State of Utah
Department of Commerce
Division of Public Utilities

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**-=-= M E M O R A N D U M =-=-**

**TO:** Public Service Commission of Utah

**FROM:** Division of Public Utilities
Chris Parker, Director
William Duncan, Manager, Telecommunication & Water Section
Shauna Benvegnu-Springer, Utility Analyst

**SUBJECT:** In the Matter of the Application of Cedar Ridge Distribution Company for an Increase in Rates

**RE:** Docket No. 11-2423-02

**DATE**: September 12, 2011

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## DRAFT RECOMMENDATION:

The Division of Public Utilities (DPU or the "Division") is in the process of completing a compliance audit and rate case analysis of Cedar Ridge Distribution Company (the Corporation) based on the Corporation's request for a rate increase dated April 21, 2010. The Public Service Commission approved their rate for the current tariff on July 11, 2011.

The Corporation has requested a rate increase in order to provide funding for the legal and accounting costs of the CPCN issued on July 11, 2011, ongoing operating costs, and costs to install meters to each connection. The Division is not recommending a special assessment, but is recommending an increase in the minimum rate, implementation of a standby fee, implementation of an overage fee for those customers using in excess of 12,000 gallons per month, and implementing a capital reserve account.

The Division is recommending funds in the amount of $190,000 from the sale of the water well to Tremonton City be deposited and recorded as property of the Corporation. The Division also recommends the Commission deny the special assessment issued by the Corporation on August 9, 2010. . The Division recommends the Commission order the Corporation to issue a credit memo in the amount of $970 to each customer's account to eliminate the $970 assessment charge and to issue a refund with interest, to those customers who paid the $970 assessment.

The Division further recommends the original cost of the meter installation should be borne by the developer and recovered by the Corporation.   The replacement cost of the meters should be paid by the customers through depreciation expense.

## **BACKGROUND**

The water company is serving 31non-metered customers, 2 lots on stand-by status and the potential of 57 additional connections for a total of 90 connections.  Currently, the Corporation is authorized by the Commission to operate 33 connections.

On July 11, 2011, the Commission granted Corporation a Certificate of Public Convenience and Necessity (CPCN) and approved its tariff through docket number 11-2423-01.  The rates approved by the Commission provided an interim tariff of $45 per month for unlimited water use, a late fee of $5.00 per incident, and a reconnect fee of $75.00 per incident and no standby fee as this time.

## **ANALYSIS:**

The Corporation filed for a rate increase to $114.99 per month and a standby fee of $26.05 per month.  The Division reviewed the annual report submitted by the water company for the years ending December 31, 2010 and has reviewed the general ledger for the Corporation from April 15, 1981 to the September 6, 2011.  The Division also tested the Corporation's reliability of the financial records, compliance with other state agencies requirements and the Bear River Health Department.  Mr. David Thompson, President of the water company and Ms. Jennifer Arbor, an employee of the Thompson and Son Cabinet, Inc. are very knowledgeable of their respective areas of the Corporation's operations and finances, and were cooperative with the Division during its analysis.  The Division is working with the Corporation to obtain information and documentation on items 10.1, 10.2, 10.3, 10.4, 10.6, 10.7, 10.9, 10.10, 10.11, 10.18 and 10.19 of the data request issued September 6, 2011.

### ***Test Year***
The Division used the calendar year 2010, which was 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 a reasonable and sound forecast for 2011.  Based on recent trends, as well as conversations with Mr. Thompson, no growth, and therefore, no additional connections are anticipated to occur in 2011.

### ***Revenue Adjustments:***
Revenues were adjusted to cover the actual fixed and variable costs.  The Division recommends an increase in revenues of $2,128 or a 26.7% increase from the proposed revenue to cover all the expenses of a viable utility company, inclusive of those dedicated to the capital reserve account, which is addressed below.  See DPU Exhibits 1.2 and 1.7 for specific line item adjustments and detailed explanations.

