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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
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CARL J. KUNASEK
CHAIRMAN
JIM IRVIN
COMMISSIONER
WILLIAM A. MUNDELL
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF BERMUDA WATER COMPANY, INC. FOR AN INCREASE IN ITS WATER RATES FOR CUSTOMERS WITHIN MOHAVE COUNTY, ARIZONA, AND FOR AN ACCOUNTING ORDER RELATED TO ITS ACCUMULATED DEPRECIATION ACCOUNT.

DOCKET NO. W-01812A-98-0390

DECISION NO. 61854

OPINION AND ORDER

DATES OF HEARING:	March 15, 1999 (pre-hearing), March 18, 19 and 22, 1999
PLACE OF HEARING:	Phoenix, Arizona
PRESIDING OFFICER:	Jerry L. Rudibaugh
IN ATTENDANCE:	Tony West, Commissioner
APPEARANCES:	Mr. Richard L. Sallquist, SALLQUIST & DRUMMOND, P.C., on behalf of Bermuda Water Company, Inc.;
	Mr. Stephen Gibelli, Attorney, on behalf of the Residential Utility Consumer Office; and
	Mr. Peter Breen, Staff Attorney, Legal Division on behalf of the Utilities Division of the Arizona Corporation Commission.

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BY THE COMMISSION:

On June 26, 1998, Bermuda Water Company ("Bermuda" or "Company") filed with the Arizona Corporation Commission ("Commission") a rate application. On July 14, 1998, the Utilities Division Staff ("Staff") of the Commission filed a letter indicating the Company's rate application was sufficient and classifying the utility as a Class B utility. The Residential Utility Consumer Office ("RUCO") requested and was granted intervention in this matter.

Our July 20, 1998 Procedural Order set the matter for hearing commencing on March 18, 1999 at the Commission's offices in Phoenix, Arizona. On March 12, 1999, the Company filed a Motion to Strike Testimony ("Motion"). On March 15, 1999, Staff filed its Response. Oral argument was heard on the Motion on March 15, 1999. The Motion basically alleged that there were numerous errors in Staff's prefiled exhibits and testimony. On March 18, 1999, the Motion was denied since the determination of factual errors could not be resolved until the conclusion of the hearing. Bermuda, RUCO and Staff appeared through counsel. Evidence was presented and, after a full public hearing, this matter was adjourned pending submission of initial and reply briefs on April 12, 1999, and April 19, 1999, respectively.

I. INTRODUCTION

Bermuda is an Arizona corporation engaged in providing water service to approximately 4,000 customers in the southern portion of Bullhead City, and on the Mojave Mesa in Mohave County, Arizona. Bermuda received its initial certificate of convenience and necessity ("CC&N") in Decision No. 33710 (February 26, 1962) and now serves over 18 square miles. Much of the Company's growth[1] over the years has been financed through line extension agreements with a number of different developers. Bermuda's existing rates and charges were set in Decision No. 55113, dated July 24, 1986. In its application, the Company requested an increase in revenues of $540,279 or 36.27 percent. Initially, Staff proposed a decrease of $302,479 or 20.3 percent. RUCO proposed a decrease of $79,554 or 5.3 percent.

II. RATE BASE

[1] The Company had approximately 800 customers at the time of its last rate case.

The Company proposed an original cost rate base ("OCRB") of \$3,274,200[2]. This amount was significantly higher than the Company's actual test year ending December 31, 1997 ("TY") balance as a result of four proforma adjustments proposed by the Company. The most significant adjustment was a proforma increase of \$1,475,000 in the plant-in-service account balance for Mains, Services and Hydrants. Staff recommended an OCRB of \$443,897[3] or \$2,830,303 less than the Company's proposal. RUCO recommended an OCRB of \$1,743,307[4] or \$1,530,893 less than the Company's proposal.

A. Plant Balance Restatement.

The Company hired a professional engineer to examine the Company's depreciation practices, and to perform engineering valuation calculations for the restatement of the original cost of plant-in-service for the mains, services and hydrants plant accounts for the years 1985 to 1990 inclusive. The Company claimed that during the period of 1985 to 1990, its plant account and construction cost reporting did not fully capture the customary utility costs and overheads. According to the Company, it had failed to capitalize the Company's direct labor and other overhead costs on projects funded by contributions and advances by developers. The Company also asserted that it has unbooked plant which was not funded by developer contribution or advances. The Company indicated that its own employees had installed significant quantities of plant in a relatively economical manner including installations for which little or no labor charges became part of the recorded costs. In order to correct this alleged problem, the Company reverse trended its 1997 construction cost experience for plant accounts for mains, services and hydrants for the period 1985 to 1990. The Company asserted this adjustment is similar to adjustments to plant made by Staff engineers for other small utilities.

The combined total difference between book costs and the reverse trended amounts was \$1,966,927. The Company acknowledged that a portion of the alleged discrepancy was its fault and as a result proposed increasing plant by 75 percent of the \$1,966,927 amount or \$1,232,170[5].

Staff and RUCO opposed the request to revalue the rate base. According to Staff and RUCO,

2 Subsequently revised upward to \$3,336,390.
3 Subsequently revised downward to \$333,421.
4 Subsequently revised downward to \$1,741,868.
5 Includes an estimated amount of depreciation.

the Company has no records to support its contention that payroll overheads were not booked as part of plant construction ten years ago. According to RUCO, if the Company's arguments on payroll overheads is accepted, it would imply that 70 percent of the Company's payroll for the years 1985 through 1997 were capitalization related. Furthermore, Staff and RUCO indicated that the Company's request to restate plant balance for failure to capitalize payroll during 1985 through 1990 would result in double recovery for the Company. According to Staff and RUCO, those amounts would have been expensed and it would be a double recovery to allow them to capitalize the same costs. RUCO indicated that the contributions-in-aid-of-construction ("CIAC") and advances-in-aid-of construction ("AIAC") contracts the Company entered into with developers were designed to cover the entire cost of plant additions. As a result, RUCO concluded that any restatement of the plant additions would also require an offsetting adjustment to CIAC and AIAC. The Company indicated that RUCO's argument erroneously assumes the Company's contractual obligations under its line extension agreements could be revised. RUCO and Staff recommended removal of the $1,232,170 proforma adjustment.

