

DECISION MEMORANDUM

**TO: COMMISSIONER KJELLANDER
COMMISSIONER SMITH
COMMISSIONER HANSEN
COMMISSION SECRETARY
COMMISSION STAFF
LEGAL**

FROM: SCOTT WOODBURY

DATE: OCTOBER 15, 2004

**RE: CASE NO. UWI-W-04-3 (United Water)
PROPOSED SALE OF CARRIAGE HILL DOMESTIC WATER SYSTEM;
PROPOSED AMENDMENT OF CERTIFICATE AND REQUEST FOR
ACCOUNTING ORDER**

On August 9, 2004, United Water Idaho, Inc. (United Water; Company) filed an Application with the Idaho Public Utilities Commission (Commission) requesting authority to remove the Carriage Hill Subdivision from the Company's certificated service area and for an accounting order regarding distribution of proceeds from the sale of the Carriage Hill domestic water system from United Water to the City of Nampa. On August 25, 2004, the Company filed supporting testimony for its Application.

Background

On March 29, 1999, the Commission in Order No. 27976 approved an expansion of United Water's certificated service area to include the Carriage Hill Subdivision in Canyon County, Idaho near the City of Nampa. The expansion was pursuant to a Non-contiguous Water System Agreement between the Company and Carriage Hill dated *November 20, 1998*. At the same approximate time, the Company's corporate parent, United Waterworks, entered into a separate understanding with the Carriage Hill developers that United Waterworks would loan the developers up to \$350,000 to finance the construction of the Carriage Hill source of supply system only. Reference 1) Design-Build Promissory Note dated December 7, 1998 and 2) Joint and Several Individuals Guaranty signed by Carriage Hill developers.

As initially constructed the Carriage Hill development had only one well to serve as the source of supply. In the spring of 2002, the developer had embarked on Phase 2 of the

distribution system that would add 20 lots to the original 27 in Phase 1. Eventually, 25 lots would be connected, the maximum permitted by the Idaho Department of Environmental Quality (DEQ) for a system with only one source well. Under DEQ requirements, a second source of supply is required for a water system serving more than 25 connections.

In early 2003, the Carriage Hill developers informed United Water that they did not have funds to construct a second source of supply or to continue payments to United Waterworks. Without a second source of supply Carriage Hill would not be able to expand. Without expansion, Carriage Hill developers would be unable to generate funds to finance a new well or to pay United Waterworks.

On August 15, 2003, the City of Nampa indicated its desire to enter into negotiations with United Water and Carriage Hill in connection with the ownership, operation and maintenance of the Carriage Hill domestic water system and the connection of the system to Nampa's Municipal Water System.

On August 25, 2003, Carriage Hill requested a waiver from the Idaho Department of Environmental Quality to allow an additional ten lots in the subdivision to be connected to the water system prior to the installation of a second source of supply, which second source of supply, it was stated, would take the form of connection to Nampa's Municipal Water System. As of the date of this Application approximately 30 lots in the Carriage Hill Subdivision have been connected to the domestic water system.

Purchase Agreement—United Water/City of Nampa

United Water (Seller) has entered into a Purchase Agreement (Agreement) with the City of Nampa (Buyer) dated 12 March, 2004. As reflected in the Agreement, the purchase price is \$375,000. A small portion of the purchase price, approximately \$36,000, is to be paid to United Water Idaho. The remainder of the purchase, approximately \$338,000, is to be paid to United Waterworks, Inc., owner of a Design-Build Promissory Note in the original principal amount of \$350,000 dated December 7, 1998, said note being the joint and several obligation of Carriage Hill LLC.

United Water contends that acquisition of the Carriage Hill domestic water system by the City of Nampa is consistent with the Public Convenience and Necessity because:

- Nampa has adequate source of supply and operational capability to provide safe and reliable water service to the subdivision;

- The connection of Nampa's distribution system to the Carriage Hill domestic water system will provide a second source of supply as required by DEQ rules thus insuring reliable water supply to the subdivision and permitting further expansion of the subdivision; and
- The rates charged by Nampa for domestic water service are lower than the rates charged by United Water, and customers within the subdivision will therefore experience a decrease in the cost of domestic water service.

