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IDAHO PUBLIC
UTILITIES COMMISSION

BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION OF UNITED WATER IDAHO INC. FOR AUTHORITY TO INCREASE ITS RATES AND CHARGES FOR WATER SERVICE IN THE STATE OF IDAHO	**Case No. UWI-W-04-04**

POST-HEARING BRIEF

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INTRODUCTION

COMES NOW, United Water Idaho Inc., ("United," "United Water," the "Company") and submits the following Post Hearing Brief. Included in this Brief are issues United believes may benefit from further explanation. There are additional issues which remain disputed but which, in the Company's opinion, are adequately discussed in the hearing record. The fact that an issue is not discussed in this Brief should not be construed as acquiescence in any other party's position.

A. THE COMMISSION SHOULD REJECT, FOR THIS CASE, USE OF A THIRTEEN MONTH AVERAGE RATE BASE.

In this case, Staff proposes a dramatic, and crippling, change from past ratemaking practice with respect to United Water Idaho. In each of United's past four rate cases, rate base was calculated on a year-end basis with post-test year adjustments for known and measurable plant additions. (*See* Case No. BOI-W-93-1, Order No. 25062; Case No. BOI-W-93-3, Order No. 25640; UWI-W-97-6, Order No. 27617 and Case No. UWI-W-00-1, Order No. 28585). Now, Staff calculates a rate base by averaging the monthly balances from July 31, 2003 through July 31, 2004 for Plant in Service, and Customer Advances and Contributions in Aid of Construction. Except for investment associated with the Columbia Water Treatment Plant (CWTP), post-test year investment through December 31, 2004 is treated as if it occurred in the last month of the test year. In consequence, that investment is included in rate base at 1/13 of the amount actually invested. (*See* Harms, Di. Tr.575-577). Additionally, Staff proposes to cut-off investment allowed in rate base five months after the end of the test year, with the result that any investment made after December 31, 2004 is not recognized in rate base at all. (*See* Lobb, Di. Tr.790).

Solely due to a change in ratemaking methodology, the Company will have no opportunity to earn a return on more than Fourteen Million Dollars of investment now providing service to customers. (*See* Peseau Reb. Ex. No. 17). For the reasons discussed below, the Commission should decline Staff's invitation to embark on this sudden, and devastating, detour from established ratemaking practice for United Water Idaho.

1. <u>Neither Order No. 29505 nor Order No. 29602 requires use of an average rate base for all utilities</u>.

Staff's apparent rationale for changing to an average test year rests on the assertion that United's use of a year-end test year in this case is inconsistent with the Commission's recent decisions in Idaho Power (Case No. IPC-E-01-13) and Avista (Case No. AVU-04-10) rate cases. (Lobb, Di Tr.785). In both of those cases, however, the utility in its initial filing proposed use of an average rate base and the choice between the average and year-end methods was not a contested issue. Moreover, Order Numbers 29505 (IPCo) and 29602 (AVU) advised utilities that when proposing post-test year additions to rate base a corresponding revenue and expense matching adjustment should be made. As discussed below, United has complied with this directive. Neither order declared that the average rate base method was the only or necessary solution to the mismatching problem.

Wisely, the Commission has never, to United's knowledge, pursued a one-size-fits-all policy with respect to rate base methodology. In fact, there are instances in which the Commission has simultaneously used an average rate base for some companies and a year-end rate base for others, depending on the circumstances of each company. For example, in Case BOI-W-93-3, filed in December of 1993 and decided in August of 1994, the Commission employed a year end test year for Boise Water. At about the same time the Commission in Case No. IPC-94-5 (filed in June of 1994, decided in February of 1995) employed an average rate base for Idaho Power Company.

2. United's proposal to match post test year revenue and expense with post test year investment complies with Commission directives.

In Order No. 29505 (IPCo), the Commission said, "Generally speaking, the Commission expects all utilities to attempt to identify expense saving and revenue producing effects when proposing rate base adjustments for major plant additions." United complied with this guidance by adding annualized customer growth revenue at current rates to the Company's base revenues for all customers anticipated to be added to the entire system from the test year through May 31, 2005. (*See* Wyatt Di. Tr.16; Gradilone Di. Tr. 233; Exhibit No. 6). The Company's approach thereby matches the higher level of end of period May 31, 2005 revenues with the higher level of rate base as of the same date. The Company also reflected post test year expense savings (*See* Healy Di. Page 79 and Exhibit No. 3, Schedule 1, Page 16 of 34). This method fully addresses the Commission's concerns expressed in the Idaho Power and Avista cases.