We concur with Staff and RUCO. The Company may have improperly expensed some labor and overhead that should have been capitalized, but this does not justify allowing the Company to collect these monies a second time from ratepayers. Further, the Commission would expect all the plant to be installed in an economical manner and not to be revalued upward just because it was installed economically. Lastly, the records of the Company do not support plant revaluation for the period 1985 to 1990.

B. <u>Restatement of Accumulated Depreciation, Accumulated Deferred Income Taxes, Accumulated Amortization of CIAC.</u>

The Company's engineering expert concluded that the five percent composite depreciation rate that was approved in Decision No. 55113[6] was excessive and has resulted in the reserve for depreciation being overstated. According to the Company's witness, the reserve has accumulated at a more rapid rate than the economic usefulness of the property has been consumed. The Company

[6] The five percent rate resulted from a settlement agreement between Staff and the Company in Decision No. 55113.

indicated that the over-accrual of the depreciation has been charged as an operating expense. The Company opined that the 29.70 percent book reserve should be adjusted to 16.00 percent to more accurately reflect the actual usefulness that has been consumed. For future years, the Company proposed utilizing a composite depreciation rate of 2.76 percent.

The Company proposed reducing the accumulated depreciation by $859,305. Since the Company did utilize that depreciation as an expense, the Company also proposed an offsetting adjustment to recognize the tax effect on the Company and to recapture the related accumulated amortization of contributions-in-aid-of-construction ("CIAC"). These offsets reduce the Company's proposed net rate base increase to $154,548. The Company also asserted that this does not constitute retroactive ratemaking since there was no request to retroactively change a tariffed rate up or down. According to the Company, the adjustments affect tariff rates on a prospective basis.

Staff and RUCO opposed the request to add depreciated plant back into rate base. Neither Staff nor RUCO opposed the new depreciation rates on a going forward basis but did oppose the Company's proposed retroactive application. According to RUCO, the Commission in Decision No. 57645, dated November 2, 1991, held that the depreciation rate "was approved on a going forward basis and cannot be approved retroactively." According to Staff and RUCO, the Company's proposal would result in retroactive ratemaking. Staff and RUCO indicated that the Company proposal would credit customers with having paid at the annual rate of 2.65 percent when in fact ratepayers have paid an annual rate of 5 percent, and that if the Company's proposal is adopted, ratepayers would be required to pay a return on plant for which they have already paid, which would result in a double recovery.

We concur with Staff and RUCO. It would result in a double recovery to modify past depreciation rates that have been included in rates charged to customers. We concur with the Company's request to change to a 2.76 percent rate on a going forward basis.

C. <u>AIAC/Accounting Order.</u>

The Company proposed an adjustment to reduce AIAC balances by $127,529. According to the Company, the adjustment is necessary to neutralize the harm caused by the use of a 5 percent depreciation rate coupled with line extensions which have failed to produce sufficient customers to generate AIAC refunds to match the 5 percent depreciation rate. The Company asserted this has caused rate base to erode. According to the Company, the alleged penalty will continue unless the Commission issues an accounting order to permit the Company to annually "true-up" advances where customer in-fill has been slow. In order to "true-up" AIAC amortization with refunds made to developers each year, the Company requested an accounting order containing the following provisions: "(1) When the refund period for a Line Extension Agreement expires, and the advance is to be converted to a contribution in accordance with the Commission's rules, a calculation will be performed using the composite depreciation rates in effect over the relevant period of time to determine the net plant balance for the plant financed with the Line Extension; (2) If the resulting net plant balance is less than the unrefunded balance of the agreement, then that difference will be credited to the expense Account 403, Depreciation Expense, and debited to Account 272, Accumulated Amortization of Contributions in Aid of Construction; and (3) The Company will maintain such records necessary to support any entries under that order."

Staff opposed the proposal. According to Staff, the proposed accounting order could create an over-earning situation for the Company because the level of refunds may fluctuate wildly. Further, Staff asserted that line extensions even for unsuccessful developments provide cash flow benefit as a depreciation expense. Staff indicated that a simpler method of correcting any difficulties would be to allow a write-off of CIAC amortization in those cases where the plant in question is retired before the CIAC amortization is completed.

RUCO also opposed the Company's adjustment to reduce AIAC balances by $127,529. RUCO agreed with the Company that when advanced plant is depreciated faster than AIAC is refunded, the rate base will decrease. However, RUCO did not agree that this was a penalty to the Company. RUCO opined that it "simply means that the utility has recovered investment it has not made." RUCO indicated that unrefunded advances do not represent investor supplied capital and it would be inequitable to allow the Company to recover these monies through depreciation expense. RUCO asserted that the Company's proposed accounting order would simply give the Company an annual license to earn a return on plant investment it had not made.

We concur with RUCO and Staff. We do not dispute the Company's allegations that slow customer in-fill can in certain circumstances result in a reduction to rate base. However, the Company could avoid this alleged "penalty" by investing the excess depreciation collected back into additional plant to offset any rate base erosion.

D. System Acquisitions.

During 1997 and 1998, the Company acquired Mohave Valley Water Company ("Mohave Valley")[7] (See Decision No. 60469, dated October 22, 1997) and Pebble Lake Water Company ("Pebble Lake")[8] (See Decision No. 60776, dated April 8, 1998). According to the Company, NARUC provides clear guidance that the acquiring company must account for all assets acquired. The Company indicated that Staff did not follow the NARUC guidelines which resulted in an underbooking of assets for Mohave Valley and Pebble Lake of $38,630 and $62,040, respectively.