Application Exhibit E (revised) sets forth United Water's proposed journal entries to account for the \$36,000 to be received by United Water at closing. Revised Exhibit E reflects Advanced Plant in Service of \$354,906 and Contributed Plant in Service of \$177,439. The advanced plant reflects the source of supply portion of the system and was provided by the developer. The contributed plant reflects the distribution portion of the system and was fully funded by the developer. Because advanced plant and contributed-plant are not included in the Company's rate base, United Water states that customers have not, through their rates, paid any return on those investments. It is the Company's contention that its customers have not acquired any financial or equitable interest for which they should be compensated upon sale of the Carriage Hill assets. United Water contends that the Company's accounting proposal is consistent with established regulatory accounting principles and requests that the Commission approve it.

On September 1, 2004, the Commission issued a Notice of Application and Modified Procedure in Case No. UWI-W-04-3. The deadline for filing written comments was September 27, 2004. The Commission Staff was the only party to file comments (attached). On October 12 the Company filed Reply Comments (attached).

Staff does not object to the sale of the Carriage Hill Water System to the City of Nampa. Staff contends however, that United Waterworks has no legal claim to any portion of the proceeds from the sale of the Carriage Hill Water System. Staff contends that the interests of ratepayers in advanced or contributed property is equivalent to that of the Company and should be treated as such in an equitable distribution of sale proceeds. Staff proposes that the proceeds from the sale be accounted for in a different manner than recommended by the Company. The Company in Reply Comments (and Affidavit) notes that in attempting to structure a solution to the dilemmas presented by the Carriage Hill situation, the Company did not proceed based on a

rigid analysis of the legal rights and obligations of the various parties. Rather the Company looked for a practical solution that did not harm any ratepayers and that unwound the financial obligations in a way that all parties were made whole. What the Company did may not be required from a strict legal point of view, but neither, it contends, is it prohibited. United Water contends that Staff's proposed distributions and recommended accounting proposals are contrary to law and sound public policy. United Water requests the opportunity to present oral argument. This matter has been tentatively scheduled for Monday, October 25 at 10:00 a.m.

COMMISSION DECISION

United Water requests the opportunity to present oral argument with respect to its Application, the Staff Comments and the Company's Reply Comments. Oral argument has been tentatively scheduled for 10:00 a.m. on Monday, October 25. Does the Commission agree with the proposed procedure and scheduling?

Scott Woodbury

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BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION OF)
UNITED WATER IDAHO INC. FOR AN) CASE NO. UWI-W-04-3
AMENDMENT TO ITS CERTIFICATE OF)
PUBLIC CONVENIENCE AND NECESSITY NO.)
142 AND FOR AN ACCOUNTING ORDER.) COMMENTS OF THE
) COMMISSION STAFF

COMES NOW the Staff of the Idaho Public Utilities Commission, by and through its Attorney of record, Scott Woodbury, Deputy Attorney General, and in response to the Notice of Application, Notice of Modified Procedure and Notice of Comment/Protest Deadline issued on September 1, 2004, submits the following comments.

BACKGROUND

On August 9, 2004, United Water Idaho Inc. (United Water; UWI) filed an Application with the Idaho Public Utilities Commission (Commission) requesting authority to remove the Carriage Hill Subdivision from UWI's certificated service area and for an accounting order regarding distribution of proceeds from the sale of the Carriage Hill domestic water to the City of Nampa (Nampa). On August 25, 2004, UWI filed supporting testimony for its Application.

UWI proposes to sell the Carriage Hill well and water distribution system to the City of Nampa through an agreement reached through arms length negotiations over the past year. Nampa

proposes to purchase the well for \$375,000. The City will finance the acquisition through a Local Improvement District (LID).

The Carriage Hill system was established in 1999 through a non-contiguous system agreement with UWI (Order No. 27976). The distribution system and water source was contributed to UWI in December 1999 as part of that agreement. UWI booked the system valued at \$532,345 for rate base treatment with two contra balances of \$177,439 as contribution in aid of construction for the distribution system and \$354,906 as an advance in aid of construction for the source supply.

