STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

IN RE:	**KENT COUNTY WATER AUTHORITY'S RATE FILING**	**) DOCKET NO.) 3942**

POST-HEARING MEMORANDUM OF THE DIVISION OF PUBLIC UTILITIES AND CARRIERS

I. Introduction

The Kent County Water Authority ("KCWA") filed its rate application with the Public Utilities Commission ("Commission") in March of 2008. Subsequent to that filing, the Division of Public Utilities and Carriers ("Division") retained Thomas S. Catlin, a principal of Exeter Associates, to review KCWA's revenue requirements. After conducting an extensive investigation, the Division filed Direct and Surrebuttal Testimony of Mr. Catlin. Prior to and at hearing, which occurred on September 24, 2008, KCWA and the Division were able to resolve all but the following three issues: (i) Infrastructure Replacement ("IFR") funding, (ii) Employees Contributions to Health Insurance, and (iii) Operating Revenue Allowance ("ORA"). A copy of the updated schedules that reflect areas of the parties' agreement is contained in KCWA's Response to Commission Data Request No. 6. Based upon the Division's positions regarding the contested issues (discussed further below) and the agreed-to issues reflected in KCWA's updated schedules, the Division recommends that the Commission make the following proposed findings:

1. KCWA's Rate Filing of March 31, 2008, is hereby denied and dismissed;
2. KCWA is granted a revenue increase of $3,157,863 for a total cost of service of $19,532,849 to be applied to usage on and after November 1, 2008;

3. In determining KCWA's allowed cost of service, a 10% employee contribution toward Blue Cross health insurance premiums has been recognized. To the extent that KCWA elects not to require such employee contributions, that amount shall be absorbed out of the ORA;

4. The allowance for IFR funding included in rates shall be increased from the current level of $4.805 million to $5.40 million effective November 1, 2008. This amount shall be deposited to the restricted IFR account;

5. KCWA is allowed funding for its O&M Reserve of $199,691 and for its R&R Reserve of $200,000. To the extent these amounts are not required to meet increases in the reserve requirements established by its bond indenture, any excess shall be set aside in a separate restricted account to be used to meet future capital needs;

6. In addition to the amounts identified in Findings 4 and 5 above, KCWA shall continue to restrict the following amounts collected through rates: Debt Service - $3,932,319 and Capital Equipment - $100,000;

7. KCWA's proposal to implement seasonal rates is denied in this proceeding and will be reconsidered at such time as KCWA implements monthly billing; and

8. KCWA is allowed a 1.5% ORA of rate revenues.[1]

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[1] Paragraphs 8-10 are alternative proposed Findings in the event that the Commission approves a 3.0% ORA:

8. Of the total ORA, 1.5% shall be unrestricted for use by KCWA in meeting expense overruns and revenues shortfalls of up to 0.5% of total rate revenue. The remaining 1.5% of the total ORA shall be restricted and may only be used to cover shortfalls in total allowed rate revenue when the shortfall exceeds 0.5% of such revenue. If the shortfall exceeds 0.5% of total rate revenue, KCWA may seek recovery of the full shortfall. If revenues exceed the total allowed rate revenue by more than 3%, the full amount of the revenue in excess of the allowed rate revenue shall be deposited to the restricted operating revenue reserve.

9. Total allowed rate revenues will initially be set at the rate revenues allowed in this proceeding. This amount shall be adjusted annually based on the annual change in the Consumer Price Index (CPI) for the Northeast. In addition, any increase in revenues approved for the pass-through of Providence Water Supply Board rate increases shall also be recognized.

10. The balance in the restricted ORA shall be limited to 6% of total rate revenues. KCWA shall file a report by November 1 of each year that presents the revenues for the prior fiscal year and the level of the restricted operating revenue reserve. If the restricted ORA balance exceeds 6% of total rate revenues, the Commission will open a proceeding to address the appropriate adjustment to the KCWA's rates.