The Company included positive adjustments totaling $27,083 for the acquisitions of Mohave Valley and Pebble Lake. While the Company acknowledges previous Commission orders disallowing acquisition adjustments, the Company opined the facts are distinguishable in this case. The Company urged the Commission to revisit the matter even if the facts are not distinguishable.

According to the Company, the Commissioners and Staff have opined that it is beneficial to the public to have water served by larger, viable systems. The Company asserted that the acquisition adjustments are a policy matter which the Commission should consider if it is going to apply its stated intent to strengthen and encourage consolidation of small water utilities. The Company indicated that both Mohave Valley and Pebble Lake were small, under-built, under-funded, under-staffed, and noncompliant water companies which were lacking in the ability or desire to serve the public. The Company asserted that the customers of Mohave Valley and Pebble Lake have benefited from the acquisition through better water quality and service and in the long term, lower rates. Lastly, the Company opined that the Commission must provide some incentive to buyers of small non-viable companies.

RUCO opposed the acquisition adjustments for the Pebble Lake and Mohave Valley systems. According to RUCO, Decision No. 56747 (dated December 3, 1991) set forth the Commission policy

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[7] Mohave Valley had approximately 160 customers.
[8] Pebble Lake had approximately 410 customers.

that "Arizona allows a return on invested plant, not on the sale price paid for the utility." RUCO asserted that the policy prevents companies from buying and selling utilities to increase rate base. RUCO did not dispute the Company's argument that the Commission is not obligated to grant a full acquisition adjustment if the facts do not support it. However, RUCO asserted that the Company has provided no cost-benefit analysis to show that any cost savings have offset the value of the purchase price.

This Commission shares RUCO's concerns with the possible practice of utility company trades/purchases solely for the purpose of increased plant values, but the Commission also wants to encourage consolidation of small water utilities. An acquisition adjustment is one mechanism to encourage the consolidation of small or non-viable water utilities into larger, well managed systems. In the future, an acquisition adjustment will be allowed only when a clear demonstration of benefits is made through a cost benefit study. In this case, the Company has benefited the Pebble Lake and Mohave Valley customers by bringing the two small water companies into compliance with Commission and ADEQ regulations. At the same time however, the rates for both Pebble Lake and Mohave Valley will increase. While, as RUCO indicated, no formal cost benefit analysis has been provided, based on all the circumstances herein, we find it appropriate to allow the full value of the acquisition adjustment or $27,084. In the future, we will require submission of a cost-benefit analysis prior to allowing such acquisition adjustments.

E. <u>Gain on Sale to Fort Mojave Tribal Utility Authority</u>

In 1989, the Company sold a portion of its system known as the Bermuda Water System at a gain to the Fort Mojave Tribal Utility Authority ("FMTUA") and requested cancellation of its Certificate of Convenience and Necessity ("CC&N") (See Decision No. 56512, dated June 9, 1989). The Company realized a net gain of $246,362. The Company recorded the sale below the line, accruing the entire gain to stockholders. RUCO proposed that the gain should be shared equally between the Company and its customers and amortized over a six year period at $20,530 per year.[9] RUCO argued that all customers, and not just the customers who left the system, paid for the

[9] RUCO cited the following Decision Nos. to support its sharing argument: 55175 (August 21, 1986); 55931 (April 1, 1988); 57075 (August 31, 1990); and 56659 (October 24, 1989).

Bermuda City assets through rates.

The Company opposed RUCO's adjustment. First, the Company asserted that the Commission did not order sharing the gain as part of Decision No. 56512; secondly, that the alleged Commission policy cited by RUCO was established after the sale to FMTUA; and third, that FMTUA acquired both the assets and the customers served by the assets. The Company pointed out that the Bermuda City system was not interconnected with the main system even though it had the same rates, and that further, the Bermuda City customers no longer receive service from the Company. According to the Company, if there were to be any sharing of gain, it would be shared with the Bermuda City customers, not the remaining customers. As a result, the theory of sharing with customers that paid for those assets would not apply. Finally, the Company argued that customers have benefited from the gain since the proceeds of the sale to FMTUA were invested back into the Company.

We find RUCO's proposal is consistent with Commission policy, and we concur that the gain on the sale of assets to the FMTUA should be split between the Company and its customers. We also find that a six year amortization period is appropriate. With that said, we are also cognizant of the fact that the sale took place over ten years ago. Although the records of the Company indicate that only the shareholders have benefited by the gain, we believe customers have also indirectly benefited since the Company's last rate case was approximately 15 years ago. As a result of the circumstances in this case, we will not adopt RUCO's proposed amortization. We want to make it clear, however, that the Commission policy remains that gains should be shared with customers absent unusual circumstances.

F. Working Capital

The Company requested $209,500 in working capital of which $120,248 was for cash working capital ("CWC"). The parties differed on the amount of working capital as a result of different expense levels. In addition, the Company included rate case expenses in working capital and $50,000 of restricted loan funds.

RUCO recommended removal of rate case expense from the CWC requirement, asserting that the Company should not be allowed to earn a return on rate case expense. RUCO indicated that its adjustment is consistent with Decision No. 61110, dated August 28, 1998. According to the Company, rate case expenses are clearly legitimate operating costs which should be included in working capital.

RUCO also recommended the Company's working capital be reduced by $50,000 to remove funds restricted by CoBank. The Company has a Master Loan Agreement ("Agreement") with CoBank which requires the Company to maintain a $50,000 debt service reserve account. According to RUCO, the Company has been earning interest on these funds, and ratepayers should not have to provide additional earnings through working capital.

As to the $50,000 in restricted funds, the Company argued that virtually all restricted funds included in working capital allowances include some accrued interest component. Further, the Company asserted this is a legitimate cost and should be recognized in the working capital allowance. According to RUCO, the Company earns a return on the funds in its reserve account and records the interest on such funds below the line. As a result, RUCO concluded that stockholders have already been compensated for their investment.

