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BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE JOINT APPLICATION OF UNITED WATER IDAHO INC. AND THE CITY OF BOISE, IDAHO FOR APPROVAL OF AN AGREEMENT FOR REPLACEMENT AND OPERATION OF FIRE HYDRANTS AND RELATED RATE MAKING TREATMENT.	**CASE NO. UWI-W-15-02** **COMMENTS OF THE COMMISSION STAFF**

COMES NOW the Staff of the Idaho Public Utilities Commission, by and through its Attorney of record, Brandon Karpen, Deputy Attorney General, and in response to the Notice of Application and Notice of Modified Procedure issued in Order No. 33300 on May 12, 2015, in Case No. UWI-W-15-02, submits the following comments.

BACKGROUND

On April 10, 2015, United Water Idaho Inc. ("United Water") and the City of Boise, Idaho ("Boise" or the "City") filed a joint Application seeking Commission approval of an agreement between the parties to transfer responsibility for operation, maintenance, and replacement of fire hydrants within Boise's municipal boundaries from the City to United Water. United Water also seeks approval of related non-standard ratemaking treatment to recover the increased costs associated with the transfer from ratepayers.

The parties represent that Boise currently owns and maintains more than 6,700 fire hydrants in Boise's city limits. In July 2014, the parties entered into the agreement for the City to transfer ownership and operation of the hydrants to United Water over a 40-year period (the "Agreement"). The Agreement calls for Boise to provide an annual report to United Water identifying hydrants that need to be replaced at the end of their 40-year life cycle. United Water will then replace and maintain the new hydrants. The parties estimate that approximately 168 hydrants will be replaced each year over the next 40 years.

United Water further requests assurance from the Commission that the costs associated with the transfer will be fully included in rate base (not using the traditional 13-month average), and recovered in any subsequent general rate proceedings over the life of the Agreement. United Water estimates that "the annual revenue requirement associated with the initial capital investment [will be] approximately $765,000." Application at ¶ 7. According to United Water, this initial cost would increase the initial year's rates by approximately $1.45 per customer. *Id.* at ¶ 12.

Each party has reserved the right to declare the Agreement "null and void" should the Commission not approve the Agreement, including the specific accounting treatment requested by United Water. Agreement at § 2.

STAFF REVIEW

Rationale for the Agreement

The Application and direct testimony of Neil Oldemeyer of the City of Boise explains the rationale for the Agreement. Application at 9; Oldemeyer at 4. Mr. Oldemeyer discusses several reasons for the Agreement: (1) to provide operations consistent with other communities in the state; (2) to create equity among taxpayers and ratepayers; (3) to make available capital funding for fire protection infrastructure; and (4) to vest ownership of the hydrants with the entity that owns the infrastructure connected to the hydrants. The City also suggests that the proposed transaction should conform with the intent of the franchise agreement. Staff will address each of the stated reasons below.

1. <u>To provide operations consistent with other communities in the state</u>

United Water and the City argue that Boise is unique in Idaho because in nearly all other cities, the entity that provides the water for fire protection also owns the fire hydrants. While this is true, the parties fail to acknowledge that in nearly all Idaho cities, it is the city that owns the water system <u>and</u> the hydrants <u>and</u> provides the water for fire protection. By transferring ownership of hydrants to UWI, Boise will stand out as one of the only cities in the state to not own its fire hydrants.

If consistency with other communities in Idaho is a worthwhile goal, the proposed transfer may only partially achieve this end. Regardless, Staff does not believe that consistency with other cities in the state is necessarily important. Boise has always been unique with regard to water services and fire protection and will continue to be unique, even if the Application is approved.

2. To provide equity among taxpayers and ratepayers

In its testimony, the City points out that in Boise, customers of United Water pay for the entire water system except for fire hydrants. The hydrant expenses are paid from the City's General Fund which is supported primarily by property taxes. Governments, non-profits, and other tax-exempt entities do not pay property taxes, yet they receive the benefits of fire protection. The City contends that it would be more equitable for all water users to pay for the fire hydrants, which would occur under United Water ownership.