II. Discussion

A. Infrastructure Replacement

KCWA requests funding for its IFR plan of $6.0 million per year. Direct Testimony of Thomas S. Catlin at 24. This amount represents an increase of $1,995,522 over actual test year IFR funding. By contrast, the Division recommends that the Commission increase KCWA's IFR funding to $5.4 million per year rather than $6.0 million, an increase of $1,995,522 over actual test year funding. Direct Testimony of Thomas S. Catlin at 24. The substantial evidence on the record supports the Division's recommendation.

At the proposed level of $5.4 Million, KCWA will have $18.1 million in IFR funds available in FY 2009 and FY 2010 to undertake anticipated projects. Direct Testimony of Thomas S. Catlin at 25. KCWA's IFR spending plan for FY 2009 "includes final payments for its 2005 and 2007 IFR construction, expenditures for its 2006, 2007 and 2009 IFR plans, and expenditures for the Quaker booster refurbishment and Tiogue service area conversion projects." Direct Testimony of Thomas S. Catlin at 24. These projects require funding of $15.65 million.

KCWA concedes that in FY 2006 and FY 2007, the Commission authorized KCWA to fund its IFR account at $4.8 million per year. Transcript of Hearing dated September 24, 2008 at 58. For each of those years, KCWA did not fund the account at its authorized levels (*i.e.,* KCWA under-funded the account). At no time has the Department of Health notified or cited KCWA for failing to fully fund its IFR account or rejected any IFR plan for lack of funding. Transcript of Hearing dated September 24, 2008 at 59.

The record further reflects that KCWA is "a lot more conservative than . . . the other utilities in Rhode Island" when it comes to undertaking IFR projects. According to Mr. Catlin, other Rhode Island utilities "tend to spend the cash [IFR funds] . . . more currently…" than KCWA. Transcript of Hearing dated September 24, 2008 at 80, 156-57.[2] At hearing, KCWA confirmed Mr. Catlin's observation in this regard. According to Mr. Brown, KCWA will not commit to a construction contract with a contractor until it has "sufficient funds in the account" to pay the entire contract. Transcript of Hearing dated September 24, 2008 at 80.

Lastly, even if KCWA were given the IFR funding that it requests, it is highly improbable that the utility would expend the authorized funds within the rate year. Mr. Brown conceded at hearing: "…there's really only so much you can do in a year as well . . . There is a limit . . . [given KCWA's] existing staffing levels." Transcript of Hearing dated September 24, 2008 at 81-82.

The record reflects that $5.4 million will be more than sufficient to enable KCWA to undertake its IFR spending plan for FY 2009. The Commission, therefore, should approve the Division's adjustment reducing KCWA's requested IFR funding by $600,000. See TSC-2 (Updated 9/10/2008).

B. Employee Contributions To Health Insurance

Currently, KCWA does not require "employees to make any contribution toward either medical or dental insurance premiums." Direct Testimony of Thomas S. Catlin at

[2] KCWA's approach to capital expenditures reflects a similar conservativism. KCWA will have $21 million in capital improvement funds available in FY 2009 and FY 2010. Even if all the utility's projects were to be completed in the rate year, $9 million of the existing $21 million would still be available to undertake anticipated projects in FY 2009 and FY 2010. Response to Commission Data Request No. 5.

11. The Division proposes "to reduce the employee insurance costs (but not retirees) to be included in rates to reflect a 10% employee contribution toward medical insurance premiums." Direct Testimony of Thomas S. Catlin at 11. The Division's recommended funding results in a negative adjustment to KCWA's rate year expense of $46,723. See TSC-6 (Updated 9/10/2008). The substantial evidence on the record supports this proposed adjustment as well.