In its application, the Company proposed a meter deposit balance of $160,164. RUCO recommended an adjustment of $9,266. Subsequently, the Company concurred with RUCO's adjustment and agreed the meter deposit balance is $169,430. We concur with the Company and RUCO. RUCO's adjustment to the meter deposit balance is adopted.[10]

While we concur with the Company that reasonable rate case expenses are legitimate operating costs, we don't share their conclusion that they should be included both in operating expenses and as working capital. As the Company is already permitted to collect rate case expenses after the amortization period expires, we do not find it reasonable to also allow them an additional return as part of working capital. Accordingly, we approve RUCO's removal of rate case expense from working capital.

We concur with the Company that the $50,000 in restricted funds should be included as part of working capital and the Company should earn a return on the funds. We also concur with RUCO

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[10] This adjustment is already included in the Company's revised rate base.

that the stockholders of the Company should not receive interest on the funds in addition to a return via working capital. Accordingly, we shall make an adjustment to operating income to reflect the interest on such funds.

G. Gross-Up Taxes

The Tax Reform of 1986 required the inclusion of funds from contributions and advances to be included as ordinary income in the year received. Pursuant to Commission Decision No. 55774, dated October 21, 1987, companies were given options for collection of the "gross-up tax" one of which was to charge developers a gross-up based on the company's effective tax rate. Bermuda opted for the gross-up option and from January 1, 1987 through approximately June 1996 charged developers a gross-up on line extensions at a 68.00 percent rate. Staff alleged that the Company failed to refund over-collected income tax to the developers, and Staff treated the alleged over-collected taxes as CIAC, and deducted this from rate base. Staff asserted that the Company was collecting "gross-up" at the rate of 68.00 percent, while its effective tax rate during the period in question was 40.47 percent. As a result, Staff concluded that the Company overcollected at least $711,300. According to the Company, Staff has used estimated numbers contained in line extension agreements for many projects that were not completed and where no money changed hands. The Company also asserted that Staff excluded State income taxes of nearly $380,000. In response, Staff indicated the $380,000 amount was the total State taxes for the period. According to Staff, a more appropriate amount of State taxes would be the amount paid as a result of the amount of advances.

The Company had general standard line extension agreements filed with and approved by the Commission. Those agreements provided for the developer(s) to pay the estimated gross-up tax associated with the line extension. The agreement contained language which required Bermuda to do the following:

(1) Compute its income taxes including the income from advances and contributions;

(2) Compute its income taxes without income from advances and contributions;

(3) Subtract (2) above from (1) above to determine total income taxes to be paid by all those entities that have entered into agreements for the taxable year; and

(4) Each developer is allocated his pro rata share of income tax calculated in (3) above.

After the above computational language, the standard line extension agreement stated:

> "The foregoing computation shall be provided to Developer in writing and shall be certified by Bermuda's tax accountants. In the event the amount computed under subparagraph (b)(iv), above, is less than the balance of the Tax Account at the time of the payment of income taxes, Bermuda shall promptly refund the balance of the Tax Account to Developer."

The Company asserted that no developers have complained to the Commission indicating the gross-up taxes have not been properly refunded. Further, the Company provided letters from its certified public accountants confirming that during 1990, 1991, 1992 and 1993 the Company did not over collect taxes.

We find the computation methodology in the line extension agreements as set forth above was fair and reasonable. We also find that the verification method agreed to by the Company and the respective developers appeared to be reasonable. If a developer was not satisfied with the verification received, they could have filed a complaint with the Commission to resolve the matter. To date, no such complaints have been received. As a result, we find that no gross-up tax refunds are appropriate at this time. Accordingly, we reject Staff's proposed adjustment for "over-collection of gross-up tax".

H. Contributions/Advances

In its application, the Company deducted net advances and contributions totaling $3,841,363 from its net utility plant as part of its determination of OCRB. RUCO concurred with the Company. Staff increased the net adjustment by $185,207 for a total deduction of $4,026,570.

The Company was highly critical of Staff's proposed adjustment to advances and contributions. According to the Company, Staff made numerous errors including the following: used amounts for plant never constructed; used estimates for complete subdivisions, instead of the phases completed; included advances approved by the Commission in 1998, but where construction activity has not begun; included two CIAC agreements (Beverly Hills Estate and Sun Valley) that been included in the 1984 TY rate case; and amortized CIAC at a rate not approved by the Commission.

In response, Staff indicated the Company had supplied volumes of data that were not in a usable format. Staff opined that it attempted to reconcile the Company information with the line extensions approved and on file with the Commission. Staff was unable to reconcile the information and as a result relied on the line extensions on file.

While the Company has to accept some responsibility for poor record keeping, we find the evidence better supports the Company and RUCO as to the proper amount of contributions and advances. Clearly some of the line extension amounts contained estimates that differed from the actual amounts. In addition, Staff did include CIAC agreements that had been previously included in the 1984 rate case.

I. Original Cost Rate Base Summary

Based on the foregoing, the following statement details the adjusted TY OCRB for ratemaking purposes for Applicant:

Applicant's Proposed Adjusted Rate Base	$ 3,336,390
Commission Approved Adjustments	
Plant Balance Restatement	($1,232,170)
Restatement of Accumulated Depreciation	
Accumulated Deferred Income Taxes	
Accumulated Amortization of CIAC	($ 154,548)
AIAC/Accounting Order	($ 127,592)
Working Capital	($ 1,529)
	$1,820,551

III. RECONSTRUCTION COST NEW RATE BASE

In Schedule B-1 of Applicant's Exhibit No. 2, Applicant presents a jurisdictional reconstruction cost new rate base ("RCNRB") of $9,487,199. Utilizing the same ratios set forth in Exhibit No. 2, the Commission approved adjustments to OCRB are modified as follows:

Plant Balance Restatement	$2,464,340
Restatement of Accumulated Depreciation	$ 347,733
AIAC	$ 287,082
Working Capital	$ 1,529
	$6,386,515

IV. FAIR VALUE RATE BASE

The Commission has traditionally determined the "fair value" rate base ("FVRB") by taking the average of OCRB and RCNRB. No party has suggested that a different weighing be used in this proceeding. Consequently, we find that the adjusted FVRB for the Company is $4,103,533.

