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BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION OF UNITED WATER IDAHO INC. FOR AUTHORITY TO INCREASE ITS RATES AND CHARGES FOR WATER SERVICE IN THE STATE OF IDAHO	**CASE NO. UWI-W-04-4** **COMMISSION STAFF POST-HEARING MEMORANDUM**

INTRODUCTION

United Water Idaho, Inc. (UWI) filed an Application on November 30, 2004, requesting authorization to raise its rates and charges for providing water service to its customers. UWI requested authority to increase its rates in excess of 21%, alleging in its Application that it needed additional revenues "to recover increased operating expenses and costs associated with plant additions, and to produce a fair rate of return, thereby enabling it to continue to provide adequate and reliable service to its customers."

The Commission Staff reviewed the evidence provided with UWI's Application, as well as information obtained through an audit and discovery requests. On April 6, 2005, the Staff filed its case recommending a rate increase of approximately 1.8% for UWI. Prior to the hearing, Staff and UWI reached a settlement on an appropriate return on equity and cost of debt, which raised the Staff's recommended rate increase to approximately 4.5%, and reduced UWI's rate increase request to 17.5%. Evidence presented at the hearing revealed significant differences between Staff and UWI on specific accounting entries and precise dollar amounts to include in the Company's revenue requirement. A more significant issue, however, is the difference between the Company and the Staff in the calculation of the test year rate base. The rate base calculation is particularly important in this case because UWI's capital investment *during* the test year it selected is significantly less than its investment *after* close of the test year. Because the time provided for post-hearing briefs is limited, Staff will focus on the difference in rate base methodology and will not discuss in this memorandum other issues that separate its case from UWI's.

The Commission has Provided Clear Instruction for Rate Base Methodology when Late Plant Investment is Added to a Test Year

The test year selected for a rate case is intended to be representative of the normal operations of a utility seeking a rate increase. It is appropriate to make adjustments to the test year for occasional expenses or investments that are known and measurable. Making post-test year adjustments for significant plant investment, however, presents real problems of a mismatch between investments, operating revenues and operating expenses. The Commission in recent rate case orders for Idaho Power Company and Avista Corporation discussed the mismatch problem and required an adjustment to address it. For example, the Commission in the Idaho Power case noted "that including investment in the calculation of average year rate base as if it were in service the entire year when it was not . . . creates a mismatch between test year revenue and expenses." Tr. p. 784, *quoting* Order No. 29505. In both cases the Commission, in the absence of an adjustment proposed by the companies, accepted a proxy adjustment to revenues and expenses rather than waiting for future rate cases to include specific new plant investment in rate base. It is important to note the Commission in both cases, *in addition* to approving an average rate base methodology, required an adjustment to revenues and expenses when post-test year plant was included in rate base. The Commission also directed the companies in future cases to present a corresponding adjustment to revenues and expenses if seeking full recovery of plant investment as if the plant had been in operation a full test year. Tr. p. 785, *quoting* Order No. 29602.

UWI in this case did propose one adjustment to revenues and expenses to account for adding one significant post-test year investment in the entire test year. The Company's case fails, however, to adequately address the mismatch problem identified by the Commission. Staff addressed the problem by proposing use of a 13-month average rate base calculation, the same methodology approved by the Commission in the Idaho Power and Avista rate cases, and by limiting the time between the test year and the investment.

The Company's Year-End Rate Base Methodology Fails to Adequately Address the Mismatch Problem

The Company in its Application and prefiled testimony explained that it selected a test year ending July 31, 2004. The increase in UWI's rate base during the test year, however, was fairly insignificant, and the Company sought to adjust the test year to include capital improvements completed through May 31, 2005, a date beyond even the hearing in the case. The Company's rate base methodology is counter to recent Commission guidance, and even past practice for UWI rate cases, in two distinct but related respects. First, the Company proposed a year-end rather than 13-month average rate base. Second, UWI intended to add significant post-test year plant at the period end investment amount, which affects the rate base as if the plant had existed from the first day of the test year. The final costs of the most significant construction project – the Columbia Water Treatment Plant (CWTP) – will not be known until sometime after May 31, 2005.

By using a year-end methodology to add in post-test year investment, UWI proposed a rate base that increases dramatically after close of its chosen test year. UWI testified that its rate base increased from $98,862,937, the amount approved in its last rate case, to more than $140,000,000. Tr. p. 11. Of the $41.1 million increase, however, approximately 64%, or $26.6 million, was not in service until after close of the test year on July 31, 2004. The Company proposed to continually update its investment figures to the time of or even after close of the hearing on May 26, 2005. The Company's approach to the test year presents significant issues of fairness and mismatch between investment and revenues, and renders the purpose of a historical test year almost meaningless.

