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TO: **PUBLIC SERVICE COMMISSION OF UTAH**

FROM: **DIVISION OF PUBLIC UTILITIES**
Philip J. Powlick, Division Director
Bill Duncan, Manager, Telecom & Water Section
Mark Long, Utility Analyst

DATE: January 4, 2010

SUBJECT: **In the Matter of the Request of Hidden Creek Water Company for Approval of a Rate Increase**

RE: Docket No. 09-2440-01

RECOMMENDATION: APPROVE DIVISION RECOMMENDATION

The Division of Public Utilities (DPU or the "Division") has completed a compliance audit and rate case analysis of Hidden Creek Water Company ("Hidden Creek" or the "Water Company") based on Hidden Creek's request for a rate increase dated July 2, 2009. The rates have remained unchanged since Hidden Creek was granted a Certificate of Convenience and Necessity (CPCN) eleven (11) years ago. Since that time, the developer has subsidized the Water Company in order for it to cover its expenses. Hidden Creek has requested a rate increase in order to recover increased operating expenses and to earn an adequate rate of return.

COMPANY BACKGROUND

On June 22, 1995 Hidden Creek Water Company registered as a non-profit corporation. On November 23, 1998, the Commission granted Hidden Creek a CPCN and approved its tariff through docket number 97-2240-01. The CPCN was granted with the provision that the developer, Five Star Financial, transfer title of the infrastructure, ultimately valued at $550,000, and deed sufficient water rights to the Water Company per CPCN Findings of Fact, numbers 3 and 2, respectively. Hidden Creek Water Company's infrastructure was constructed and/or funded by Five Star Financial as well as other development companies (hereafter "the Developer"). The Developers and Hidden Creek all have the same four (4) principals.

In 2000, Hidden Creek changed its status from a non-profit to a for-profit corporation.

Hidden Creek Water Company is located in Hobble Creek Canyon's Left Fork. Its physical address is 274 Hobble Creek, Springville, UT. The service area includes Mountain Air Estates, The Cottages at Hobble Creek and Cedar Knoll. The lot sizes range from 1 to 87 acres. The Water Company is serving 18-metered customers with an additional 30 lots on stand-by status. Of those 30 lots on stand-by status, nine lots are owned by the Developer.

To date, the rates set in 1997, consisting of $33.00 per month system fee plus 78.3¢ per 1,000 gallons regardless of the quantity used, have remained unchanged. Consequently, Hidden Creek's operations have been subsidized by the Developer since its inception through on-going financial contributions as well as through labor provided at well below market value, thus keeping rates artificially low.

ANALYSIS:

The Division reviewed annual reports submitted by the Water Company for the years ending December 31, 1998 through December 31, 2008. Ms. Tracy Tanner, President of the Water Company is very knowledgeable of all aspects of Hidden Creek's operations and finances, and was helpful during the Division's analysis. All information was provided to the Division timely and in a usable format. Ms. Tanner not only provided any and all requested information, but she included her own reconciliations and audit trails when applicable. The Division met with Water Company representatives and corresponded often throughout the rate design process. Hidden Creek is currently in compliance with all of its reporting requirements to the Division.

Test Year

The Division used 2008, the most recent completed calendar year, as the base year. Adjustments were made based on trends, including past, as well as current year activities to arrive at reasonable and sound projections for 2010. Based on recent trends as well as conversations with Ms. Tanner, no growth, and therefore, no additional connections are anticipated to occur in 2010.

Revenue Adjustments:

Revenues were adjusted largely to cover the actual fixed and variable costs. As to the amount of the increase, the Division recommends an increase in revenues of $16,545, or 98.6% to cover the increased expenses, exclusive of those dedicated to the capital reserve account, which is addressed below. In light of the fact that Hidden Creek has not raised its rates in approximately eleven (11) years, and considering the increase in operational costs as well as the Developer subsidies over that time, the Division does not regard an increase of this amount as unreasonable. See DPU Exhibits 1.2 and 1.7 for specific line item adjustments and detailed explanations.

Operating Expense Adjustments

The 2008 Annual Report shows Hidden Creek recorded a net operating loss of $11,477, meaning that Hidden Creek did not cover its operating expenses. Operating expenses were adjusted based on historical trends, prior year amounts, and future anticipated needs. See DPU Exhibit 1.2 for specific line item adjustments and detailed explanations. However, adjustments of significant magnitude that require specific mention here are as follows:

1. Promissory Note

The rate increase request included repayment of a $550,000 promissory note executed January 1, 1998 by the Developer, which represents the amount paid for the Water Company's Utility Plant in Service (infrastructure) by the Developer. According to the terms, the note is interest free until January 1, 2009 at which time 7% annual interest starts to accrue with semi-annual payments starting on June 30, 2009. The annual cost of these loan payments is $38,080.