V. OPERATING INCOME

A. Revenue Annualizations

Applicant had actual revenues during the TY of $1,337,127. The Company adjusted that upward by $152,595 primarily to annualize TY-end customers and to reflect the addition of Pebble Lake customers. The Company subsequently accepted RUCO's annualization of revenues in the amount of $6,220. We concur with the Company and RUCO's annualization adjustment.

B. Bill Determinants

The Company grouped its customers' consumption patterns and utilized the mathematical mid-point for those ranges to "prove-up" its usage and revenues. While RUCO did not dispute the Company's determination that the mid-point of 30,001 and 35,000 is 32,500, RUCO argued that was not the mid-point of that billing range, but that because the actual high end of the 30,001 – 35,000 range is 35,999, the appropriate mid-point is the average of 30,001 and 35,999 or 33,000. RUCO acknowledged that its use of the mid-point of the billing range would likely result in some error, but that its adjustment is appropriate because the Company failed to provide the actual billing determinants. The Company asserted that RUCO's methodology results in an overstatement of usage and overstated revenues by $5,021. Further, the Company argued that RUCO's variation of the long established procedure would add more uncertainty to a company's rate application.

In the absence of actual billing determinants, we find RUCO's method of estimating the mid-point of the billing range to be reasonable. Accordingly, we adopt RUCO's $5,021 adjustment.

C. Annual Operating Expenses

Applicant had actual operating expenses for the TY of $1,223,835. The Company proposed pro forma adjustments of $168,134 for TY adjusted expenses of $1,391,969. The Company accepted various adjustments proposed by Staff and RUCO totaling $28,645 resulting in its final adjusted TY expenses of $1,363,324. Staff proposed adjustments which resulted in TY adjusted expenses of $1,190,277. RUCO proposed adjustments which resulted in TY adjusted expenses of $1,282,535.

1. Salaries and Wages

Staff and RUCO decreased operating expenses by $18,172 to remove year-end "bonuses" and to annualize the Company's end of TY level of payroll, employee benefits, payroll tax expenditures, and professional services expense. RUCO eliminated the year-end bonus, or 27th pay period, in the amount of $15,380. According to RUCO, the bonus is simply being paid for ordinary work, and therefore increases employee pay beyond a normal pay level. As a result, RUCO asserted shareholders should be responsible for the bonus payments. RUCO's conforming adjustments for payroll taxes, professional services, retirement expenses, and 401K contributions would further reduce salaries and wages by $2,882.

The Company indicated that the so-called year-end "bonus" has been routinely paid for many years, and that further, the 27th pay period is prorated for employees who have served less than 12 months with the Company. The Company asserted that neither RUCO nor Staff have supplied any evidence that Bermuda's employees are paid in excess of a "normal" annual pay level. Further, the Company indicated it should be of little concern to regulators whether the Company employees are given 26 or 27 paychecks.

We concur with the Company. Other than the fact that the Company utilized 27 instead of a more normal round 26 pay periods, there was no evidence that Bermuda's employees were excessively paid. We do not find the utilization of an extra pay period as dispositive of the issue.

2. Administrative Office

According to the Company, the record supports the necessity of all personnel, equipment and expenses associated with the Administrative Office that the Company maintains in Scottsdale, Arizona. Further, the Company asserted that many utilities regulated by the Commission have administrative offices much further than 200 miles from their service area. The Company indicated that no unrelated businesses have been conducted at the Administrative Office since 1991.

RUCO did not dispute the Company's right to recover costs for maintaining administrative offices. However, RUCO proposed disallowance of the incremental costs of locating the office so far away from its customers, concluding that stockholders should pay these unnecessary additional costs. RUCO asserted that the company's choice to locate its corporate offices in Scottsdale rather than its service territory have unnecessarily increased transportation, travel, and long distance costs. RUCO therefore proposed a disallowance of $15,176 transportation expenses related to a 1996 Ford Explorer located in Scottsdale, and a $9,520 disallowance for travel and long distance telephone charges associated with the Scottsdale office.

Staff proposed disallowance of three Administrative Office positions, all office equipment and office space for a total recommended disallowance of $150,617.

We concur with the Company. With availability of modern communications facilities, we do not find it necessary for the Administrative Office to be located in the service area. In addition, there are valid reasons for a regulated entity to have an administrative office near the Phoenix area. As to additional transportation and communication costs, we are not convinced that there would be no offsetting additional expenses if the Company had to commute frequently to the Phoenix area.

D. Depreciation and Amortization

RUCO recommended decreasing depreciation expense by $36,021 to reflect its amortization of CAIC and depreciation expense calculated on the level of plant recommended by RUCO. RUCO proposed amortizing the gain and sale to the FMTUA resulting in a reduction in the expense amount of $20,530. The Company indicated it differed from Staff because Staff failed to break out the Company's office and shop building from the "other structures" as recommended by Engineering Staff, and that in addition, Staff failed to amortize the CIAC as required by Decision No. 55113.

We find the primary difference in depreciation expense is the level of plant being recommended by the various parties. Consistent with our rate base findings herein, we will adjust depreciation expenses by $41,794.[11]

E. Professional Services

Staff recommended that the Company's professional expenses in the amount of $30,515 be amortized over a five year period. According to Staff, many of these expenses relate to the acquisition of new certificated territories and as such are not proper annual expense.