Staff generally agrees that all beneficiaries of fire hydrants should contribute toward their costs. However, Staff has two concerns with this reasoning. First, Staff believes that the proportionate amounts each customer pays could be substantially changed as a result of the transfer of ownership. Under the City's "ownership" concept the amount beneficiaries pay through taxes is based mostly on property value. Under United Water ownership, hydrant costs would primarily be recovered through customer charges, which vary by meter size. Depending on the specific property characteristics and water demands, some customers could pay substantially different amounts for fire hydrants under United Water ownership than under City ownership. For example, a large, multi-story office building may have relatively minor water usage because its water usage is due only to bathrooms, break rooms, and perhaps cafeterias, with little or no outside landscaping requiring irrigation, yet have a high property value and a more costly requirement for fire protection. At the opposite extreme, a homeowner's association with lots of landscaping may be a large water user, but will pay less taxes and have little or no requirements for fire protection.

Staff is not suggesting that a substantial reshuffling of the amounts individual customers ultimately pay for fire protection is inappropriate, just that some customers could be significantly affected. Without knowing the specific taxes, meter sizes, and possible future rate changes, it is not possible to reasonably predict the impact on specific customers. Granted, at present, there would be no impact because United Water is not proposing rate increases or changes due to the proposed transfer of hydrant ownership. In the future, Staff believes rate changes would be necessary for United Water to recover the revenue requirement associated with the hydrants.[1]

Second, while governments and other entities are exempt from paying property taxes, each of these entities do pay a 3% franchise fee that is ultimately credited to the City's General Fund. As explained in greater detail below, the franchise fees paid by all United Water customers within city limits is more than 2.5 times the City's budget for maintaining and replacing fire hydrants. See "Franchise Fees" section below. For example, the City currently budgets about $450,000 for fire hydrants, but collected about $1.16 million in franchise fees from United Water in FY 2014. *See supra* Table 1.

3. <u>To make available capital funding for fire protection infrastructure and other essential services</u>

In testimony supporting the Application, Boise's witness states that the City currently includes about $450,000 in its capital budget for fire hydrant work, which includes replacement of about 100 hydrants annually. Mr. Oldemeyer further states that "If the fire hydrants were owned and operated by United Water, the City's fire hydrant budget could be eliminated and, in the discretion of the Council, this money be reallocated to the replacement of other critical fire equipment such as engines and trucks or to enhance or preserve the current level of services for fire, police, libraries and parks." (Direct, p. 6, lines l2-16).

In production requests, Staff asked why Boise City believes United Water customers should fund Boise's fire protection equipment, infrastructure, enhance or preserve the current level of services for fire, police, libraries and parks. In response, the City stated that it simply believes United Water and/or its customers should be responsible for the ownership, replacement and maintenance costs of integrated hydrants within the City. Costs associated with ownership, replacement and maintenance, the City believes, are utility related and should be allocated and collected from ratepayers as they are in virtually every city in Idaho. The City further stated that the costs of funding Boise's fire protection equipment, infrastructure, enhancement or

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[1] United Water filed a general rate case on May 24, 2015 seeking an overall average rate increase of 13.2 percent. The rate case filing does not include any rate, revenue or cost impacts to the proposed transfer of ownership of fire hydrants from the City to United Water.

preservation of the current level of services for fire, police, libraries and parks will continue to be borne by the City's General Fund, which includes all taxpayers of the City. The City notes that approximately 85 percent of United Water customers are Boise citizens and represented by the City's elected officials who approved the hydrant transfer agreement. This 85 percent along with the other 15 percent of United Water customers already pay, as incorporated in their rates, for the operation and maintenance of hydrants owned and operated by United Water in unincorporated Ada County and areas of Eagle.

It is beyond dispute that one of the City's primary motives for proposing the ownership transfer is to free-up funds currently used for hydrant maintenance/replacement and use these funds for other purposes in the future. This represents a windfall for the City. Unless there is an offsetting reduction in franchise fees charged to United Water customers for the benefit of the City, or alternatively, a reduction in taxes charged by the City, customers will effectively continue to pay the City, through taxes and franchise fees, for services it no longer provides, while <u>also</u> eventually paying United Water for services formerly provided by the City. Furthermore, as revenue requirement increases for United Water and its customers due to the transfer, revenue generated by the city through franchise fees will also increase. In effect, the City is able to increase its available budget without having to raise taxes. While this result may be reasonable from a tax payer standpoint, Staff does not believe it should be the responsibility of United Water customers to fund the City's services for fire, police, library and parks.