However, the CPCN Report and Order, docket number 97-2240-01, page 2, item 2 states,

> "The Developer claims plant costs of $513,000, already paid, and an additional $150,000 in future costs to complete the next phase. Title to all plant has been transferred to Applicant. Aside from a $1,550 connection fee, all other developer expenses are to be recouped through lot sales."

Therefore, the infrastructure costs of $550,000 originally claimed by Hidden Creek as its investment in Utility Plant in Service has been removed and reclassified by the Division as Contribution in Aid of Construction (CIAC).

Since the $550,000 promissory note represents the entire value of Hidden Creek's Utility Plant in Service, the net effect of classifying the $550,000 promissory note as CIAC is as follows:

a). removes its entire loan obligation from Hidden Creek,
b). removes all of the Utility Plant in Service from the rate base,
c). removes the accompanying depreciation expense and accumulated depreciation from the accounting records, and
d). Adds the entire $550,000 amount to CIAC.

2. Labor Expenses

In the Division's initial review, total annual labor costs charged by Ms. Tanner for billing ($2,400), water master duties ($8,400) and testing ($1,200) for $12,000, $1,000 per month appeared excessive. Since labor expense makes up such a large percentage of Total Operation & Maintenance Expenses (43%), the Division requested that Ms. Tanner prepare a description of her duties and obtain bids from qualified independent contractors to perform her water company functions. Ms. Tanner received two bids for $1,500 and $1,900 per month, much higher than the $1,000 monthly wages requested by Hidden Creek Water Company's operator, Ms. Tanner. Based on time spent in the past year, Ms. Tanner reported that she will be paid approximately $25 per hour as an independent contractor, although after expenses her net pay will be much less. As in the past, as well as going forward, Ms. Tanner is paying for all her own transportation expenses such as wear and tear on her vehicle, gas and automobile insurance as well as various office and field tools and instruments. The Division determined that the labor amounts are reasonable and recommends that the $1,000 monthly labor costs be funded in the rates. See Exhibit 1.8 to review the aforementioned job description and bids.

3. Depreciation Expense

As discussed previously under the Promissory Note treatment, the Division's analysis determined that the assets listed under Utility Plant in Service were incorrectly reported as depreciable assets purchased by the Water Company when they were actually donated to the Water Company and should have been reported as CIAC. For rate-making purposes, since no depreciable assets remain on the accounts of Hidden Creek, there can no longer be any depreciation expense.

Capital Reserve Account:

The Division is concerned about the Water Company's lack of financial reserves. Reserves are a necessary part of a sound financial management plan for an on-going and effective water system. Setting aside reserves is critical to developing and maintaining financial stability and can mean the difference between a system that is self-sustaining and one that may fall victim to disrepair or become financially unstable during even a relatively small emergency. Capital reserves are funded through rates and should be maintained in a protected account and allowed to accumulate or used for qualifying expenses as the need arises.

In past cases, the reserve amount informally consisted of the amounts accumulated in an accumulated depreciation account with no oversight as to its use. In the past several rate case Orders, the Commission has approved funding a reserve account at an amount equal to the annual depreciation expense plus the annual amortized CIAC using the same service life years as if it had been depreciated.

For example, many of the regulated water companies commonly have several hundred thousand dollars in accumulated depreciation and should therefore have a like amount in reserves to replace or improve capital assets. If not, there should be an accounting of the capital assets for which they were used to replace or improve. Inspection of the records of the aforementioned companies show that many of these same companies have negative retained earnings, meaning that the depreciation expense amounts paid by ratepayers through rates were likely used for day-to-day expenses and not properly saved to replace capital assets. This situation poses the question as to what were these rate-payer generated funds that were supposed to be set aside for capital asset replacement and improvement spent on? To answer this question and to safeguard the ratepayers' funding of the Capital Reserve Account via the annual depreciation expense and the amortized CIAC the Division recommends the following:

1. Capital reserve amounts generated from rates are to be deposited into a restricted account, such as a separate escrow account, within 30 days from the receipt of rate payments.

2. Withdrawals are to be made from the Capital Reserve Account for capital replacements and improvements only.

3. In accordance with Utah Administrative Rule R746-401-3A, expenditures in excess of five percent of total Utility Plant in Service, require the water company to file a report with the Commission, at least 30 days before the purchase or acquisition of the asset or project, and to obtain written Commission approval before transacting such acquisitions. At the present time, in this case, expenditures over $27,500 ($550,000 *times* 5%) would require submission of a written report and Commission approval.

4. Hidden Creek shall provide an 'annual accounting' of the Capital Reserve Account with its Annual Report and at any such other time as the Commission requests. The 'annual accounting' shall be in the form of bank statement encompassing the entire calendar year showing a series of deposits made within 30 days from the receipt of rate payments for each billing cycle and withdrawals that meet requirements 1, 2 and 3 above.