The Company asserted that it had demonstrated that the level of Professional Services incurred during the TY was similar in magnitude to at least the last two years. While Staff referred to the Company's Annual Report listing no Professional Services, the Company indicated that those

[11] Utilizing the 2.76 percent depreciation rate.

expenses are not identified in the Annual Report. According to the Company, the Professional Services account includes engineers, accountants, hydrologists, tax advisors, lawyers, and environmental experts.

In reviewing the professional service amounts for the past three years, we find that the TY amount is a reasonable on-going level. While certainly some of the professional services will not be recurring, it is apparent the on-going level is represented by the TY amount. Accordingly, we concur with the Company.

F. Property Tax

The Company proposed a property tax amount of $123,055. The Company included an adjustment to reflect an increase in its 1998 property tax valuation. The Company asserted that it applied the TY "unit cost" in conjunction with the Company's known and measurable change in its 1999 assessed valuation to arrive at its property tax expense.

RUCO and Staff recommended a downward adjustment of $49,306 to reflect the actual 1998 property tax bill of $73,749. As a result of additional information from the Company, Staff and RUCO accepted the 1998 property tax in the amount of $76,658. RUCO asserted that the Department of Revenue has discretion in how it evaluates property taxes and as a result any change from the 1998 actual property tax bill is not known and measurable.

The Company subsequently agreed to use the 1998 actual tax bill, but with a 12.5 percent adjustment to reflect an increase in property tax valuation that included Pebble Lake. As a result, the Company proposed an adjusted property tax amount of $80,944.

We do not find the Company's proposal to be known and measurable. We concur with Staff and RUCO that the appropriate property tax is $76,658.

G. Tank Repairs and Maintenance

The Company incurred $85,946 in tank repairs and maintenance during the TY and proposed a pro forma adjustment of $11,243 for a total request of $97,169 in its application. Subsequently, the Company accepted adjustments reducing the repairs and maintenance amount to a level of $69,175. RUCO supported the Company's request.

Staff recommended a reduction of $43,430 from the repair and maintenance account.

According to Staff, the interior re-coating of one tank and the outside painting of two tanks were extraordinary events. The Company asserted that it has numerous large tanks that must be maintained on a cyclical basis to assure quality reliable service and asserted that it should not be forced to compromise an established maintenance program due to a lack of funds.

The last three years the Company has averaged $64,423 in repairs and maintenance expense. As a result, we find the Company's adjusted amount of $69,175 to be a reasonable on-going level for repair and maintenance expense.

H. Purchased Power

The Company accrued the purchased power expense for the TY pursuant to the NARUC system of accounts. RUCO concurred with the Company's purchased power amount of $112,603. Based on a review of the purchased power invoices, Staff proposed a $2,000 reduction.

The Company argued that Staff did not allow an accrual of $2,000 to the purchased power amount. In response, Staff indicated that because the Company failed to reduce any accrual for the January 1997 bill that pertains to December 1996, Staff concluded no accrual should be made for the December 1997 billing.

The Company criticized Staff for failing to use the Company's estimated pro forma purchased pumping power cost for the Mohave Valley and Pebble Lake systems. In response, Staff indicated it used a four year average of actual power costs for those two systems. Since the Company has alleged that these two systems were inefficient, Staff concluded that the historical average should be more than adequate to cover future power costs.

After a review of Company Exhibit A-26, we find that Staff has recommended a reasonable level of purchased power expense for the Company including the recently purchased Mohave Valley and Pebble Lake systems. Accordingly, we adopt Staff's $2,000 adjustment.

I. Rate Case Expenses

The Company included $36,700 for rate case expense in its application. Subsequently, the Company has revised its rate case expense to total $42,800. The Company asserted that neither Staff nor RUCO suggested this level was inappropriate. However, Staff proposed a five year amortization while RUCO proposed a three year amortization period. While the Company's previous rate case was thirteen years ago, the Company opined that three years is a reasonable amortization period. According to the Company, no one is predicting the continuation of the robust customer growth of the past thirteen years.

The fact that the Company's previous rate case was thirteen years ago makes either a three or five year period seem reasonable under the circumstances. Clearly, the Company needs to file rate cases more often than every thirteen years. We will approve a four amortization period at the Company's proposed $42,800 amount.

J. Income Tax

All the parties proposed income tax adjustments based on their recommended revenues and expense levels. We will make an income tax adjustment consistent with the Commission approved revenue and expenses.

K. Statement of Net Operating Income

Based on the foregoing, the following statement details the adjusted Test Year Net Operating Income for ratemaking purposes:

Operating Income Summary

Operating Revenues (As Adjusted Herein)	$1,500,963
Operating Expenses (Per Company)	$1,363,324
Commission Approved Adjustments	
Depreciation	($ 41,794)
Property Tax	($ 4,286)
Purchased Power	($ 2,000)
Rate Case Expense	($ 3,567)
Income Taxes	$ 20,286
Total Operating Expenses	$1,331,963
Net Operating Income[12]	$ 171,500

VI. COST OF CAPITAL

A. Capital Structure

The Company requested approval of its TY ended capital structure consisting of 32 percent debt and 68 percent equity. RUCO and Staff concurred with the Company's capital structure. Accordingly, we will approve a capital structure consisting of 32 percent debt and 68 percent equity.

[12] Includes an adjustment of 5.00 percent interest on the $50,000 of restricted funds included in working capital.

B. Cost of Debt

RUCO and the Company proposed a cost of debt of 8.70 percent. The Company utilized its projected interest expense for 1998 and divided that by the outstanding debt at the end of the projected year to arrive at a cost of debt of 8.70 percent. Staff analyzed the Company's four loans and determined the appropriate weighted cost of debt was 8.45 percent. Staff noted that during the TY, one of the variable rate loans was at 8.50 percent which was subsequently reduced in November of 1998 to7.75 percent.