4. <u>To conform with the intent of the franchise agreement</u>

United Water currently operates in the City of Boise under a November 1, 1994, franchise agreement that expires on November 1, 2015. Sections 5(d) and (e) of the franchise agreement require United Water to provide apparatus, equipment and fixtures to maintain a Class III fire rating and to follow a capital improvement plan for improving fire protection. The City states that hydrants are a small but integral part of the water system necessary to provide fire protection within the City. United Water owns and maintains all other portions of water mains necessary to provide that protection. The parties, Boise states, believe that hydrants should be part of the fire protection works, apparatus and fixtures provided by United Water pursuant to the franchise agreement.

The current franchise agreement does not specifically address ownership of fire hydrants. Further, while the parties claim that it is the intent of the franchise agreement for United Water to own the hydrants, the current agreement has been in place for nearly 21 years and the parties appear to have operated under a completely opposite interpretation of the franchise agreement's intent. Nonetheless, Staff recognizes that a new franchise agreement will be negotiated very soon in which hydrant ownership could specifically be addressed, and the parties can then express their intent clearly.

If the Commission denies the transfer of ownership of new and replacement hydrants, Staff is uncertain as to whether the City could require United Water to take ownership as a condition of the new franchise agreement. Clearly, both United Water and the City have power to negotiate, while the Commission has none. Nevertheless, Staff believes that it would be unlikely that United Water could be forced to take ownership of hydrants it currently does not possess.

5. <u>To vest ownership of the hydrants with the entity that owns the infrastructure connected to the hydrants, and has the experience and expertise to maintain them</u>

In response to production requests, Boise states "while Boise operates sewer, geothermal and irrigation systems, which require expertise and resources similar to maintaining a municipal water system and its components, greater efficiencies can be obtained if UWI owns and maintains the hydrants. Integrating the hydrants into the United Water system, the City states, will allow United Water to apply their expertise on common maintenance practices; location and maintenance tracking systems; contract preparation and bid processes; and up-to-date knowledge of industry practices and standards to ensure the system can be operated and maintained in a more efficient manner." Answer to Staff Production Request No. 4.

It may be desirable for the entity that owns the hydrants to also own the infrastructure connected to them in order to ensure that they can deliver sufficient fire flows in an emergency. However, it could also be argued that the entity that would normally operate the hydrants, i.e. Boise City and its firemen, be very familiar with the locations, capabilities, condition and operation of the hydrants they must depend upon in an emergency. Staff believes it is essential that both United Water and the City have full confidence in the locations, capabilities, condition and operation of the hydrants, regardless of which entity owns them.

Although they are an extremely critical component of nearly every water system, fire hydrants are very simple devices that require very little expertise to operate and very minimal costs and effort to maintain. Staff believes both the City and United Water have ample ability to properly operate and maintain fire hydrants. If this Application is approved, Boise City states that it will retain the expertise and continue to maintain responsibility to operate and maintain the hydrants it will still own over the projected 40-year transition period. The City pledges to work closely with United Water to ensure consistent and ongoing operation and maintenance of the hydrants, consistent with the expectations and standards outlined in the Agreement.

Both Boise City and United Water believe that United Water ownership of fire hydrants will eventually provide a greater level of fire protection than is currently being provided under Boise City ownership. In response to Staff production requests, the City stated that it would expect better coordinated maintenance and operation of the system and hydrants, work being completed by industry specialists, and funding readily available for timely replacement and installation of the hydrants. All of these elements, the City states, should create a better and more efficient level of fire protection for Boise City.

Staff does not necessarily disagree, but believes that ownership by either party will ensure adequate fire protection. Boise admits it has maintained a Class III fire rating—the same as would be maintained under United Water ownership—for more than 24 years and would anticipate that rating to continue if it continues to own hydrants. Furthermore, hydrants currently owned by the City that are at or near their 40-year life cycle are replaced by a contractor certified to work on UWI's system.