3. Staff's application of a thirteen month methodology creates a significant mis-match of investment with revenues.

In contrast, Staff's case fails to properly match its proposed thirteen-month and rate base estimates with corresponding revenues. As demonstrated by Staff Exhibit 126, Staff used the same level of annualized revenues, those for the period ending May 31, 2005, that are contained in the Company's filing. To be consistent with its suggestion to use the thirteen-month average rate base, Staff should also have reduced the May 31, 2005 annualized revenues in the Company's filing back to the actual test year revenues centered at January 2004. (Peseau Reb. Tr.1031). Thus, Staff mismatches rate base on a thirteen-month average basis, with a higher level of revenues calculated on a forward annualized period ending May 31, 2005. This flawed application of the thirteen-month method compels rejection of the Staff proposal.

4. The cost characteristics of United Water Idaho justify use of a year-end test year.

As noted above, the Commission has consistently chosen test year methodologies based on the characteristics of the individual utility and has not blindly adhered to a single approach.

In 1993, when the Commission changed from a thirteen-month to year-end method for United, the Commission said:

> According to Staff, Boise Water's rate base would be $1,163,281 lower if calculated based on a 13-month average as opposed to year-end. While it might be advantageous to ratepayers to have a lower rate base, no party challenges Boise Water's proposal to utilize a year-end rate base. Boise Water's customer base and its investment in plant are both growing rapidly. A year-end calculation of rate base for a utility experiencing rapid growth is, in this case, a more accurate reflection of that utility's investment in plant. In light of the foregoing and the absence of objection, we find that a year-end calculation of rate base for Boise Water is fair, just and reasonable. Order No. 25640.

The same considerations apply just as strongly today. United Water is highly capital intensive and its growth in rate base cost per customer is at a rate much greater than its customer or usage growth. This is conclusively shown by the following chart, contained in the rebuttal testimony of Dr. Peseau:

United Water Idaho
Change in Rate Base per Billing Unit

Item	Test Year Ending July 31,2004 Adjusted	Pro Forma Year Ending May 31, 20005	Percent Change
Rate Base(1)	$113,575,180	$140,652,083	23.84%
Commodity Use (CCF) (2)	20,407,679	20,671,823	1.29%
Rate Base per CCF	$5.57	$6.78	21.75%
Bills Rendered (3)	440,686	450,336	2.19%
Rate Base Per Bill Rendered	$257.72	$311.02	20.68%

(Tr. 1037).

As shown, rate base cost per customer has grown recently by over 20%, while customer or usage growth has been approximately 2% or less. The circumstance is compounded by the fact that the Company is adding customers whose revenues or bills are below system average, due largely to a high percentage of customers taking service in areas where alternative sources of irrigation water are available.

These conditions—rapid growth in rate base per customer compared to usage growth, coupled with declining incremental revenue per customer—lead clearly to the conclusion that under the Commission's own decision criteria, the year-end method is more appropriate for United Water.

5. <u>Staff's proposal to include post test year investment at 1 /13 of its actual amount is arbitrary</u>.

Under Staff's proposal, except for the Columbia Water Treatment Plant projects, post-test year plant additions through December 31, 2004 are treated as if they occurred in the last month of the test year or as of July 31, 2005. As a result, those investments are included in rate base at 1/13 of their actual amount. (*See* Harms Di. Tr.575). It is undisputed that the water plant investments made through December 31, 2004 are currently in service and providing benefits to customers. Yet, 92% of that investment is, according to Staff's proposal, disallowed in rates.

The Idaho Supreme Court has recognized that the utility is entitled to have included in rates post-test year plant additions that meet the "known and measurable" test, which the investments in this case undisputedly do. In *Utah Power v Idaho Public Utilities Commission,* 102 Idaho 282, 629 P.2d 678 (1981) the court said:

> Test year data should be adjusted for known and measurable changes where the changes are shown to be reliable and certain. *E. g., Citizens Utility Co. v. Idaho Public Utilities Comm'n,* 99 Idaho 164, 579 P.2d 110 (1978); *Agricultural Products v. Utah Power & Light Co.,* 98 Idaho 23, 557 P.2d 617 (1976). The Commission should include in the rate base all items which are proven with

> reasonable certainty to be justifiably used by the utility in providing services to its customers. *Citizens Utility Co. v. Idaho Public Utilities Comm'n, supra.* 102 Idaho at 284.

Staff does not advance any cogent rationale for departing from or creating an exception to the *Utah Power* rule that "all items which are proven with reasonable certainty" should be included in rate base. To the extent the proposal is aimed at solving a perceived problem of mis-matched revenue and expense, it cannot conceivably be true that the revenue producing or expense reducing effects of new investment are of such a magnitude that 92% of the investment should be disallowed.