In accordance with the non-contiguous agreement, UWI reimburses the developers at a rate of \$800 per lot once a customer connects to the system and begins taking service. The reimbursement rate was established in Case No. UWI-W-98-1, Order No. 27718, as the average embedded per customer cost of supply improvements. The total reimbursement amount is limited to the lesser of the total number of connected lots at subdivision build-out or the total advance in aid of construction. Reimbursements are also limited to a maximum of 15 years.

The UWI investment in the Carriage Hill system is equal to the reimbursement of \$800/connected lot and purchase of meters for each customer. Carriage Hill customers paying standard UWI rates each contribute approximately \$200 per year per customer. This annual revenue amount is much less than the average UWI customer bill of over \$300 due to availability of irrigation water through a separate delivery system.

The Carriage Hill system is not included in UWI's current rate calculation. The test year of the last UWI general rate case (Case No. UWI-W-00-1) was the year ending September 30, 1999 and the Carriage Hill system was contributed to UWI in December 1999. A UWI general rate case has not occurred since the approval of the Carriage Hill non-contiguous water system.

ORIGINAL FINANCING AND AFFILIATE RELATIONSHIPS

As noted in Section VI of UWI's Application, in 1998 Carriage Hill, L.L.C. executed a Design-Build Promissory Note with UWI's parent, United Waterworks, Inc. (UWW) in the original principal amount of \$350,000. The note provided funds to assist Carriage Hill in the construction of the water system within the subdivision. In 1998 the principals of Carriage Hill also executed a Joint and Several Individuals' Guaranty in favor of UWW as guarantee for the Promissory Note. However, in 2002 Carriage Hill L.L.C. failed to make the payments required under the Promissory Note to UWW and the Promissory Note became delinquent (Wyatt, Di, page 2, lines 8 and 9). UWI personnel made numerous contacts with the developer requesting payment to UWW. In addition,

UWI personnel discussed loan refinancing with their corporate accounting and treasury departments and subsequently made proposals to the developer regarding a potential refinancing of the loan (Wyatt, Di, page 2, lines 11 through 14). Further evidence that UWI was operating on behalf of its parent was the decision by UWI to stop its contractually obligated refunds to the developers of the project water system source of supply investment. "When Carriage Hills became delinquent in its loan repayment obligations [to United Waterworks], United Water Idaho suspended the refund payments." (Wyatt, Di, page 7, lines 9 through 21).

On page 3 of his direct testimony, Mr. Wyatt describes the Carriage Hills project as precarious in early 2003. "The Carriage Hills developers informed me that they did not have funds either to continue payments to United Waterworks or to drill a new well. Without a second source of supply the project would not be able to expand and thereby generate funds to finance the new well or to pay United Waterworks." (Wyatt, Di, page 3, lines 6 through 9). As a result, in 2003 UWI started discussions with the City of Nampa regarding the sale of the system. Section XII of UWI's Application indicates that subject to final adjustment, approximately \$339,000 of the \$375,000 purchase price for the sale shall be paid to UWW to discharge the accrued interest and principal owing pursuant to the Design-Build Promissory Note. Greg Wyatt notes that this is a unique set of circumstances that justifies such a disbursement of sale proceeds. On page 9, lines 16 through 17 of his direct testimony, he states "there are no other non-contiguous projects in which United Waterworks operates as a financier, and I would not anticipate there would be any in the future."

Staff strongly encourages United Waterworks and its wholly-owned regulated subsidiary United Water Idaho to refrain from further financing transactions of this nature. Staff believes that this transaction created a conflict of interest for UWI to maximize proceeds from the sale of company assets and to recover a delinquent loan for the benefit of the parent company. Moreover, difficulties arise in reviewing, separating and allocating UWI costs between the two affiliates.

According to UWI, the Carriage Hill system is earning a 6.914% return on rate base. This is below the 8.843% return authorized in UWI's last rate case, Case No. UWI-W-00-1, Order No. 28505, page 2. As described further in the Engineering Section below, the Carriage Hill water system is currently limited to 35 customer connections due to its single well. Given that limitation, it is highly unlikely the system will substantially increase the return it is earning to become self-supporting and avoid being subsidized by other customers.

ENGINEERING

Staff believes both the City of Nampa and United Water have adequate water system management and the financial capability to serve customers. Both the City of Nampa and United Water Idaho employ full-time qualified experienced water system personnel. The City of Nampa, the second largest city in the state and UWI, the largest regulated water company, both have adequate financial capabilities to serve its customers.