Other Issues

Franchise Fees

Over the past five fiscal years, Boise City has collected a total of $5.37 million, or an average of $1,074,973 per year in franchise fees from United Water. See Table 1 below. The City currently assesses a 3% fee upon United Water's customers based upon the amount billed by United Water. *Idaho Code* § 50-329A(1)(a). Section 50-329A further provides that:

> Franchise fees paid by [United Water] will be in lieu of and as payment for any tax or fee imposed by a city on a public service provider by virtue of its status as a public service provider including, but not limited to, taxes, fees or charges related to easements, franchises, rights-of-way, utility lines and equipment installation, maintenance and removal during the term of the public service provider's franchise with the city.

Idaho Code § 50329A(1)(e) (emphasis added). Staff maintains the Legislature intended franchise fees be "in lieu of and as payment for any tax or fee imposed by a city for the installation, maintenance and removal" of hydrants during the term of United Water's franchise with the City. *Id.* As noted above, in last three fiscal years, the City collects over $1 million in franchise fees from United Water but budgets about $450,000 per year. Oldemeyer Direct at 5.[2]

The City states that it does not now or in the past use funds collected from United Water through franchise fees to fund any specific costs associated with ownership and maintenance of fire hydrants. In other words, according to the city, no portion of the franchise fees collected from UWI ratepayers are specifically ear-marked or dedicated for fire hydrant maintenance and replacement. Instead, the City reports, United Water franchise fees are combined with franchise fees collected from other public utilities, monies from property taxes, and other revenue sources, and placed into the City's General Fund. The General Fund is used to pay a wide variety of City expenses.

Table 1

FY	UWI Franchise Fees
2010	$ 946,921
2011	984,722
2012	1,104,221
2013	1,183,182
2014	1,155,817
	$5,374,863

Source: City response to Staff Production Request No. 7.

The City states that it has no intention of reducing its franchise fee even if it will no longer be responsible for ownership and maintenance of fire hydrants. Franchise fees collected from United Water, Boise argues, are a general payment to the City for the right to do business within the City, to operate a water system in lieu of the City's operating that system and to utilize public property and rights of way without the necessity of paying fees associated with the use of those properties. The City is statutorily limited to collecting a maximum of three percent of United Water's gross revenues for the right to operate within the City. Franchise fee revenues, the City maintains, are connected to hydrant maintenance only in the incidental sense that franchise fees are co-mingled with other General Fund revenues which are used to pay all General Fund requirements, including replacement and maintenance of hydrants.

[2] This budgeted amount is projected to fall short in the near future. Oldemeyer Direct at 5.

Staff agrees with the City that it is allowed by statute to charge a franchise fee of up to three percent. Nevertheless, Staff believes that a reduction in franchise fees would provide equity for the increase in cost that will be borne by ratepayers.

<u>City Taxes</u>

The City explained that funds for hydrant maintenance and replacement are drawn from its General Fund. Boise admits that residents will not necessarily realize any tax reductions or other savings if fire hydrant ownership is transferred to United Water. If the cost of hydrant replacement and maintenance is assumed by United Water and its utility ratepayers, which the City believes is fair, equitable and consistent with practices throughout the State of Idaho, the General Fund will no longer provide for expenditures for hydrant replacement and maintenance. Boise acknowledges that it is in the discretion of its City Council whether these savings will result in a tax reduction, a deferred tax increase or a re-allocation of the resources to fire protection or other General Fund uses.

