



GARY HERBERT.  
Governor  
GREG S. BELL  
Lieutenant Governor

State of Utah  
Department of Commerce  
Division of Public Utilities

FRANCINE GIANI  
Executive Director

THAD LEVAR  
Deputy Director

PHILIP J. POWLICK  
Director, Division of Public Utilities

----- MEMORANDUM -----

**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 *ML*

**DATE:** February 22, 2010

**SUBJECT:** In the Matter of the Request of Sherwood Company for Approval of a Rate Increase

**RE:** Docket No. 09-075-01

**RECOMMENDATION: APPROVE DIVISION RECOMMENDATION**

The Division of Public Utilities (“DPU” or the “Division”) has completed a compliance audit and rate case analysis of Sherwood (“Sherwood” or the “Water Company”) based on Sherwood’s request for a rate increase dated August 14, 2009. The rates have remained unchanged since the current owner(s) purchased Sherwood more than eleven (11) years ago. Sherwood has requested a rate increase in order to cover increased operating expenses and to earn an adequate rate of return to cover its debt.

**COMPANY BACKGROUND**

On March 31, 1983, the Commission granted Sherwood a Certificate of Convenience and Necessity (CPCN) and approved its tariff.

Sherwood Water Company was owned and operated by Mrs. Flora Wood until July 1, 1998 at which time Mark Johnson purchased the company. Mark Johnson, President, ran Sherwood until he passed away on December 31, 2008. Mark Johnson’s, wife, Beth Johnson, former Vice President, became the President with their six children becoming Vice Presidents, instead of Directors. Scott Johnson is the Operations Manager

in addition to holding the Vice President position. Peggy Bryner became the Secretary/Treasurer and Breanne Johnson became the Bookkeeper.

According to the records of the Utah Division of Corporations, Sherwood Water Company was registered as a for-profit corporation until letting its license expire on February 13, 2002. Several years ago Sherwood changed its tax status from a for-profit corporation to a non-profit corporation. Sherwood has assured the Division that it is in the process of officially notifying the Utah Division of Corporations of its intentions of becoming a licensed non-profit corporation.

Sherwood Water Company is located approximately two and one half miles west of Delta, Utah on the Gunnison Bend Reservoir. Sherwood's service area is highlighted in red on the map presented here.



The subdivision consists of a mixture of permanent structures, trailers and mobile homes which includes full-time residents as well as seasonal users.

**ANALYSIS:**

The Division assisted Sherwood in completing and filing their past-due 2008 Annual Report as well as in completing 2009's Annual Report in order to conduct the audit and analysis of the financial data in order to make a recommendation regarding their rate increase request. In order to obtain the most accurate figures to use in the rate case, the Property, Plant and Equipment account as well as Accumulated Depreciation and the Amortization of any recorded Contribution in Aid of Construction was reconstructed starting in 1993, the earliest available data. Mrs. Peggy Bryner, Secretary/Treasurer was the Division's main contact and assisted throughout the case. Mrs. Bryner and Breanne Johnson, Bookkeeper, were very helpful during our analysis and eager to learn more about the accounting requirements and office management of Sherwood.

In addition to being president of Sherwood, Beth Johnson is also the president of Mark's Backhoe Service ("Mark's Backhoe"). Since Mr. Mark Johnson purchased Sherwood in 1998, Mark's Backhoe Service regularly paid for many of Sherwood's expenses. Additionally, Mark's Backhoe donated many hours of labor to Sherwood. In order to obtain an accurate accounting of Sherwood's expenses the Division requested Mrs. Bryner to go back through the records of Sherwood and Mark's Backhoe for 2009 and assign the expense to the appropriate company. Sherwood's 2009 annual reports reflect accurate revenues and expenses, which incidentally resulted in a loss of over \$40,000 for the year.

***Test Year***

The Division and Sherwood agreed that 2009 would be the appropriate test year to use. Based on recent trends as well as conversations with Sherwood personnel, no growth, and, therefore, no additional connections are anticipated to occur in 2010.

***Revenue Adjustments:***

Revenues were adjusted from \$25,317 to \$51,726 to cover the actual adjusted fixed and variable expenses. In light of the fact that Sherwood 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 and into the future, the Division does not regard an increase of this amount as unreasonable.