The end result of the Staff proposal is completely out of proportion with the end result of adjustments recently made by the Commission in other cases to take into account revenue producing, expense reducing effects. In the recently concluded Avista rate case, the Commission, with some reluctance, employed a variant of a proxy approach developed in the preceding Idaho Power Company rate case. (*See* Order No. 29602, Pages 16—17). This resulted in approximately 12% of post test year investment being excluded as opposed to almost 92% proposed by Staff in this case.

6. <u>Staff's proposal to cut-off allowed investment five months after the test year is arbitrary and contrary to prior ratemaking practice</u>.

In each of United's past four rate cases, the Commission has permitted capital additions up to the time of hearing, subject to the requirement that the additions be known and measurable and not merely budget estimates. (*See* Case No. BOI-W-93-1, Order No. 25062; Case No. BOI-W-93-3, Order No. 25640; UWI-W-97-6, Order No. 27617 and Case No. UWI-W-00-1, Order No. 28585). In this case Staff proposes a new, arbitrary, cut-off date of five months after the test year end. The effect of the Staff proposal is to produce a rate base that does not accurately reflect the Company's actual investments.

The Idaho Supreme Court has explained the reason for the rule requiring inclusion of all investments which meet the known and measurable test. In *Citizens Utilities v. Idaho Public Utilities Commission*, 99 Idaho 165, 579 P.2d 110 (1978), the court reversed the Commission's refusal to allow in rate base the cost of a billing machine placed in service after the test year. The court explained:

> This Court has stated before that test year data should be adjusted for anticipated and known changes where the changes are shown to be reliable and certain. *Agricultural Prod. v. Utah Power and Light Co.*, 98 Idaho 23, 557 P.2d 617 (1976). There was no reason to exclude the cost of the billing machine from the rate base. Citizens introduced sufficient evidence to establish that the 1975 test year data which did not include the cost of the billing machine did not accurately reflect Citizens' capital investments. Citizens also introduced sufficient evidence to establish the cost of the billing machine. The Commission should include in the rate base all items which are proven with reasonable certainty to be justifiably used in providing services. There are two good reasons for including these items in the rate base; first, to avoid a rate base which does not adequately demonstrate real revenue needs and second, to reduce the necessity of a future application to adjust the rate base to represent additional investments. The decision of the Commission on this particular item is error. The cost of the billing machine should have been included in the rate base.

While Staff audit review of post test year investments is appropriate, an arbitrary cut-off date after which investments that are known and measurable will not be considered deprives the utility of its legal entitlement to have those items included in rate base.

7. The rates proposed by Staff are unreasonable, unjust and confiscatory and their enforcement would deprive United of its property in violation of the Constitutions of the United States and the State of Idaho.

The Company and Staff have stipulated that a reasonable rate of return on invested capital is 8.357%. (*See* Staff Exhibit No. 131). Yet, it is a mathematical certainty that the rates resulting from the thirteen-month average rate base methodology will be insufficient to allow the Company the opportunity to earn that allowed return. This is demonstrated by Company Exhibit No. 17 which shows clearly that the net operating income resulting from rates proposed by Staff will only produce a return of 7.22% on capital actually invested at the start of the new rate period, a rate of return shortfall of 116 basis points. [1]

In *Idaho Power Co. v. Idaho Public Utilities Commission*, 99 Idaho 374, 582 P.2d 720 (1978), the court held that rates which will not produce the rate of return found to be reasonable are illegal. There, the Commission found a fair rate of return to be 8.23%. The Commission, however, made an incorrect adjustment to the company's interstate sales for resale that had the effect of producing an actual return of 8.09%. The court vacated the Commission's Order saying:

> To deduct these sales for resale twice produces a rate of return of only 8.09 percent and is less than the rate of return found by the IPUC to be fair, just and reasonable. Orders based on findings by the IPUC that are not supported by the evidence must be set aside on appeal. We recognize that the Public Utilities Commission is a fact finding and administrative body, exercising great discretionary powers, and that this court's review of its orders is limited. Const. Art. 5, § 9; § 61-629, I.C.; *State ex rel. Taylor v. Union Pac. R. Co.,* 60 Idaho 185, 89 P.2d 1005; *In re Mountain States Tel. & Tel. Co.,* 76 Idaho 474, 284 P.2d 681. However, embraced within that review and within the determination of the question as to whether it has regularly pursued its authority, the findings of the commission must be based upon substantial evidence; its findings not thus supported, or which are contrary to the evidence, cannot be accepted by the court as a basis for upholding the conclusions of the commission. Const. Art. 2, § 1; *Idaho Power & Light Co. v. Blomquist,* 26 Idaho 222, 141 P. 1083; *Nez Perce Roller Mills of Lewiston v. Public Utilities Comm.,* 54 Idaho 696, 34 P.2d 972; *Mountain View Rural Tel. Co. v. Interstate Tel. Co.,* 55 Idaho 514, 46 P.2d 723; *State ex rel. Taylor v. Union Pac. R. Co.,* 60 Idaho 185, 89 P.2d 1005; *Application of Nichols,* 68 Idaho 490, 199 P.2d 255; *Application of Lewiston Grain Growers,* 69 Idaho 374, 207 P.2d 1028; *Application of Pacific Tel. & Tel. Co.,* 71 Idaho 476, 233 P.2d 1024. 99 Idaho at 381.