<u>Benefits to United Water Ratepayers</u>

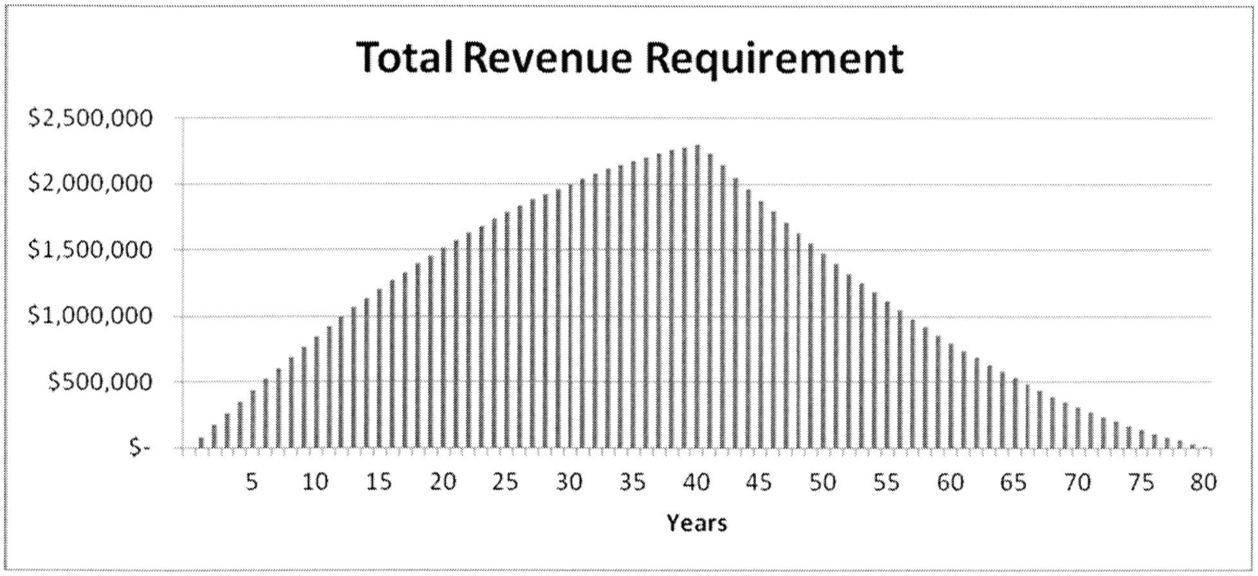
As reflected in Mr. Oldemeyer's filed testimony (page 7, lines 17-21), if the proposal is approved, United Water customers will benefit from having the oversight and maintenance of the hydrants managed by United Water which has the experience and expertise to operate and maintain the water distribution system (including hydrants). For many years United Water has owned and operated a fleet of over 1,000 fire hydrants in its service area outside the City of Boise. Integrating the hydrants into United Water's system, the utility contends, will allow the Company to integrate the operation and maintenance of those hydrants into its tracking systems (GIS & work management), contract preparation and bid processes, and current industry practices and standards to ensure operational efficiency. United Water also points out that it has the financial, technical, and operational resources to ensure that fire hydrants are maintained, repaired, and/or replaced more quickly without the delay of coordinating those efforts with City of Boise personnel. As reflected in Boise City's response to Staff's First Production Request No. 5, the City of Boise uses on-duty firemen to perform inspection and maintenance, while United Water uses trained and certified water distribution system operators to perform hydrant maintenance.

United Water admits that the proposed change in fire hydrant operation and maintenance responsibility is not easily correlated to a direct one-to-one cost, service, or quality benefit, at least not from a customer perspective, such as is the case when an old under-sized water main is replaced with a new larger pipe with greater flow capabilities. However, the Company states, water customers would benefit over time through enhanced overall fire protection system integrity stemming from United Water's expertise, and technical and financial resources, and ability to respond promptly to and resolve fire hydrant problems. United Water believes all customers benefit from being connected to a domestic water system that is capable of delivering safe and dependable service, including fire protection.

