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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
Shauna Benvegnu-Springer, Utility Analyst

DATE: March 8, 2010

SUBJECT: **In the Matter of the Request of Pine Valley Irrigation Company for Approval of a Rate Increase**

RE: Docket No. 09-2179-01

RECOMMENDATION: APPROVE DIVISION RECOMMENDATION

The Division of Public Utilities (DPU or the "Division") has completed a compliance audit and rate case analysis of Pine Valley Irrigation Company ("Pine Valley" or the "Water Company") based on Pine Valley's request for a rate increase dated September 1, 2009. The rates have remained unchanged since January 24, 2002 when the Public Service Commission approved their amended tariff. Since that time, the Company has managed its resources and has reported a profit for the years 2002 through 2008. Pine Valley has recently completed a number of improvement projects to comply with state requirements and to improve the water service to its customers. The Company has requested a rate increase in order to provide funding for the new loan payments and ongoing operating costs of the new projects. The Division is not recommending a special assessment, but is recommending an increase in rates and fees, expanding the service area and implementing a capital reserve account.

COMPANY BACKGROUND

On July 13, 1903, Pine Valley Irrigation Company registered as an irrigation non-profit corporation and reincorporated as a non-profit mutual water company in 1948. In 1976, the shareholders converted the system to a piped underground spring source and added culinary water service for its customers. The water company was originally organized as a mutual water company, but when the culinary water was added to the water system, surrounding neighbors requested utility services who were not shareholders or stockholders, which the water company accommodated.

Pine Valley Irrigation Company is located in a valley on the south slope of the Pine Valley Mountains in Washington County. Its physical address is 435 East Main Street, Pine Valley, Utah. The service area includes the following designated developments:

- town of Pine Valley (22 blocks)
- Pine Valley Meadows
- Pine View
- Mangum Subdivision
- Springer Creek Pines
- Shadow Hills Estate Phase 1
- Mountain View Estates Phase 1
- Pine Tree Subdivision
- Sunflower Acres
- Al Truman's Subdivision
- Deiro Subdivison, and
- Pine Valley Ranchos A-G.

The lot sizes range from as small at ¼ acre to 1 acre. The water company is serving 481-metered customers, 225 lots on stand-by status and the potential of 94 additional connections for a total of 800 authorized connections.

On July 26, 1991, the Commission granted Pine Valley a Certificate of Public Convenience and Necessity (CPCN) and approved its tariff through docket number 91-2179-01. The rates set in 2002, consisted of $20.00 per month minimum charge for the first 3,000 gallons, $.50 per 1,000 gallons for the next 3,000 gallons, $.75 per 1,000 for the next 3,000 gallons and usage above 9,000 gallons was $1.00 per 1,000 gallons.

ANALYSIS:

The Division reviewed annual reports submitted by the water company for the years ending December 31, 2000 through December 31, 2008 and the general ledger for 2009. The Division also tested the water companies' internal controls, Commission compliance, and reliability of the financial records. Mr. Judd Burgess, President of the water company, Ms. Janece Gardner, a staff member, Ms. Carrie Neilson, a staff member, Mr. Ryon Gardner, the water master, and Lee Snow, Secretary of the water company were very knowledgeable of their respective areas of Pine Valley's operations and finances, and were cooperative with the Division during its analysis. All information was provided to the Division in a timely and usable format. The Division met with water company representatives and corresponded often throughout the review and rate design process. Pine Valley is currently in compliance with all of its reporting requirements to the Division.

Test Year

The Division used the calendar year 2008, 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 2010. Based on recent trends, as well as conversations with Mr. Burgess, no growth, and therefore, no additional connections are anticipated to occur in 2010.

Revenue Adjustments:

Revenues were adjusted to cover the actual fixed and variable costs. The Division recommends an increase in revenues of $48,904, or 19.14% 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. In light of the fact that Pine Valley has not raised its rates in approximately eight (8) years, and considering the increase in operational costs as well as the cost of the additional transmission lines and mains, 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 Pine Valley recorded a net operating profit of $22,249 when $31,725 of non-utility income was reported. Without the non-utility income, a $9,476 loss was realized from the operations of the water company, meaning that Pine Valley 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 require specific mention are here as follows:

1. ***Debt Service***

   The rate increase request included repayment amount of $100,300 for principal and interest of two loans from Division of Water Resources, which total $1,126,413. The Division made an adjustment of $60,364 to eliminate the principal amount. Additionally, the Division added the annual interest of a third loan (Village Bank) of $1,048. The interest expense is an allowed expense for ratemaking purposes but not the principal, which is to be recovered by the allowable rate of return on investment.