Staff further believes that interconnection with the City of Nampa will immediately improve the supply capacity of the system. Currently the Carriage Hill water system is allowed to exceed the maximum number of customers served by a single well through an agreement between UWI and the Department of Environmental Quality (DEQ). DEQ requires a second source once the number of full time customers exceeds 25. The agreement allows for up to 35 customers to be connected to the Carriage Hill system until the issue of purchase by the City of Nampa is resolved. If the sale/purchase is approved, the city will interconnect Carriage Hill with its existing citywide system providing an adequate second source. If the purchase does not proceed, the Non-contiguous Water System Agreement requires the developers to install a second water source. UWI has indicated that the cost of the second source is expected to be approximately \$90,000. If the developer cannot fulfill its obligation then UWI would be required to make the necessary system improvements.

As of September 17, 2004, Staff is aware of one customer comment concerning water quality. The customer indicates that the City of Nampa water sources are of lesser quality (harder water) than the current Carriage Hill system. Staff assumes that it is the city's intention to keep the Carriage Hill well in operation. While Staff has not analyzed pressure differences between the city's system and the Carriage Hill system it is logical to assume that even with the interconnection, customers should continue to receive the majority of their water from the existing Carriage Hill well with backup supply from the city. In any case both systems must meet statewide water quality standards as set by the Department of Environmental Quality.

One area where customers will benefit from the sale of the system is from the rate differential between UWI and the City of Nampa. Currently Nampa's rates are significantly less than those of UWI (See Attachment A). Customers should also experience easier access to water system administration with offices in Nampa as opposed to Boise.

Staff was initially concerned that existing customers would end up paying twice for water system improvements, once through the purchase price of lots and also through the local

improvement district. Staff's investigation indicates that no existing customers will be included in the assessment of the local improvement district.

ALLOCATION AND ACCOUNTING OF SALE PROCEEDS

UWI has proposed a distribution of sale proceeds as part of its Application. That proposed distribution would initially allocate a portion of the sale proceeds to United Water Idaho to "make the Company [UWI] whole". These are the funds necessary to reverse all the entries on UWI's books as a result of taking ownership of the Carriage Hill water system (water system). UWI then proposes that the balance of the sales proceeds be distributed to United Waterworks, an affiliate of UWI, to satisfy an obligation in the amount of \$308,117.56 (principal note balance of \$262,345.60 and accrued interest through October 15, 2004 in the amount of \$45,771.96). This represents a premium of approximately \$30,000 being paid to UWW (a UWI affiliate) from the sale proceeds.

UWI does not address any legal basis for making any payment to United Waterworks nor does it advance any rationale to justify a payment of any premium to United Waterworks. All the documentation indicates that the entire legal obligation for any debt owed to United Waterworks for the initial financing of the water project flows solely from Carriage Hill, L.L.C., hereafter Developers. The Developers borrowed the money from United Waterworks and guaranteed repayment with personal guaranties. The Developers then contributed all of the existing domestic water system to UWI. A portion in the amount of \$177,438.79 was contributed as Contribution in Aid of Construction (CIAC) (the distribution system) and a portion in the amount of \$354,905.74 was contributed as Advances in Aid of Construction (AIAC) (the source system). UWI's only obligation in return for the Developers contributing this water system was to refund to the Developers the amount of \$800 for each connection to the system as an offset to AIAC. There is no agreement by UWI to assume the Developers obligation to United Waterworks, nor was there any provision in the agreement between UWI and the Developers to accelerate the payment of the Advances in Aid of Construction upon the sale or transfer of the system, and finally, there is no evidence of any legal claim that can be asserted by United Waterworks for any portion of the proceeds from a sale of the water system. When the Developers transferred the water system to UWI, it was transferred free from all liens and other encumbrances.

Staff is in agreement with that portion of UWI's Application that indicates a portion of the proceeds should be paid to UWI to make it whole. UWI submitted Revised Exhibit E as its

proposal to achieve that objective. Staff has reviewed those entries and proposes that the following adjustments be included to fairly reflect what would be necessary to make UWI whole:

- a. include chlorinating equipment at the well head- \$1,722.00
- b. include payroll overhead on MJ 2537- \$72.33
- c. include materials overhead on MJ 2537- \$752.29
- d. include payroll overhead on MJ 2849- \$711.16

Attached, as Attachment B is UWI's proposed accounting entries with Staff's adjustments to make UWI whole.