<u>Costs to United Water Ratepayers</u>

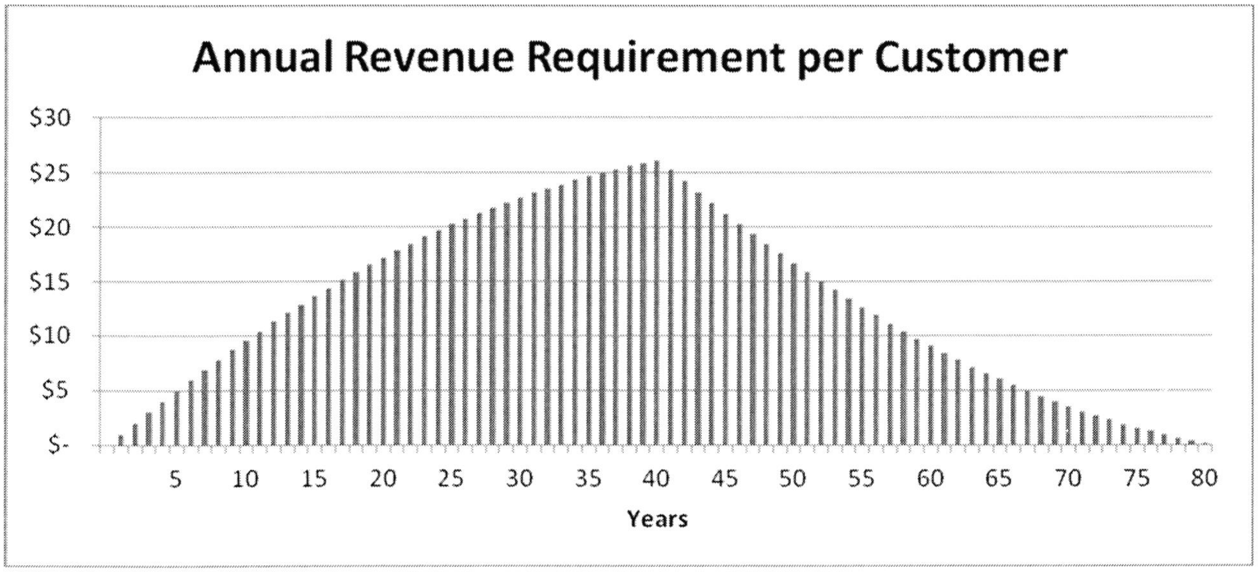
In the Application, United Water states that the annual revenue requirement per customer would be approximately $0.24 per bi-monthly bill. Application at 4. While this is a reasonable initial estimate, Staff believes that it is misleading because it fails to properly consider the long-term impact on customers. Rather, the first year revenue requirement impact of $1.45, which is the primary basis for United Water's estimate, is just the tip of the iceberg.

The full revenue requirement of the proposed transfer of ownership is more accurately represented in the graph below. Each year for the 40-year replacement cycle, United Water would invest an additional $765,000. With each year's new investment, the revenue requirement would increase in order to recover all of the revenue requirement components—return on rate base, depreciation, O&M expenses, and taxes. The revenue requirement would begin to decline in year 41 because no new investment would be considered. In actuality, however, a new revenue requirement cycle would begin in year 41 as hydrants are replaced, but the associated costs would not be attributable to the transfer of ownership from the City to United Water. Consequently, those costs are not considered for purposes of this analysis.



The total annual revenue requirement starts at only about $85,000 in the first year, which is approximately only a dollar per customer, but escalates each year until year 40 when the total annual revenue requirement peaks at approximately $2.3 million. Over the 80-year replacement and depreciation cycle, the total cumulative revenue requirement is $92.8 million,which has a net present value of $10.4 million.

On a per customer basis, as shown, the annual revenue requirement begins at slightly less than a dollar, but escalates to a peak of more than $26 per customer in year 40. Over the entire 80-year cycle of replacement and depreciation, the cumulative revenue requirement per customer will be approximately $1,050, which has a net present value of $118.



Any costs that would be associated with the transfer of ownership, including any increase in annual revenue requirement, have not been included in United Water's current general rate case filed on May 21, 2015. If the Application is approved, all costs associated with the transfer beginning immediately and going forward for the next 80 years would have to be recovered by United Water through future rate filings.

From a ratepayers' perspective, the cost of owning and maintaining fire hydrants is much less if the City retains ownership than if ownership is transferred to United Water. This is because United Water, as an investor-owned utility, is allowed to include in rates the opportunity to earn a return on its investment, whereas a municipality presumably would not earn a return. Furthermore, United Water would pay taxes on its earning, as well as pay property taxes, while the City is tax exempt. All other costs of ownership, including operation and maintenance, should be the same regardless of who owns the hydrants.