2. Bad Debt Expense
In the Division's review of expenses, the request included a bad debt expense of $1,273 in 2008 and an estimated amount of $2,000 in 2009. The Division disallowed this expense, since all accounts should be collected and not borne by the ratepayers.

3. Depreciation Expense
The Division's analysis determined that the assets listed under Utility Plant in Service were incorrectly depreciated due to incorrect service life and depreciation rates as allowed by the Commission Rule R746-332. The Division made an adjustment of $22,199 to correct the service life and add depreciation for the additional plant added in 2009.

4. Taxes
The Division included the property taxes of $1,800 that were not included in the proposed rate. An adjustment to increase income taxes due to the increase in revenue and rate of return on the investment to $17,996.09 from $6,028 as requested.

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 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 $7.16 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 $92,500 ($1,840,500 *times* 5%) would require submission of a written report and Commission approval.

4. Pine Valley 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 $ 1,120,580.

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 5.75%.

Therefore, the return on investment (profit) is **$ 64,433.33** ($ 1,120,579.72 *times 5.75%).*

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 with reserves. The Division's analysis shows a Revenue Requirement of $ 299,267.02.

The Revenue Requirement consists of the following amounts:

Annual profit of (5.75% rate of return):	$64,433.33
Capital Reserve of:	$ 60,339.00
Estimated state and federal income taxes of:	$12,858.68
Operating expenses & interest expense of :	$161,636.00
TOTAL:	$ 299,261.03

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 Pine Valley	Recommended by Division
System Expense	$10.00 per month	$14.50 per month	$22.25 per month
First 3,000 gallons/recommend 5,000 gallons	$20.00 per month	$29.00 per month	$34.25 per month
Usage per 1,000 gallons over 3,000 gallons Usage per 1,000 gallons over 6,000 gallons Usage per 1,000 gallons over 9,000 gallons	$.50 per 1,000 gallons $.75 per 1,000 gallons $1.00 per 1,000 gallons	$.80 per 1,000 gallons $1.05 per 1,000 gallons $1.30 per 1,000 gallons	$1.30 per 1,000 gallons over 5,000
Disconnect Fee per incident	n/a	n/a	100.00
Reconnect Fee per incident	n/a	n/a	100.00
Late Fees:	1.5% of the unpaid balance	1.5% of the unpaid balance	$5.00 fee or 1.5% of the unpaid balance, whichever is greater
System Expansion Impact Fee*	$1,500	$1,500	$2,000
Hook- up Fee**	$500	$500	$900
Name Transfer Fee	n/a	n/a	$25
Returned Check/NSF Fee	n/a	n/a	25.00
Unwarranted Service Call	n/a	n/a	50.00

*The system expansion/impact fee is being increased to cover the additional expense to the system for a new water storage tank. This will maintain proper storage capacity for the additional customers of the service area taking the authorized number of authorized connections to eight hundred (800).

**Actual costs for placing the meter, parts, average line, and labor warrant the hook-up fee to be increased to $900.

CUSTOMER IMPACT

Below, the Division has shown the increase in monthly rates (impact) on four (4) of Pine Valley'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	10,000	$24.75	40.75	$16.00	64.65%
B	48,000	$62.75	90.15	$27.40	43.67%
C	650,000	$664.75	872.75	$208.00	31.29%
D *(Not Connected)*	0	$10.00	$22.25	$12.25	122.50%

CONCLUSION:

The Division believes that the recommended rates and charges represent an appropriate balancing of ratepayer interests and the interests of Pine Valley. 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. The Division recommends the service area be increased to allow an additional 94 connections for a total of 800 authorized connections. The Division also recommends implementation of the capital reserve account as discussed.