Moreover, rates which will not produce a reasonable return on invested capital are confiscatory in the constitutional sense. The Idaho Supreme Court recognized this in *Intermountain Gas v. Idaho Public Utilities Commission*, 97 Idaho 113, 540 P.2d 775 (1975), where quoting from the *Bluefield* case, it said:

[1] The values in Exhibit 17 would be slightly, but not materially, different based on Staff's final positions at hearing.

> Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment. This is so well settled by numerous decisions of this court that citation of the cases is scarcely necessary: . . ." 262 U.S. at 690, 43 S.Ct. at 678.

In this case, not only is the actual return of 7.22% far below the stipulated reasonable return, it is below the 7.75% which Staff identified as the lower boundary of a reasonable range of cost of capital for United Water. (*See* Carlock Di. Tr. 840).

Acceptance of Staff's thirteen-month proposal would lead the Commission into clear legal error.

B. UNITED WATER'S INVESTMENT IN ITS FINANCIAL ACCOUNTING AND ASSET MANAGEMENT SYSTEM SHOULD BE ALLOWED IN RATES.

In October 2004 United Water upgraded its accounting system since the version in use by the Company was outdated and no longer supported by the vendor. The new asset is in service and has been providing service since October 2004 as acknowledged by Staff (Harms Di. Tr. 582) Harms stated that the allocation of the cost to United Water Idaho was explained, the system was in service, the Capital Expenditure Authorization for the project was reviewed and the amount was included in the capital addition Exhibit No. 8 of Company Witness Rhead and made no disallowance in its filed case. Witness Harms made a correction during the evidentiary hearing changing Staff's position and disallowing the investment merely because Staff wasn't able to precisely substantiate the allocation method used by the Company to determine the amount of the investment included in the Company's rate base. (Harms Cross Tr. 585)

1. <u>Staff's complete disallowance of this investment is extreme</u>.

The traditional grounds for disallowance of rate base investment are that the plant is not used and useful in providing service (*See* Idaho Code § 61-502A – Restriction on Rates Authorizing Return on Property not Providing Utility Service) or that utility management was imprudent in selecting between least costly resource acquisition options. Staff's disallowance is not based on either of these traditional rationales. Rather, Staff appears to be proposing disallowance as punishment for a failure to provide information relating to the allocation of cost in a timely manner. The type of missing information surrounding the allocation of the cost of the system to United Water Idaho from its parent has been the subject of a detailed Staff audit in the Company's previous rate case (UWI-W-00-1). In that proceeding Staff reviewed all Management & Service Company allocation methods, all of the allocation factors, the basis of the allocations and each component of all allocated charges from the parent and concluded that "…..I reviewed numerous transactions and found no evidence of any inappropriate charges being flowed through to United Water Idaho." (Smith Di, Tr. p. 671) Further, Mr. Smith described the audit as "more in detail than ever before." (Smith Cross p. 692). Since that time there has been no change to any of the methods or the basis of allocation reviewed in Staff's last audit, and in particular as related to the allocation of the new IT system from the parent to United Water Idaho, and therefore the Staff's argument for the disallowance on that stated basis is unsupported and provides no reason to believe that further investigation would likely lead to any different result. In addition, the appropriate allocation information was provided by the Company as Exhibit No. 15, Schedule 12 at hearings.

C. UNITED WATER SHOULD BE ALLOWED TO RECOVER ITS PENSION EXPENSE DEVELOPED USING GENERALLY ACCEPTED ACCOUNTING PRINCIPLES.

As with a number of issues in this case, Staff has proposed a significant change from past ratemaking practice for United Water and in this instance the proposal is contrary to Generally Accepted Accounting Principles (GAAP) as well. Staff recommends that the long standing and universally accepted method of developing a company's pension liability be abandoned due to the size of United Water's current rate request and because no cash contribution is required by the Company in the current year.