UWI recognized that the Commission in the Avista and Idaho Power cases expressed concern "that when significant plant improvements are completed during the test period proper, or post-test year, there should be an effort made by the Company to identify expense reductions and/or revenue additions associated with the plant improvements." Tr. p. 17. Accordingly, the Company proposed an adjustment to revenues and expenses to correspond only to adding the CWTP in the test year. UWI made one revenue increasing adjustment "attributable to the CWTP"; that is, UWI increased test year revenue by $462,480 "to account for additional customers, annualized at existing rates, from July 31, 2004, the end of the test year, through May 31, 2005." Tr. p. 18. The Company also made one expense reducing adjustment "that is attributable to the CWTP." Tr. p. 19. The Company's witness testified "an expense adjustment for power and chemical expense of $139,580 has been made to reflect changes in system operation caused by use of the CWTP." Tr. p. 20.

The Company's own testimony, however, demonstrates the difficulty in determining an appropriate adjustment when adding late plant investment to the test year. A UWI witness testified that, because "the amount of investment associated with a facility such as the CWTP is known and measurable, the return and depreciation expense are easily calculated. Operations and maintenance expense can also be estimated with a high degree of accuracy." Tr. p. 18. On the other side of the equation, however, "the revenue producing and expense mitigating effects of the CWTP are much more difficult to identify because they are not yet known and measurable." *Id.* Even the Company's consultant conceded that "adding known and measurable changes to a test year base case must be used with extreme caution because of the high potential for abuse." Tr. p. 1057. That is because, according to the Company's expert, "in a rate case, utilities have every incentive to identify changes that increase the revenue requirement, but no incentive at all to find revenue enhancing changes." Tr. pp. 1057-58; Exh. 137.

Staff's Average Rate Base Methodology is Fair and Complies with Commission Directives

Staff believes the Company's test year methodology unfairly inflates its rate base for ratemaking purposes. Consistent with fairly explicit direction provided by the Commission in the electric utility rate cases, Staff proposed two adjustments. First, Staff proposed use of an average test year rate base. The purpose of an average rate base is to reduce the unfair impact that plant added late in the test year or after the test year has on the rate base to be included in rate recovery. The second adjustment Staff proposed is to restrict rate base to capital improvements completed by December 31, 2004, rather than including everything in rate base up to or even beyond May 31, 2005, as UWI proposed.

Staff did propose an exception for the CWTP. Staff included the CWTP in rate base as if it were in place throughout the test year, and so accepted the related revenue and expense adjustment the Company proposed. That adjustment, however, did not address all of the rate base issues. First, UWI proposed to include other than CWTP out-of-test year investment as if in place the full test year, but did not propose any corresponding revenue or expense adjustment. The non-CWTP, post-test year investment totaled approximately $5 million. Second, UWI proposed no practical cut-off date on plant to include in the test year, instead proposing to offer updated figures for late plant it wanted to include up to the time of hearing. Staff recommended cutting off post-test year investment, other than for CWTP, at December 31, 2004. Even UWI's expert witness conceded, when considering what limits to put on post-test year investment, "there must be some limit on the time interval between the test year and pro forma adjustments." Tr. p. 1058.

This case proves the incentive a utility has to find expense enhancing adjustments to a test year when a year-end calculation is used, as demonstrated by a comparison with the Idaho Power and Avista cases. In this case, UWI proposed to include 90 post-test year plant additions it planned to make through May 31, 2005, a full 10 months after close of its test year. Tr. p. 783. In Case No. IPC-E-03-13, Idaho Power filed its application during the test year itself, and provided actual test year balances prior to the time Staff prefiled its testimony. The Company proposed to include only three plant additions that were made within five months after close of the test year. *Id.* In Case No. AVU-E-04-1, Avista included four plant additions completed beyond the test year. In both cases, the companies used an average test year calculation. Even so, the Commission was concerned in both cases about a mismatch that occurs when investment is included in rate base as if it were in service the entire year when it was not. The Commission accordingly required an adjustment to revenues and expenses.

UWI argued that because the Commission accepted a year-end rate base in the Company's rate cases since 1993, it should be permitted the same methodology in this case. First, in three rate cases prior to the 1993 case (Case No. BOI-W-93-1), the Commission used an average rate base methodology for setting the Company's rates. In the 1993 case, the first case where the Company filed without an average test year, the Commission stated that the 13-month average test year "should have, at the least, been presented to us as an option in this proceeding." Noting that another rate case would be filed in approximately one year, the Commission instructed the Company "to present, as an option, a 13-month average calculation of rate base in its next general rate case." Order No. 25062, p. 3, Case No. BOI-W-93-1. Second, it is clear the Company was allowed use of a year-end rate base in later cases only because no party objected. The Company complied with the Commission's instruction in the 1993 case and included an average rate base test year in its next filing. No party, however, including Staff, objected to the Company's proposal to use a year-end calculation rather than the average rate base.