***Operating Expense Adjustments***

The 2009 Annual Report shows that Sherwood's expenses exceeded their revenues by \$41,494. While the expenses on their 2009 Annual Report represent an accurate accounting of their expenses, some of the expenses were actually paid for by Mark's Backhoe with no expectations or obligations on the behalf of Sherwood to repay Mark's Backhoe.

Adjustments of significant magnitude that call for specific mention are as follows:

***1. Payment on Tank Loan***

In 2006, a new 136,000 gallon water storage system was built to provide adequate water supply and to replace old obsolete tanks. Mark's Backhoe built and financed the new water tank. The documented expenses associated with the construction came to \$156,354. Division review of the financial transactions regarding the tank revealed that additional significant labor and materials were donated by Mark's Backhoe, although an exact amount could not be determined. In 2007 Mark's Backhoe Service financed the amount of \$136,000 still owed by Sherwood for 10 years at 18% simple interest. Since it would have been virtually impossible for Sherwood Water to obtain financing elsewhere the terms of this loan were considered appropriate.

In order to keep the rates as low as possible for the rate payers, Mark's Backhoe volunteered to refinance Sherwood's remaining loan balance of \$126,197.92 over 20 years at 6% simple interest. The \$18,556 adjustment represents the annual savings based on the new terms of this loan.

***2. Services - Billing, Accounting, Office***

This includes billing, accounting and all other office duties performed by Peggey Bryner and Breanne Johnson. They are willing to be paid for a combined 30 hours per month at \$10 per hour, with no benefits, to perform these duties. Based on the number of hours spent last year in performing the office duties, 30 hours per week is a conservative time estimate.

***3. Water Master Duties***

This includes all functions of keeping the water company running smoothly, efficiently and in accordance with all state and federal regulations. These duties include, but are not limited to, reading and testing the meters, performing routine maintenance and repairs, routinely checking the system for proper operation as well as performing administrative duties as needed/required. The \$5,400 is based on the time Scott Johnson spent last year on the above mentioned duties at \$20 per hour. As in the past, as well as going forward, Mr. Johnson is paying for all his own transportation expenses such as wear and tear on his vehicle, gas and automobile insurance as well as various field tools and instruments. The Division determined that the labor amounts of \$5,400 are reasonable.

In order to help keep rates affordable, Scott Johnson has agreed to perform the same duties at the same level of care for \$1,000 less per year, therefore, the Division recommends that \$4,400 (\$366.67 monthly) be funded in the rates.

**4. *Repairs***

During 2009, \$11,229 was spent on repairs and replacements for Sherwood's aging infrastructure. Much of this was paid for through Mark's Backhoe and not charged to Sherwood. Scott Johnson volunteered to charge Sherwood no more than \$7,500 for repairs in the upcoming year. Any additional repair expenses, within reason, will be donated by either Scott Johnson or Mark's Backhoe.

**5. *Liability Insurance***

Sherwood presently has no liability insurance. This \$2,500 adjustment is an estimation of the annual amount needed in purchasing liability insurance for which Breanne Johnson is currently seeking bids.

**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 the past several rate case Orders of other water companies, 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. Following the same practice in Sherwood's case significantly understates the amount that would typically be set aside as capital reserves because the Water Company was purchased for approximately \$50,000 by Mark Johnson in 1999 with no records or an accounting of the value of the infrastructure.

Based on the best information available, the annual Depreciation Expense of \$4,813 and annual amortized CIAC of \$421, for a total of \$5,234 is the amount to be set aside to fund the Capital Reserve account. This is significantly less than what is likely needed to replace and repair a 30-year-old infrastructure. In a recent rate case of another water company with a similar number of connections and a similarly aging infrastructure the Division recommended that \$27,496 be set aside annually to fund their Capital Reserve account. The Division believes that this amount would be appropriate in this case as well, but calculations show that an additional \$19 per month per connection would be required to fund this. In the interest of keeping the water prices affordable for the rate payers, Mark's Backhoe and Scott Johnson have verbally volunteered to donate significant labor and some materials in systematically replacing the old infrastructure

over the next several years as their schedule and funds allow. In light of this, the Division, with reservations, agrees to recommend that \$5,234 fund the Capital Reserve Account for this rate case.