Financial Accounting Standard 87, (FAS 87) is a stable accounting measure which has been in effect for over 20 years in the U.S. and has served to provide a consistent method of computing an annual expense amount. The annual expense amount was defined to reflect accrual accounting for pension plans, making sure that the cost of pension benefits are expensed during the time earned – supporting a matching principle under GAAP as well as this Commission's expressed preference for the guiding principle of matching revenue with expenses. FAS 87 establishes accurate accrual accounting which produces equitable results for generations of customers and employees, and also offers a consistent stable methodology with little discretion from a company on how it is determined. This long standing and accepted method prescribes that while an employee is actively working and delivering services to the company and customers, any deferred compensation must be recognized against company books during active employment. Waiting to recognize benefits promised – and earned – until retirement is a clear mismatch of expense and revenue.

Since 1989 the Company has adopted Financial Accounting Standards Board No. 87 (FAS-87) for the recording of its pension costs. At least since the merger of General Waterworks and United Water Resources, this Commission has accepted this method of accounting for ratemaking since United Water's 1996 rate case and has authorized rate recovery of the associated expense in all rate proceedings since then. Without this matching, the Company is not properly recording the future liability it must pay to its retirees in the future. If the Company were to have an underfunded pension asset and was unable to pay future benefits, the then current customers would be funding the shortage for those employees that provided service in a prior period.

1. Staff's recommendation is inconsistent with its treatment of post employment benefits other than pension (OPEB).

Similar to FAS 87, there is a matching standard for the accounting for OPEB costs promulgated by the Financial Accounting Standards Board as FAS 106. This standard mirrors the accounting treatment and requirements of FAS 87 and employs the same matching principle of identifying and accruing the current expense with the service provided and revenue recognition. In this case the Staff has not recommended that the Commission depart from past ratemaking practice as it relates to OPEB rate recovery as it has with pension. There is no explanation expressed by Staff for this inconsistency in treating similar accounting and ratemaking issues, other than the magnitude of the rate increase.

2. Staff's Recommendation Is Contrary to the Express Purpose of FAS 87 and of this Commission to Avoid Expense Volatility.

Staff's recommended approach would have United Water contribute to its pension plan only when ERISA mandates a contribution, with expense recovery only when that contribution is required. ERISA Minimum Funding contributions are expected to dramatically increase given the funded status of United Water's Plan. When plans fail to retain a satisfactory funded position, the ERISA Minimum contribution adds a Deficit Reduction Contribution which accelerates contributions and requires an employer to make cash contributions to pay off the unfunded obligations. (Degann, Re Tr. 761) The estimated contribution that will have to be made by United Water Idaho in the coming year is expected to be approximately $1.8 million. (Degann, Cross Tr. 733) This method is volatile, inconsistent, and contrary to GAAP accounting and past Commission practice.

3. Staff's Recommendation does not Allow United Water the Opportunity to Achieve its Authorized Rate of Return.

In accordance with Generally Accepted Accounting Principles (GAAP) the Company must record the pension liability on its books and records as developed by its actuary. Without matching rate recognition there is a mismatch of revenues and expenses leaving the Company with lower than authorized earnings. This underperformance impacts the view of the Company from bondholders and bond rating agencies and may result in a poor credit rating that ultimately leads to higher debt costs that will be paid by customers through higher rates.

D. STAFF'S RECOMMENDATION TO DENY RECOVERY OF CERTAIN KNOWN AND MEASURABLE EXPENSE IS NOT BASED ON FACT

Staff has recommended that United Water's expense associated with its information technology initiatives as they relate to the Finance and Accounting system be disallowed on their belief that the expenses are nonrecurring and not supported by contracts. The contracts supporting the costs clearly provide the basis of the costs and demonstrate that the amounts are indeed recurring expense amounts and not one time charges. Staff wrongly assumes that since the upgrade of the Accounting and Finance system is not something that occurs every year, then it follows that the associated expenses are nonrecurring as well. This misinformed judgment denies United Water recovery of known and measurable expenses that it will incur annually and to which it is contractually bound. While the contracts were provided to Staff during the hearing, the explanation of what the charges represented were provided during discovery where Staff had sufficient time for analysis and follow up if necessary. (Response to Production Req. No. 175) The provision or lack of provision of the contracts does not support the incorrect assumption by Staff that the costs are nonrecurring.

E. BUSINESS INSURANCE COSTS SHOUD BE ALLOWED

In this case, Staff recommends disallowance of on-going business insurance costs on the basis that the costs are not supported by policies and the assumption that the costs are only estimates and therefore not known and measurable. This assumption is based on an uninformed judgment with no acknowledgement of previously supplied insurance policy support provided to the Staff during their audit in response to Staff Audit Request 50. A summary of this information was provided during the hearing (Healy, Re. Tr. 895) where Staff was critical of not having an opportunity to review. However, the Staff had more than ample time to review the supporting detail when provided during the audit. The submission of this material in summary form as a reminder that the information was clearly known and measurable should not be grounds for disallowance of these known and measurable costs that will be incurred by United Water.