5. The balance in the reserve account must be clearly identifiable in the audited financial statements as a restricted account.

To further clarify, what should be considered qualifying expenditures for replacement or improvements that may be made from the Capital Reserve Account, the following guidelines are provided:

a). "Capital improvements" are typically high cost items with long service lives including: the distribution pipe mainlines, storage reservoirs, wells and surface water intakes, etc. Expenditures that qualify as capital expenditures are those which extend the life of an asset and/or enhance its original value with better quality materials or system upgrades.

b). Capital improvements do not include such minor expenses as repair clamps, inventory parts and fittings, spare pieces of pipe kept to facilitate repairs, small tools, maintenance supplies such as paint or grease, service contracts and other such day to day supplies. Expenses for these items are properly classified as "operating and maintenance" expenses.

c). Additionally, it is not appropriate to use capital replacement funds received from existing customers for system expansion, that is, to extend main lines to serve new areas or customers or to install new services. Funds for the expansion of the system should come from new development, connection fees, assessments or other sources so that those benefiting from the improvement contribute the funds for its construction.

Rate Base

Rate base represents the investor-supplied plant facilities and other investments required to supply water service to customers. Amounts per the annual reports indicate a total net rate base of $333,209. After the Division correctly reclassified the Utility Plant in Service investment as CIAC the correct rate base consists solely of the Cash Working Capital amount of $8,727.

Rate of Return and Return on Investment

The rate of return, representing the amount allowed to be earned, is expressed as a percentage of the utility's rate base. In this case, the rate of return is 12%. Therefore, the return on investment (profit) is $1,047 *($8,727 times 12%).*

Revenue Requirement Adjustments:

The revenue requirement represents the total amount of money that must be collected from customers to pay all costs including a reasonable return on investment and ensuring the continual operation through reserves. The Division's analysis shows a Revenue Requirement of $48, 858. The Revenue Requirement consists of the following amounts:

Annual profit of (12% rate of return):	$1,047
Capital Reserve of:	$16, 640
Estimated state and federal income taxes of:	$4,422
Operating expenses of :	$27,749

DIVISION RECOMMENDATIONS:

Rates and Charges

Rate Changes: *(Table 1)*			
Description	**Current Tariff**	**Requested by Hidden Creek**	**Recommended by Division**
System Expense	$33.00 per month	$130.00 per month	$61.00 per month
First 12,000 gallons	$5.00 per month	$0.00 per month	$49.50 per month
Usage per 1,000 gallons over 12,000 gallons	78.3¢ per 1,000 gallons	$5.00 per 1,000 gallons	$5.00 per 1,000 gallons
Water Service Turn-on & Turn-off charges	$25.00	$100.00	$100.00
Late Fees: (To be assessed each billing period if there is a prior balance owing on a customer's account.)	$5.00	$5.00	$15.00
First time service connection fee, up to a 2" service connection. (One time charge for hot tap and install meter and setter in can with lid.)	*See below for original service connection fees*	$3,350.00	$3,350.00
First time service connection fee, up to a 2" service connection. (One time charge to set yoke and meter in can.)		$2,850.00	$2,850.00
¾″-Line meter connection fee	$1,550.00	*These fees replaced by the above service connection fees.*	
1″-Line meter connection fee	$2,000.00		
2″-Line meter connection fee	$2,500.00		
Inspection Fee	$25.00	$25.00	$100.00

CUSTOMER IMPACT

Below, the Division has shown the increase in annual rates (impact) on four (4) of Hidden Creek's customers based on actual 12- month usage amounts.

Comparison of Current Bills and New (Recommended) Bills

(Table 2)

Customer	Annual Usage in Gallons	Annual Amount @ Current Rates	Annual Amount @ Proposed Rates	Annual Increase	% Increase
A	87,174	$555.63	1,332.66	$777.03	139.85%
B	258,810	$737.97	$2,262.75	$1,524.78	206.62%
C	643,910	$1,106.07	$3,825.55	$2,719.48	245.87%
D *(Not Connected)*	0	$456.00	$732.00	$276.00	60.53%

In the past, the Division has often recommended an increase of this scale to be phased in over a period of time. Unfortunately, with relatively so few customers and pending needs, Hidden Creek does not have the luxury of time. In small water systems such as this, without Developer subsidizes, there are few customers among whom to spread the costs, thus creating higher than desirable rates. The Division is acutely aware that this is a large increase and will have a big impact on ratepayer's bills, but without a developer subsidizing the Water Company as in the past, and keeping prices artificially low, the Water Company must now fund its expenses and establish a minimum financial reserve through its revenues.

CONCLUSION:

The Division believes that the recommended rates and charges represent an appropriate balancing of ratepayer interests and the interests of Hidden Creek.

The Division asserts that the rates and charges set forth in Table 1 are just and reasonable and consistent with the public interest and, therefore, the Division recommends that the Commission approve these new rates and charges.