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 \$11,934 (\$238,674 *times* 5%) would require submission of a written report and Commission approval.
4. Sherwood 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 ("Capital 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 of Return and Return on Investment***

The 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 \$197,173. The rate of return, representing the amount allowed to be earned, is expressed as a weighted percentage of the utility’s rate base. Since Sherwood is non-profit the only return they are entitled to is the interest amount they must pay on their debt. Therefore, the rate of return is 4.46%, which will generate \$8,794 to cover the amount of their annual interest on their debt.

**DIVISION RECOMMENDATIONS:**

***Rates and Charges***

<b>Rate Changes:</b>		<b>Table 1</b>	
<b>Description</b>	<b>Current Tariff</b>	<b>Requested by Sherwood</b>	<b>Recommended by Division</b>
System Expense	\$15.00 per month	\$35.00 per month	\$31.25 per month
First 8,000 gallons			\$10.50 per month
Standby Fees	\$15.00 per month	\$25.00 per month	\$31.25 per month
Usage per 1,000 gallons over 8,000 gallons	50¢ per 1,000 gallons	\$2.50 per 1,000 gallons	\$1.75 per 1,000 gallons
Water Service Turn-on & Turn-off charges	\$25.00	\$100.00	\$100.00
Late Fees on bills past due by 30 days or more.	None	18% per annum or 1.5% per month	18% per annum or 1.5% per month
First time service connection fee	\$2,200.00	\$2,500.00	\$2,500.00

<b>Rate Changes:</b>		<i>Table 1</i>	
<b>Description</b>	<b>Current Tariff</b>	<b>Requested by Sherwood</b>	<b>Recommended by Division</b>
Fee for unwarranted service call: (Unwarranted service call defined as a service call that is determined to be customer responsibility.)	None	Actual cost	Actual cost
Transfer of ownership fee	None	\$500.00	\$500.00

The monthly rates recommended by the Division are somewhat higher than those rates originally requested by Sherwood, because after Division analysis, and in consultation with Sherwood, it is evident that, in order to cover the remaining expenses, Sherwood would have to raise their rates higher than they originally planned.

**CUSTOMER IMPACT**

In the past, the Division has often recommended an increase of this scale to be phased in over a period of time. In Sherwood’s case, the cash flow needs are such that the Division is recommending that the rates become effective March 1, 2010.

***Company Subsidization***

Typically, a developer of a sub-division would retain ownership of the water company and subsidize the water system until the lots are sold and the water system is fully developed since the developer’s best interests are served by maintaining a high quality water system with low rates in order to sell more lots. After the subdivision is fully developed, the developer generally either sells the water company or turns it over to the water users. If the water company is sold, the new owner typically sets appropriate rates that provide revenues to cover all expenses and earn a fair rate of return on their investment. If the water company is turned over to the water users, the rates would be set to cover the expenses of producing and delivering water. Regardless, the water company must, at a minimum, cover their expenses through rates.

Sherwood’s situation is unique because after Mr. Johnson purchased the Water Company in 1998 he continued to subsidize expenses through personal and business (Mark’s Backhoe) contributions, making the rates artificially low for many years. To obtain an accurate financial picture of Sherwood’s operation, all of Sherwood’s expenses were accounted for and recorded to determine what rates were necessary to fund these expenses. These rates were approximately double the rates recommended in this analysis. Sherwood and the Division spent many painstaking hours adjusting, trimming and shifting expenses in order to keep the rates as low as possible for the rate payers.



Some of the expenses were shifted to Mark's Backhoe and Scott Johnson as future contributions in the form of both labor and supplies. Additionally, refinancing the loan to Mark's Backhoe at a much lower interest rate and over more years significantly lowered the rates.

While the Division commends Mark's Backhoe and Mr. Johnson for their support of Sherwood and Sherwood's rate payers, the Division is concerned about the day that the subsidies stop or the Water Company is sold and the actual expenses must be covered by the rates. Also of concern is the pending project regarding the reduction of arsenic in order to comply with the Division of Drinking Water's requirements. This has the potential of being very expensive and must be covered by the rate payers.

**CONCLUSION:**

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

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.