F. FULL RECOVERY OF ELECTRIC POWER COSTS DEFERRED PURSUANT TO ORDER NO. 28800 SHOULD BE ALLOWED.

In Case No. UWI-W-01-2 the Commission entered Order No. 28800, which authorized the Company to establish a deferral account for purchased power costs associated with Idaho Power Company's purchased power adjustment clause (PCA). In reliance on Order No. 28800 the Company has deferred $1,469,292 (through June 2005) and now seeks to amortize that amount over a three-year period. Staff recommends that the deferral be reduced to $1,034, 098, an amount Staff claims represents "market crisis" costs, leaving un-recovered $435,194, which Staff characterizes as "poor water conditions" costs.

Staff's theory for disallowance is that the "...deferral was intended only to provide temporary relief from the extremely high power costs resulting from the short-term Western energy crisis." (Sterling Di. Tr. 641).

There is, however, nothing in the plain language of the Order that supports the limitation suggested by Staff. The Order recites that the Company requested a deferral of PCA costs "ordered by the Commission in Cases IPC-E-01-7 and IPC-E-01-11 *and any subsequent* related surcharge that may be authorized prior to the Company's next general rate case." The ordering language provides, "...the Commission does hereby approve establishment of a deferral account for incremental costs related to *recent and future* PCA related increases…" (Emphasis added).

The plain meaning of prior orders cannot be ignored or changed by subsequent orders. In the recent case of *Idaho Power Company v. Idaho Public Utilities Commission,*___ Idaho____, 04.8 ISCR 270 (2004) the Commission entered an order providing that IPCo direct costs and lost revenue impacts "may" be treated as a purchased power expense in the PCA. Later, the Commission entered a subsequent Order denying recovery of lost revenue impacts. On appeal the court held that the plain and reasonable meaning of the word "may" connoted permissibility and the Commission could not re-interpret its first Order to deny what it had already granted.

The same should hold true here. Staff is attempting to re-interpret Order No. 28800 by inserting a hidden condition that is not apparent from the plain and reasonable meaning of the Order.

Staff's proposal is also unfair. It is undisputed that the amounts recorded in the deferral account are correctly computed from an accounting point of view and it is undisputed that United actually incurred the costs reflected thereby in providing service to its customers. In good faith reliance on the plain language of Order No. 28800 the Company deferred correctly calculated amounts with the legitimate expectation that amortization would be permitted. (Healy Reb. Tr. 884).

The Company and Staff also disagree regarding the length of the amortization period. The Company proposes a three year recovery; Staff recommends a four year amortization. While selection of a reasonable amortization period is, admittedly, a matter of judgment for the Commission, a balancing of the relevant considerations weighs in favor of a three year recovery. A three year recovery more closely matches the average interval between rate cases—United has filed five cases in the last twelve years or an average of 2.4 years between cases. Further, a three year recovery would not materially burden ratepayers while permitting retirement of the deferred balance from the Company's books within a reasonable length of time.

Finally, fairness to the Company requires that during the amortization period—at whatever length the Commission selects—the unamortized balance should be included in rate base.

G. THE COMMISSION SHOULD CONTINUE TO ALLOW FOR THE TAX IMPLICATIONS ASSOCIATED WITH THE ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION (AFUDC)

Staff claims the Company's calculation of its AFUDC rate applied to construction work in progress is incorrect because the equity portion of the rate includes a gross-up factor for federal income taxes and Staff recommends that the Commission disregard the GAAP, NARUC and FASB accepted practice of adding a tax gross-up to the AFUDC component of construction projects. Staff logic is flawed since Staff recognizes the need and requirement outlined in FAS-109 but then disregards the recognition and determines that the gross-up overstates the asset value and ultimately rate base. (Stockton, Di. Tr. 537)

Clear authority and guidance exists for this application and resides in the National Association of Regulatory Utility Commissioners (NARUC) chart of accounts and in the Financial Accounting Standards Board Statements (FAS) 71 (Accounting for Certain Types of Regulation) and 109 (Accounting for Income Taxes). Specifically, FAS-109 requires: "recognition of a deferred tax liability for the tax benefits that flow through to customers when temporary differences originate and for the equity component of the allowance for funds used during construction".