Proposed Accounting Issues

1. <u>Year-end rate base</u>

United Water has requested (Wyatt, direct, p. 6, lines 8–10) that the fire hydrants that are the subject of this case be included in rate base at full investment and not at a 13-month average rate base as ordered in Case No. UWI-W-04-4. Staff agrees with this proposal only for fire hydrants because they are neither revenue producing nor expense reducing. In Case No. UWI-W-04-4, the Commission ordered a 13-month average rate base where the rate base average reduces the expense/revenue mismatch identified by the Commission that occurs when the costs of plant adjustments are added as if they were in place for a whole year without adding any benefits. Hydrants do not create this mismatch and therefore Staff does not oppose United Water's proposal to account for hydrants with an end-of-year rate base instead of the 13-month average ordered in Case No. UWI-W-04-4.

2. <u>Allowance for Funds Used During Construction (AFUDC)</u>

United Water has requested "the Commission allow the Company to continue the calculation and accrual of post-closing AFUDC on the investments anticipated by the Agreement until such time as those investments are fully accounted for and included in rates in subsequent general rate case determinations over the life of the Agreement." (Wyatt, direct, p. 6, lines 12-16). Staff recommends that the Commission deny United Water's request for post-closing

AFUDC. AFUDC is an accounting mechanism, to recognize capital costs associated with financing construction. Generally, the capital costs recognized by AFUDC include interest charges on borrowed funds and the cost of equity funds used by a utility for purposes of construction. The main purposes of AFUDC are to capitalize with each project the costs of financing that construction; separate the effects of the construction program from current operations; and to allocate current capital costs to future periods when these capital facilities are in service, used and useful. AFUDC represents the cost of funds used during the construction period before plant goes into service. When it is placed in service, the entire cost of the plant, including AFUDC, is capitalized and is depreciated over the life of the plant. United Water, in the next general rate case, can request that the hydrant plant earn a rate of return. United Water characterizes "these investments to be, in effect, stranded, without earning any kind of return between general rate cases." (Wyatt, p.7, lines 8-9).

Staff opposes AFUDC in this case. The filing of rate cases is entirely at the discretion of the utility. Here the parties executed their agreement in July 2014 but did not file this case until April 10, 2015. There was ample time to include the costs of this case in the Company's general rate case filed May 21, 2015. The time period between future general rate cases without earning any kind of return is regulatory lag. In addition, this treatment is consistent with the treatment of other investments and not unreasonable.

Conclusions

Both the City and United Water will realize benefits if the Application is approved. Boise will relieve itself of the obligation to maintain and replace hydrants in the future, and the City will be able to eliminate its hydrant replacement budget and re-direct funds for another purpose. United Water will benefit because new hydrants will be added to the Company's rate base upon which the Company will earn an increasing return.

Customers of United Water however will realize little or no benefit, but will be responsible for significantly higher costs. Staff does not believe there will be any noticeable benefits to customers or be commensurate with the cost. Put another way, customers will pay higher costs for little or no noticeable difference in service.

STAFF RECOMMENDATIONS

Staff recommends that the joint Application of United Water and the City of Boise not be approved. Staff believes ratepayers of United Water will see very little benefit through United Water ownership, but will pay considerably more for many years to come. The franchise fees collected from United Water are more than adequate to defray the City's costs of installing and maintaining fire hydrants. Staff does not believe that the benefits would be sufficient to justify the costs.

However, in the event that the Commission does choose to approve the Application, Staff agrees with United Water's proposed end-of-year rate base when these hydrants are included in rate base. Staff disagrees with post-closing AFUDC and recommends the Commission not approve such treatment of these investments.

Respectfully submitted this 23rd day of July 2015.

Brandon Karpen
Deputy Attorney General

Technical Staff: Rick Sterling
Patricia Harms

i:umisc/comments/uwiw15.2bkrpsph comments

CERTIFICATE OF SERVICE

I HEREBY CERTIFY THAT I HAVE THIS 23rd DAY OF JULY 2015, SERVED THE FOREGOING **COMMENTS OF THE COMMISSION STAFF,** IN CASE NO. UWI-W-15-02, BY MAILING A COPY THEREOF, POSTAGE PREPAID, TO THE FOLLOWING:

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