UWI implied in its rebuttal case that an average rate base test year results in inadequate rates and thus is confiscatory. Dr. Peseau testified "Staff's thirteen-month average rate base causes actual returns to be below the fair or allowed return. This in my opinion results in a denial of fair earnings and a confiscation of shareholder property." Tr. p. 1040. Dr. Peseau also contended that the Staff recommendation to allow in rate base 1/13 of post-test year investment means "that the Company is denied a return on up to 92% of post test year investment in plant." *Id.*

UWI exaggerates its argument by disregarding Staff's actual recommendation. Staff proposed to include the CWTP as if it were in service during the entire test year, and the treatment plant is a large majority of the post-test year plant investment. Far from denying up to 92% of post-test year investment in plant, Staff's rate base methodology results in a rate base of $125,652,848, while the Company's calculation results in a rate base of $140,148,149 if accepted at year-end balances through May 31, 2005.

Finally, UWI argued in rebuttal testimony that characteristics of water utility service distinguish the Company from electric utility companies, thus justifying use of a year-end test year for UWI while an average test year may be appropriate for Idaho Power and Avista. Specifically, UWI's expert identified "capital intensity" and "growth in rate base per customer" as "key determinates" of whether the 13-month average or year-end rate base would be most appropriate, and claimed UWI "definitely qualifies as a capital intensive utility." Tr. pp. 1034-35.

Even if UWI's theory were correct, the evidence does not support its underlying premise. When the Company's attorney asked a Staff expert witness whether "it's true that a utility like United Water is more capital intensive than a utility like Idaho Power or Avista or PacifiCorp," the witness responded "No, that's not true.... Electric utilities are much more capital intensive." Tr. p. 814. Under further questioning, the witness provided specific information comparing UWI with Idaho Power:

> Idaho Power has a much larger rate base per customer growth than United Water does. Idaho Power added $124 million during its test year, some seven percent increase; United Water adds some $3 million during the test year, which is about just under three percent. The investment per customer

> for United Water is significantly less, the rate base increase per customer for United Water significantly less than the rate base increase for Idaho Power, and the Commission ordered at use or accepted and used average rate base in that case, and they [Commission] made adjustments to any post-test year – made adjustments for post-test year investments.

Tr. pp. 826-27. Staff calculated the increase in rate base for UWI during its test year to be $41 per customer, while Idaho Power's rate base increased $300 per customer during its test year. Tr. p. 832.

Clearly the theory that a year-end rate base for UWI is appropriate because the Company is more capital intensive than electric utilities is unsupported in the record. The Commission used average rate base test years for recent electric utility rate cases, and those companies have incredibly larger rate bases per customer than does UWI.

CONCLUSION

Use of an average rate base methodology by the Commission is not new and in fact was used in UWI's rate cases prior to 1993. The Company was able to use a year-end rate base calculation in cases since 1993 only because no party objected. The Commission has continued to use the 13-month average methodology in recent electric cases, and in addition has required an adjustment to revenues and expenses to address the mismatch that occurs when post-test year plant is added as if in service during the entire test year. This case exemplifies the problem identified by the Commission, as UWI proposed to include in the test year significantly more plant investment than as occurred during the year itself. By the Company's methodology, selection of the test year is almost meaningless, since all plant would be added at amounts updated to the time of the hearing, some ten months after close of the test year.

Staff proposed to use an average rate base methodology, but to include the CWTP in the test year as if in service from the beginning of the year and accept the related revenue and expense adjustment proposed by the Company. Staff's proposal addresses the mismatch problem identified by the Commission, and results in a fair and reasonable rate base calculation. If accepted by the Commission, the Staff proposal would provide a fair return on UWI's rate base and would result in rates that are just, fair and reasonable to ratepayers as well as the Company.

Respectfully submitted this 9th day of June 2005.

Weldon B. Stutzman
Deputy Attorney General

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY THAT I HAVE THIS 9TH DAY OF JUNE 2005, SERVED THE FOREGOING **COMMISSION STAFF POST-HEARING MEMORANDUM,** IN CASE NO. UWI-W-04-04, BY MAILING A COPY THEREOF, POSTAGE PREPAID, TO THE FOLLOWING:

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