### ***Operating Expense Adjustments***

The 2010 Annual Report shows the Corporation recorded a net operating profit of $26,442 when $31,040 of assessment income was reported. Without the assessment income, a $4,598 loss was reported from the operations of the water company, meaning that the Corporation did not cover its operating expenses. In the past the Corporation has operated on a cash-basis for accounting revenue and expenses. When reporting revenue and expenses for the 2010 Annual Report submitted with their application for the CPCN they used the accrual- basis and recorded revenue and expenses that would not have been reported in the past. 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 require specific mention are here as follows:

1. ***Sale of Assets***
   On March 15, 2010, Mr. Thompson, and Cedar Ridge Distribution entered into a Water Well Purchase Agreement with Tremonton City. Under the agreement, the Seller (Mr. Thompson), states that he "is the current owner of record of the 16" Cedar Ridge Water Well". Indirectly this statement is true. Mr. Thompson owns 100% of the Cedar Ridge Distribution Company. Records of the Corporation and Mr. Thompson stated that the water well was an asset owned by the Corporation. Generally accepted accounting principles dictate that the proceeds of the sale of a corporate asset are to be recorded by the corporation. Mr. Thompson further states that the $190,000 was owed to him for "selling the water rights to Tremonton City". The agreement states "the Buyer (Tremonton City) will obtain the necessary water rights from the State of Utah". The Division recommends the Corporation properly record the sale of the water well on the Corporation records.

2. ***Debt Service***
   The rate increase request included loan repayment amounts of $22,267 for principal and interest of loans from David Thompson personally and Thompson and Son Cabinet, Inc for repairing the pump in 2009. The attached debt analysis exhibit shows the Corporation had $27,500 in loans prior to the sale, an additional $4,000 loan issued on December 19, 2010 and a $6,000 loan made on September 6. 2011. The Division feels strongly that these loans should have been paid by the proceeds from the sale of the water well and pump, and is recommending the debt interest expense be disallowed. The Division made an adjustment of $2,000 to eliminate the interest on these loans.

3. ***Assessment Income***
   The Division's analysis recognizes that the sale of the water well provided enough income and equity to the Corporation, to render the special assessment unnecessary. An adjustment to eliminate and refund the assessment income to the customers is recommended.

4. ***Depreciation Expense***
   The Division's analysis determined that the assets listed under Utility Plant in Service were incorrectly depreciated due to the sale of the water well, pump and removal of service of equipment. An adjustment was also made to Contributions in Aid of Construction. The Division still verifying the amounts listed as the value of the assets. The Division made an

adjustment of $95,912.13 to correct the depreciation for equipment taken out of service or sold assets in 2009 and 2010, respectively.

***5. Meter Installation***
The Division recommends the original investment of meter installation should be an investment borne by the Corporation where it will receive a 10% recovery rate when implemented and completed. The replacement will be added to rates through the depreciation of the assets. The Corporation is strongly encouraged to purchase and install the meters by December 31, 2011, since the rates being proposed require the meter equipment.

***6. Legal and Accounting Fees***
The Corporation has paid $27, 247 in legal fees to date and $2,226.50 in accounting fees. The legal fees are divided into three categories; $2,673 for the Order to Show Cause representation, $17,025 for work related the CPCN, and $7,549 which is unknown. Legal fees for the rate case are not yet determined. The Division is recommending disallowing the amount of $2,673 related to the Order to Show Cause that should not be borne by the ratepayers. The accounting fees and $17,025 in legal fees for the CPCN are organization costs that are amortized as an expense over a five year period based on the IRS tax code. The rate case fees for accounting and legal expenses likewise are amortized over the five year period. The Division has made an adjustment for these two types of expenses.

***Capital Reserve Account:***
The Division is concerned about the water corporation'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 restricted account and allowed to accumulate or be 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 the funds 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 ratepayer 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 equal to $17.00 per month per customer who paid their bill.