When the water system was transferred from the Developers to UWI (Commission Order No. 27976), the only UWI obligation was to pay the AIAC in the amount of \$800.00 per new connection to the Developers. If the Commission approves the requested transfer, UWI's AIAC obligation to the Developers ends, and all sales proceeds are UWI's.

UWI in its testimony (Wyatt, Di, page 5, lines 20 through 21) stated that its goal "was to obtain a sale price that would produce sufficient funds to make United Water Idaho and United Waterworks whole." It is Staff's position that UWI should be viewed independently from United Waterworks, and the sales proceeds should be accounted for as if the total amount came only to UWI. The original borrowing obligation of the Developers to United Waterworks is irrelevant to the Application before the Commission. Therefore, Staff believes it is inappropriate to directly use sale proceeds to retire the debt owed by Carriage Hills LLC as proposed by UWI. The issue before the Commission should be how the sale proceeds are allocated between the parties with a vested interest in the proceeds: that being the ratepayers and UWI. The Commission should narrow its focus on the allocation of the sale proceeds to an allocation between only the ratepayers and UWI, and not be distracted by the interests of UWW or the Developers.

The proper allocation of the sale proceeds is subject to interpretation. This interpretation leads Staff to three approaches: 1) Relative risks from contributions and advances are shared equally by UWI and ratepayers so the sales proceeds should be shared equally. 2) Depreciable assets in rate base provide the floor to allocate the sales proceeds. This ratio of depreciated assets to total depreciable assets is the proper ratio to allocate the sales proceeds with the depreciated ratio going to ratepayers and the undepreciated ratio going to UWI shareholders. 3) A combination of the first two methods to recognize the actual investment and risk responsibilities in this situation for ratepayers and UWI.

With the first methodology in determining the allocation of the sale proceeds between the ratepayers and UWI, the Commission should examine the relative risks of the respective parties. The relative risks include the increase in rate base as advances are refunded, depreciation on the investment, additional expense associated with operational and maintenance expenses, and whether or not sufficient revenues are generated to cover costs. How these risks are borne by each party should guide the allocation considerations of the Commission.

Neither UWI nor the ratepayers had any risk for the initial plant investment when the water system was contributed to UWI. UWI did not have to use any of its capital to obtain the system, and the ratepayers were not exposed to any associated rate base costs. Once the system was contributed, and UWI began to refund advances for customer connections and investment in meters, both parties began to be exposed to risk. UWI was investing by way of refunds creating an increase in rate base, and the ratepayers were exposed to the upward pressure on rates caused by an increase in rate base and associated costs.

Although there is no clear methodology to quantify each party's risk, Staff believes the relative risks of the ratepayers and UWI are very similar and approximately equal. Thus, it is reasonable that the allocation of the sale proceeds should reflect the similar and equal risks of each party. To the extent risks are equal, then the net sale proceeds should be divided equally.

The second methodology develops ratios where the depreciated portion of the depreciable asset is allocated to the ratepayers and the undepreciated portion of the asset is allocated to UWI shareholders. The Supreme Court of Idaho in the case of Boise Water Corporation, v. Idaho Public Utilities Commission, 99 Idaho Reports 158, 578 P.2d 1089 (1978); has previously addressed the issue of how the processes for the sale of a utility's depreciable assets are divided between the utility's shareholders and ratepayers.

In the Boise Water Case, the Court held that as a general rule, the gain from the sale of an asset is divided between the ratepayers and the shareholders according to that portion of the asset that has been depreciated. The Supreme Court held as follows:

In the world of utility law there are two methods of treating revenue. Some revenue benefits utility customers by decreasing the amount charged for rates. Other revenue benefits the shareholders of the utility. Which class of persons receives the benefit of such revenue depends on who has borne the financial burdens and risks of that property. On property other than real property, the utility receives a depreciation allowance which effects its rate of return. The depreciation is an amortized amount allowed to the utility for the consumptive utilization of its property. Theoretically,

at the end of the depreciation period the property is useless or consumed and the utility has been paid back its cost of acquiring that property for the benefit of its customers. Again, theoretically, the utility can then turn around with the money received as a depreciation allowance and buy a new piece of equipment to perform the function of that property which has been consumed or become useless. One way of looking at a depreciation allowance on a utility's personal property is that the public buys that property from the utility as it is used up. In one sense, therefore, the public owns depreciable property, and when a utility sells depreciable property, the ratepayers are entitled to have that sale treated as if it were the sale of the ratepayers property. The revenue ought to be included in the utility's revenue receipts which reduce the rate charges to customers.

