

Staff calculates the monthly residential decrease in revenue to be $4.90.

This rate design includes zero allowance and used an average monthly consumption of 1,023 cubic feet. Giving a 20% reduction to base charge of $3.35 the resulting meter base rate is $13.42. The remaining 80% of reduction would occur through the meter rate block design. The rates as proposed by Staff are provided below:

	Current	**Staff's Revised**	Difference
Flat Service	$33.07	**$26.91**	$4.90
Meter Service Base	$16.77	**$13.42**	$3.35
0 – 500 Cubic feet	$0.0121	**$0.0110**	$0.0011
> 500 Cubic feet	$0.0175	**$0.0152**	$0.0023

Q. Does Staff recommend any other changes regarding customer count or rate design?

A. No.

Q. Does this conclude your testimony?

A. Yes.