This Commission has recognized the correct application of the gross-up in a Washington Water Power case, U-1008-209 where the parties disputed the proper amount of AFUDC to be allowed. When the Commission resolved the dispute it recognized that the amount needed to be grossed up for taxes. (Healy Reb. Tr. 906). The Company's practice is no different here and in accordance with all applicable accounting and regulatory practices.

In the Company's rebuttal testimony of Witness Healy, the Company presented Exhibit 15, Schedule 10, which demonstrated that utilizing the Staff's recommendation, the Company would be denied an opportunity to earn its authorized return. Additionally, this exhibit demonstrated that by including the gross-up not only was the Company able to achieve its authorized return, but also it did not produce any benefit to the Company at the cost of the customer. In fact, there is no adverse impact on the customer.

H. RATE RECOGNITION OF INCENTIVE PAY SHOULD BE ALLOWED TO CONTINUE

The Company included in its direct case $133,462 of "incentive pay" or "pay at risk" (See Healy, Di., Exhibit No. 3, Schedule 1, Page 1 of 34, lines 10-12) . The $133,462 is, as named on the Exhibit, composed of three different incentive pay programs: the Management Incentive Pay or STIP (Short Term Incentive Plan), $74,775, the Non-Union Incentive Pay, $44,287 and the Union Incentive Pay, $14,400. Every employee in the Company is eligible for incentive pay under one of these programs.

Notwithstanding the fact that similar expenses have been recognized in all recent United Water rate cases, Staff now recommends disallowance. Staff has asserted that incentive pay is variable and therefore not known and measurable. Additionally, Staff opines that the goals are aligned with the financial performance of the parent company and finally that the incentive compensates the employee for doing their job. (English Di. Tr. 442). In fact, only 30 % of each participant's goals are concerned with financial performance of United Water Idaho (Healy Re. Tr.873) Furthermore, a goal associated with achieving a level of financial success cannot be dismissed as unrelated to customer benefit. Goals that achieve financial targets benefit customers through enabling the Company to earn its return, which in itself yields multiple benefits, including the Company's ability to contribute toward strong bond ratings thus providing a lower cost of debt; a decreased frequency of rate increases and; more opportunity to manage earnings and have a greater availability of capital.

The purpose of the Company's incentive pay programs is to put a portion of pay at risk, to challenge employees to achieve stretch goals, which go beyond their defined job. Since the incentive pay is excluded from the employee's base pay, there is a savings to customers through reduced benefit cost that is typically tied to base pay. The prevalence in compensation is to shift to a "total cash compensation policy", with less emphasis on base pay and more emphasis on variable pay. United Water has shifted its compensation philosophy from paying at the 75th percentile of the market place for base pay in year 2000 to paying at the market median. According to Investor Owned Water Utility Survey of 2004, an average of 81.3% of the positions surveyed which represent like positions to United Water participate in Short Term Incentive Programs. The level of incentive pay in question in this case is less than 3% of United Water Idaho's $4.5 million payroll expense.

Staff also asserts that one of the reasons for disallowing recovery of this expense is that the amount is not known and measurable. When rates are set in any rate proceeding all best efforts are made to identify any clearly known and measurable amounts and to fairly represent other items that while reasonably known and measurable may consist of absolute known occurrences with a potential for variation. In the latter, a normalized amount is developed to represent this circumstance. In this case as in all prior cases, United Water Idaho has normalized this incentive pay amount and should be allowed to recover these costs that it will actually incur. Lack of rate recognition of the Company's actual expenses will not permit the Company the opportunity to earn its allowed rate of return.

The issue of United's incentive pay program is not new to the Commission. In the Company's 1996 rate case the Staff challenged payments made under a nearly identical program. In Order No. 26671, the Commission rejected Staff's position:

> We find that the Company should be permitted to recover its Management Incentive Plan payments. We find it reasonable that a portion of an employee's base pay be linked to performance. We further find that other changes in the employee expense were allowed in this case and these amounts do not appear unreasonable in light of the total salaries paid. Employee compensation is a matter for Company management to determine. The fact that a portion of some employees' salaries were put at risk based on job performance is a legitimate management tool. These amounts would never have been questioned if total salaries had merely been included without reference to the MIP. (Order No. 26671 page 8).

I. THE CURRENTLY APPROVED CUSTOMER CHARGE IS UNREASONABLY LOW AND SHOULD BE MOVED CLOSER TO ITS ESTIMATED COST.

As required by IPUCRP 121, the Company's Application in this case was accompanied by a cost of service study (COSS) that was prepared by Utility Resources Inc. In contrast to previous cases Staff was not critical of the study and apparently accepts its results as reasonable, recognizing that any cost of service study contains elements of informed judgment. (*See generally,* Sterling Di.).