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. Now, in this case, expenditures over 5% would require submission of a written report and Commission approval.

4. The Corporation 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 that 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 developer-supplied plant facilities and other investments required to supply water service to customers. The Division recommends a rate base of $64,251 subject to verification of the amounts as listed on the Depreciation Expense and Accumulated Depreciation Reconciliation.

***Rate of Recovery and Recovery on Investment***

The rate of recovery, representing the amount allowed to be recovered of the original cost, is expressed as a percentage of the utility's rate base. In this case, the rate of recovery is 10%. Therefore, the recovery on investment is **$ 6,648 annually**.

***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 of recovery and ensuring the continual operation with reserves. The Division's analysis shows a Revenue Requirement of $ 30,608.00.

The Revenue Requirement consists of the following amounts:

| | |
|---|---|
| Annual Recovery of Cost (10% ): | $6, 648 |
| Capital Reserve of: | $ 6,860 |
| Estimated state and federal income taxes of: | $0 |
| Operating expenses & interest expense of : | $17,100 |
| TOTAL: | $ 30,608 |

**DIVISION RECOMMENDATIONS:**

***Rates and Charges***

The following table illustrates the current, requested, and recommended tariff rates and fees. The Division is recommending adding additional fees to cover those incidents through the course of business where a customer may place an additional expense on the water company.

| Rate Changes: | | | (Table 1) |
|---|---|---|---|
| Description | Current Tariff | Requested by Cedar Ridge | Recommended by Division |
| System Expense | $0.00 per month | $114.99 per month | $36.25 per month |
| First 12,000 gallons | $45.00 per month | $0 per month | $9.75 per month |
| Usage per 1,000 gallons over 12,000 gallons | $0.00 per 1,000 gallons | $0.0 per 1,000 gallons | $.35 per 1,000 gallons over 12,000 |
| Disconnect Fee per incident | 75.00 | No change | No change |
| Reconnect Fee per incident | 75.00 | No change | No change |
| Late Fees: | $5.00 per incident | No change | No change |
| | | | |
| Hook- up Fee** | Not applicable | Not applicable | $1,500.00 |

**Actual costs for placing the radio meter, parts, average line, and labor warrant the hook-up fee to be increased to $1,500.

**CUSTOMER IMPACT**

Below, the Division has shown the increase in monthly rates (impact) on four (4) of the Corporation's customers based on actual month usage amounts.

| | | | | | (Table 2) |
|---|---|---|---|---|---|
| Customer | Monthly Usage in Gallons | Monthly Amount @ Current Rates | Monthly Amount @ Proposed Rates | Monthly Increase | % Increase |
| A | 12,000 | $45.00 | $46.00 | $1.00 | 2.22% |
| B | 48,000 | $45.00 | 58.60 | $13.60 | 30.22% |
| C | 188,000 | $45.00 | 111.80 | $66.80 | 148.44% |
| D *(Not Connected)* | 0 | **$0.00** | $36.25 | $36.25 | |

**CONCLUSION:**

The Division believes that the recommended rates and charges represent an appropriate balancing of ratepayer interests and the interests of the Corporation. The Division asserts that the rates and charges set forth in Table 1 are just, reasonable, and consistent with the public interest and, therefore, the Division recommends that the Commission approve these new rates and charges effective January 1, 2012.

The Division also recommends the Commission order the Corporation to:

1) record the sale of water well appropriately on its books,
2) issue a credit memo to all customers for the $970 assessment fee on their account,
3) issue a refund with interest to customers, who paid the assessment fee,
4) implement the capital reserve account as discussed, and
5) proceed with the meter installation as previously approved by the Commission.

cc: David Thompson, Cedar Ridge Distribution Company
Lee Kapaloski, Attorney for Cedar Ridge Distribution
Trisha Schmid, Assistant Attorney General
All Interveners
Service List