With this guidance from the Supreme Court, it becomes clear that through depreciation, the general ratepayers of UWI should be treated in part as equitable owners of the water system being transferred. The ratepayers' share of the sales proceeds, at a minimum, should be equal to the ratio that accumulated depreciation is to the net book value of the system. That ratio is represented as below:

Accumulated Depreciation	<u>\$ 2,334.91</u>
Net Book Value	\$26,387.09

Thus, as a minimum, the ratepayers should be entitled to 8.849% of the sales proceeds after UWI is first made whole.

The Supreme Court decision is appropriate for the proceeds associated with rate base investment that UWI has made and is being depreciated. The situation being discussed here is different. The Carriage Hill water system was completely contributed and only became rate based as advances were refunded. Since the assets were contributed as opposed to assets that were completely rate based, a strict application of the Supreme Court holding in the Boise Water case is inappropriate. The general rule of the Boise Water case should represent the minimum interest, not the maximum interest, the ratepayers have in the sale proceeds when the assets are contributed.

The considerations associated with the first and second allocation methods gives rise to the third method. This method develops a combination where the risk sharing approach allocates 50% to ratepayers and 50% to UWI shareholders for the assets contributed or 95% of the plant value. The remaining 5% of plant value is associated with depreciable assets and should be allocated 8.849% to ratepayers with the remaining 91.151% to UWI shareholders

UWI proposed that United Waterworks should be entitled to the premium from the sale proceeds (Wyatt, Di, page 8, lines 18 through 21) because it believes United Waterworks was the

entity that faced the risk of project failure. This position is not supported by the original loan documentation. UWW did not retain any legal or equitable interest in the water system at the time of the financing. The only security for the repayment of the loan and the only security accepted by UWW were the personal, joint and several guaranties of the principals in Carriage Hill L.L.C., the development company. United Waterworks' legal right to be repaid by the Developer would not change if the project fails, and its risk position does not change from the risk it assumed at the time the loan was made to the Developer. Any premium that is realized from the sale of the water system should be accounted for in the division of the sales proceeds between the ratepayers and UWI.

The net sales price for the transfer of the water system is the difference between the gross sells price from the City of Nampa, \$375,000.00 and the reversing entries to make UWI whole (Attachment B). The total of those entries is dependent upon the Commission accepting Staff's adjustments, and the final sale transaction amounts that may cause the net figure to change in a small amount. The net sales amount using the reversing entries, as put forth in Attachment B is \$336,256.02. If the Commission finds that the relative risks of the ratepayers and UWW are equal, then a reasonable allocation of the sale proceeds would be that ratepayers would be entitled to a credit against future rates in the amount of \$168,128.01. Alternatively, as a minimum, the ratepayers would be entitled to the equitable ownership from depreciation or 8.849% of the net sales proceeds, \$29,755.30, which would also be a credit against future rates. The third methodology would allocate \$161,209 to ratepayers and \$175,047 to UWI shareholders. Staff believes this is the most reasonable allocation methodology. The UWI shareholders' portion could then be applied to the UWW loan if desired.

SUMMARY

Staff believes that United Water Idaho's proposed sale of the Carriage Hill system is primarily to avoid litigation between United Water Idaho's parent company United Waterworks and the developers of the Carriage Hill development. UWI further states that its goal during negotiations was to "obtain a sale price that would provide sufficient funds to make United Water Idaho and United Waterworks whole." (Wyatt, Di, page 5, lines 20 and 21). UWI's request appears to have little concern for either improved service to customers or to reduce customers' rates. Therefore, Staff's review focused on whether the sale was in the best interest of United Water Idaho's customers both inside and outside the Carriage Hill development.