We concur with Staff. The change in the variable rate loan is known and measurable. Accordingly, we will approve a cost of debt of 8.45 percent for the Company.

C. Cost of Equity

The Company was critical of Staff and RUCO for using the discounted cash flow ("DCF") and capital asset pricing model ("CAPM") models to provide a range of cost of equity of 9.60 percent to 12.00 percent. According to the Company, these analyses are performed with portfolios that include companies that are huge compared to Bermuda. The Company asserted that there clearly is less risk for a large, diverse company than for a small single location operation.

In its rebuttal testimony, the Company proposed a cost of equity of 20.00 percent. Subsequently, the Company reduced its proposed cost of equity to 15.40 percent. According to the Company, it is entitled to a risk premium because it is a small water company. The Company asserted that because there is not sufficient public data available for companies the size of Bermuda to perform DCR and CAPM studies, the Commission must recognize a "size premium" for small companies.

RUCO calculated a cost of equity of 9.58 percent using the DCF method and the CAPM. According to RUCO, numerous studies and scholarly research have concluded there is no need to make an adjustment for company size in setting the rate of return.

Staff utilized thirteen publicly traded water and sewer companies and ten Arizona water and sewer companies as comparable for Bermuda. The average return on equity for the comparable companies in 1997 was 11.30 percent. Staff also utilized the DCF method to estimate cost of equity with a resulting range of 6.80 percent to 13.00 percent. As a further check, Staff utilized the CAPM to estimate cost of equity with a resulting range of 9.20 percent to 9.90 percent. After analyzing the above results, Staff concluded a reasonable range of values for the cost of equity would be 8.50 percent to 13.00 percent with a 10.75 percent mid point of the range. Based on the relative risk factors for Bermuda, Staff recommended an 11.00 percent cost of equity.

In response to the Company's proposed 20.00 percent cost of equity, Staff indicated it was based on one 1997 article which opined that small company betas are underestimated and therefore should be doubled. The Company took the article one step further and concluded the Company beta should be quadrupled to arrive at its 20.00 percent cost of equity. While Staff disputed the article, Staff did note that if the article's methodology was followed, Bermuda's cost of equity would have been 13.10 percent and not 20.00 percent. In addition, Staff noted that the Company's DCF analysis produced an estimate of 11.78 percent. As a result, Staff concluded that the Company's 20.00 percent estimate failed a reasonableness test and should be disregarded.

Clearly, the Company's request for a 15.40 percent or 20.00 percent return on equity is excessive. In reviewing RUCO and Staff's proposals, we find a reasonable range for the cost of equity to be 10.00 percent to 12.00 percent. Based on the overall record herein, we find the high end of the range or 12.00 percent to be appropriate for the Company at this time.

Cost of Capital Summary

Capital Components	Percentage of Total	Cost	Composite Cost
Long-Term Debt	32.00%	8.45%	.027
Common Equity	68.00%	12.00%	.0816
			.1086

VII. AUTHORIZED INCREASE

With adjustments adopted herein, the adjusted TY operating income is $171,500. Further, the 10.86 percent cost of capital translates into a 4.82 percent rate of return on FVRB as authorized hereinabove. Multiplying the 4.82 percent rate of return by FVRB produces required operating income of $197,790. This is $26,290 more than the Company's TY adjusted operating income. Multiplying the deficiency by the revenue conversion factor of 1.6495 results in an increase in revenues of $43,365 or a 2.89 percent net increase over TY revenues.

VIII. RATE DESIGN

The Company currently has a three-tier commodity rate structure with break-points at 5,000 and 10,000 gallons. The Company originally proposed going to a four-tier structure with break-points at 3,000, 7,000 and 12,000 gallons. The inverted tier rate structure was designed to encourage water conservation. The amount of water the Company may use is limited by subcontracts with the City of Bullhead City ("City") and the Mohave Valley Irrigation and Drainage District ("MVIDD") to approximately 250 and 375 gallons per day for each residential lot.

Staff recommended a flat rate design.

RUCO opposed adding a fourth tier because it would not result in conservation, it would misalign rates with costs, and it would add unnecessary complexity to the rate structure that may contribute to customer confusion. RUCO recommended a two-tier rate structure with a break-point of 5,000 gallons. RUCO also proposed a larger differential (approximately 60 percent increase) between tier one and two than proposed by the Company (approximately 20 percent increase).

The Company opined that its proposed inverted three tier structure is appropriate for several reasons. First, the customers are already familiar with the three tier structure. Secondly, the inverted rate structure is consistent with the Company's long run cost structure. Additionally, the initial tier is set at 4,000 gallons per month which is consistent with inelastic usage of customers for drinking, cooking, personal hygiene and basic needs. The Company's top tier commences at 12,000 gallons which coincides with the maximum allowable per lot water allocation. Lastly, the Company opined that a flat rate for usage would send a pricing signal for Bermuda's customers to use more water in an arid area where all water is derived from specific allocations of Colorado River Water.

In the proposed rate design, RUCO attempted to spread its recommended decrease fairly over all customer classes while recognizing that the rates of Pebble Lake and Mohave Valley customers would need to increase. RUCO recommended the rates for Pebble Lake customers be set at the same rate as all other 5/8-inch meter customers.

Staff indicated it did not support tiered rates for the following reasons: Staff had recommended a substantial rate reduction; Staff wanted to provide immediate uniformity between the Company's three systems; and the Company is not located in an Active Management Area ("AMA").

The Company requested the reconnect fee be increased from $40.00 to $50.00 to encourage customers to make payments in a more timely manner. Staff opined that such an increase would not encourage more timely payments and recommended it remain at $40.00. Staff supported the Company's requested $5.00 Late Payment Fee and $15.00 Broken Meter Lock Fee.