The cost of service study estimates that customer charges would need to be increased by 51% to achieve full cost of service, but the Company does not recommend such a dramatic move. Rather, based on its initial filing, the Company's consultant, Dr. Peseau recommended a 36% increase, representing an amount half-way between the overall recommended increase (approximately 22%) and full cost of service. (Peseau Di. Tr. 265).

While cost of service is not the sole measure of a fair rate, "It is an important criterion, and in a given case may even be largely dispositive…" *Grindstone Butte v. Idaho Public Utilities Commission,* 102 Idaho 175, 180, 627 P.2d 804 (1981). At a minimum, it is a starting point after which other factors such as rate continuity, equity and proportionally can be taken into account. (*See* Order No. 29505, Page 45, Case No. IPC-E-03-13).

A rate structure in which the fixed, non-variable costs of meters and services are recovered through the variable, volumetric rate creates at least two problems. The first is the risk to the utility of under-recovery of fixed costs and revenue instability. For United Water this problem is real. Dr. Peseau calculated that 65% of the cost of meters and services is currently recovered in the volumetric charge (Peseau Di. Tr. 1046). And, the cost of meters and services—approximately $6 million—is a large proportion of the Company's total fixed costs of approximately $11 million. (*See* Exhibit No. 14, Sch. 1 page 1). Attempting to recover such a large portion of fixed costs in the variable rate creates a very real risk of under-recovery and the need for more frequent rate cases. As Dr. Peseau explained:

> Placing these direct and individual customer costs on the commodity rate in the name of conservation only ensures that these fixed costs will not be recovered by the Company between rate cases, and will be made to be subsidized by customers whose consumption cannot be shifted (have "inelastic" demand) after subsequent rate cases attempt to distribute these revenue shortfalls. (Tr. 1043-1044)

Staff did not contend otherwise:

> Q. (Mr. Miller) Well, if the volumetric rate is essentially subsidizing the costs of meters and services, there's a possibility that revenue recovery in the volumetric rate will be insufficient to cover the cost of meters and services, obviously?
>
> A. (Mr. Sterling) Well, I think that only happens though if new customers use less water than existing customers, and I think there is some evidence of that for United Water. So that's why I agree that it could happen and probably will happen to some extent. (Tr. 682-683)

In short, the paradox of the current rate structure is that the more customers conserve on consumption (or use dual irrigation) the more fixed costs go un-recovered leading to more pressure for frequent rate increases—the exact result conservation is intended to avoid.

The second problem is, contrary to what some parties asserted, the current relationship between the customer charge and the volumetric charges sends an inaccurate conservation signal. As Dr. Peseau explained:

> The problem is that collecting the capital costs of physical, fixed customer meters and service lines outside a customer charge by spreading it as if they were volumetric or commodity costs cannot be argued to promote economic levels of conservation. This is best done within the seasonalization of the commodity costs that is contained in my cost of service study.
>
> In the context of proper rate design and the recovery of allowed revenue requirement for United Water, "forced" or excessive levels of conservation do nothing but leave capital costs and therefore allowed rates of return unrecovered. Taken as a fixed customer charge, meter and billing costs, both expenses and capital, afford some level of revenue stability for this extremely capital cost intensive water utility company. (Tr. 1044-1045)

Staff did not disagree:

> Q. (Mr. Miller) Right. And to the extent people believe that keeping the customer charge low has a beneficial conservation effect, isn't it true that any subsidized rate structure has incorrect price signals from an economic point of view?
>
> A. (Mr. Sterling) Yes, that's true.
>
> Q. (Mr. Miller) In a perfect world, if you wanted to send the right conservation signal, you would adjust the volumetric charge and collect the fixed charge through a fixed cost because that would be the more precise conservation price signal, would it not, in a perfect world?
>
> A. (Mr. Sterling) Yes, probably in a perfect world, yeah. If we -- you know, if we were to set the customer charge at what cost of service would support, it would probably be even quite a bit higher than what Dr. Peseau has recommended. (Tr. 683)

As acknowledged above, cost is not the sole criteria in rate setting; other factors may legitimately be considered. But, as the Commission has recognized, rates over time should at least move in the direction of cost of service. (*See* Order No. 29505). Because the current relationship between United's customer charge and volumetric charge is so out of balance from a cost perspective, now is the appropriate time to take steps in the right direction to increase the customer charge.

DATED this 9 day of June, 2005.

Respectfully Submitted,

UNITED WATER IDAHO INC.

By: ______________________

Dean J. Miller

Attorney for Applicant

CERTIFICATE OF SERVICE

I hereby certify that on the 27th day of June, 2005, I caused to be served , a true and correct copy of the foregoing document, by the method(s) indicated below, upon:

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