The Arizona Department of Water Resources ("ADWR") has encouraged the Company to continue to use the inverted block rate structure as an incentive to conserve limited water supplies. We concur with the Company and RUCO that the tiered rate structure should be maintained. For rate continuity, conservation and simplicity, the existing inverted three tiered shall remain in place, with the 2.79 percent increase in rates approved herein taking the form of an across-the-board increase for all customer classes. We find it important to equalize the rates paid by Mohave Valley and Pebble Lake customers with the other Bermuda customers. We recognize that the necessary increase may be too large for Pebble Lake customers to absorb all at once. Therefore, in order to minimize rate shock for the Pebble Lake customers, their proportionate share of the rate increase shall be phased in over a two year period. Prior to implementation of new rates, Bermuda shall file, for review by Staff and RUCO, rate schedules consistent with the discussion herein.

We believe the Company's proposed tier levels are reasonable and consistent with the needs of the small use customers on the system and further are necessary to promote conservation on the system. Therefore, we shall establish the three tiers for the rate design at 0 – 4,000 gallons, 4,000 – 12,000 gallons, and over 12,000 gallons. Also, to encourage conservation, we will eliminate the existing 2,000 gallon inclusion from the minimum rate. The minimum monthly charge for a 5/8 x ¾ meter shall be reduced to $11.00 per month, and the third tier commodity charge shall be at least 150 percent of the minimum block.

We approve the $10 increase in the reconnect fee requested by the Company, which we find reasonable considering that the $40 fee has been in place for thirteen years. We also approve the requested Late Payment Fee and Broken Meter Lock Fee in accordance with Staff's recommendation. We find those unopposed rates and charges set forth in Other Charges, Meter Installation Charges and Service Line Installation Charges as set forth in Exhibit A-3, Schedule H-3, Page 2 of 2 to be reasonable.

* * * * * * * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. Bermuda is an Arizona corporation engaged in providing water for public purposes to approximately 4,000 customers within portions of Mohave County, Arizona, pursuant to authority acquired from the Commission.

2. On June 26, 1998, Bermuda filed a rate application with the Commission.

3. On July 14, 1998, Staff filed a letter indicating the Company's rate application was sufficient and classified the Company as a Class B utility.

4. Our July 20, 1998 Procedural Order set the matter for hearing commencing on March 18, 1999.

5. The OCRB, RCNRB and FVRB for Applicant for the TY ended December 31, 1997 are determined to be $1,820,551, $6,386,515, and $4,103,533, respectively.

6. Applicant's adjusted TY operating income is $171,500[13], based upon adjusted operating revenues of $1,500,963 and adjusted operating expenses of $1,331,963.

7. In the circumstances of this proceeding, a rate of return on FVRB of 4.82 percent is just and reasonable.

8. Operating income of $197,790 is necessary to yield a 4.82 percent rate of return on the FVRB.

9. Applicant must increase operating revenues by $43,365 to produce operating income of $197,790.

10. Much of the Company's growth over the years has been financed through line extension agreements.

11. During the period 1985 to 1990, the Company may have improperly expensed some labor and overhead that should have been capitalized.

[13] Includes $2,500 interest for restricted funds.

12. Pursuant to a settlement between Staff and the Company, a five percent depreciation rate was approved in Decision No. 55113.

13. A change in corporate depreciation rates on a going forward basis of 2.76 percent is reasonable.

14. The Tax Reform of 1986 required the inclusion of funds from contributions and advances to be included as ordinary income in the year received.

15. Pursuant to Commission Decision No. 55774, dated October 21, 1987, companies were given options for collection of the "gross-up tax" one of which was to charge developers a gross-up based on the company's effective tax rate.

16. Bermuda opted for the gross-up option and from January 1, 1987 through approximately June 1996 charged developers a gross-up on line extensions at a 68 percent rate.

17. Mohave Valley and Pebble Lake systems were small noncompliant water companies that were acquired by Bermuda.

18. Mohave Valley and Pebble Lake have benefited from the acquisition through better water quality and service.

19. At least in the short run, customers of Mohave Valley and Pebble Lake will have higher rates a result of the acquisition.

20. The Company sold its Bermuda City system ten years ago.

21. The Company had standard line extension agreements filed with and approved by the Commission which specified a computational methodology for gross-up taxes.

22. The line extension agreements contained a gross-up verification method agreed to by the Company and the respective developer.

23. To date, the Commission has received no complaints from developers regarding a gross-up tax refund.

24. Rate continuity, conservation, and simplicity and stability all must taken into consideration for rate design purposes.

CONCLUSIONS OF LAW

1. Applicant is a public service corporation within the meaning of Article XV of the Arizona Constitution and a water utility within the meaning of A.R.S. §§40-250 and 40-251.

2. The Commission has jurisdiction over Applicant and of the subject mater of the application.

3. Notice of Applicant's application was given in accordance with the law.

4. The rates and charges for water services proposed by Applicant are not just and reasonable.

5. The rates and charges for water services established hereinafter are just and reasonable.

ORDER

IT IS THEREFORE ORDERED that Bermuda Water Company be, and hereby is, authorized and directed to file, on or before July 31, 1999; (1) revised schedules of rates and charges which shall be in accordance with the DISCUSSION, FINDINGS OF FACT and CONCLUSIONS OF LAW hereinabove.

IT IS FURTHER ORDERED that such revised schedules of rates and charges shall be effective for all service rendered on and after August 1, 1999.

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IT IS FURTHER ORDERED that Bermuda Water Company shall notify its customers of means of an insert in its next regularly scheduled billing of the revised schedules of rates and charges authorized hereinabove.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN | COMMISSIONER | COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Acting Executive Secretary of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this 21st day of July, 1999.

BRIAN C. McNEIL
EXECUTIVE SECRETARY

DISSENT ______________
JLR:dap

SERVICE LIST FOR: BERMUDA WATER COMPANY, INC.

DOCKET NO. W-01812A-98-0390

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