The Commission has "expressed its expectation" that non-investor owned utilities will "'require its employees to share in the expense of their health care premiums or implement other approaches that will clearly reduce the health care premiums paid' by the utility." In Re: Kent County Water Authority Abbreviated Application to Change Rates, Docket No. 3660, Order No. 18316 at 26-27 (August 4, 2005). Then, in In Re: Narragansett Bay Commission Abbreviated Application for Rate Relief, Docket No. 3707, Order No. 18719 at 19 (September 14, 2006), the Commission stated that "[c]ontrolling . . . health care costs . . . is a priority of the Commission to ensure that utilities are efficient and utility rates are just and reasonable." Based on testimony of Division expert witnesses, the Commission has also observed that, "it is not unusual for employees to pay a co-share for health insurance which is higher than 6% of the premium. In Re: Narragansett Bay Commission Abbreviated Application for General Rate Relief, Docket No. 3979, Order No. 19062 at 27 n. 44 (September 10, 2007).

Most recently, in Narragansett Bay Commission Application to Change Rates, Docket No. 3905, Order No. 19380 at 9 (August 20, 2008), the Division had contended that the FY 2009 health co-share for state employees with salaries over $35,000 and who pay on percentage of premium basis, ranges from 12% to 15%. Recognizing it is not unusual for employees to pay a co-share for health insurance that is higher than the 7.5% cap, the Commission adopted a Division recommendation eliminating a 7.5% cap for non-union employees' (who pay on a percentage of premium basis) health co-share. Id. at 20.

In the pending docket, Mr. Catlin testified that in the case of NBC "the limit on employee contributions, which are based on a percent of salary, is up to 7.5 percent of premiums and that percentage increases to 10% on July 1, 2009. Direct Testimony of Thomas S. Catlin at 12. Mr. Catlin also confirmed that most employees of the State of Rhode Island will be required to pay for "between 12 and 15 percent of their medical, dental and vision premiums." Direct Testimony of Thomas S. Catlin at 12. This conclusion was consistent with the general trend based on a "fairly extensive internet search" and a review of a "number of papers" that suggested that employee contributions have "significantly increased over the last several years." Hearing dated September 24, 2008 at 151. In view of this uncontested evidence, it is not unreasonable for the Commission to recognize 90% of KCWA's health insurance expense for ratemaking, and adjust downwards KCWA's rate year health expense by $46,723. Direct Testimony of Thomas S. Catlin at 12.

C. Operating Revenue Allowance

The Division recommends that the Commission set KCWA's ORA at 1.5% of rate revenues. Direct Testimony of Thomas S. Catlin at 3; Surrebuttal Testimony of Thomas S. Catlin at 3. This recommendation in fact provides the utility with a greater magnitude of ratepayer funds than would 1.5% of the utility's operating and maintenance expenses—the typical standard the Commission has adhered to in previous rate cases.

For example, in In Re: Pawtucket Water Supply Bd. General Rate Filing, Docket 3497, Order No. 17974 at 52 (October 10, 2003), the Pawtucket Water Supply Board ("PWSB") requested an ORA of 1.5% of total expenses. The Commission, however, recognized that the "actual number" for the allowance "is driven by actual expenses" and that the "[a]llowance is designed to address unexpected fluctuations in operating expenses." Id. As a result, the Commission limited PWSB's ORA to 1.5% of operating and maintenance expenses only. Id.

The Commission adhered to this method for calculating the ORA in In Re: Narragansett Bay Commission Abbreviated Application for Rate Relief, Docket 3592, Order No. 18124 at 9 (January 21, 2005). In that docket, the Commission set NBC's ORA at 1.5% (rather than 1%) of NBC's operating and maintenance expense. The Commission adopted the higher percentage (1.5%) because NBC was encountering "volatile energy costs." Id.

In In Re: Narragansett Bay Commission Application for General Rate Relief, Docket No. 3797, Order No. 19062 at 34 (September 10, 2007), the Commission acknowledged that NBC had experienced a $3 million revenue shortfall in fiscal year 2007. The Commission, however, recognized there is significant "risk of granting utilities excessively large operating reserves" even if they are experiencing revenue shortfalls. Id. at 33-34. "...[A] large operating reserve may allow a utility to be less efficient and more lax with personnel costs." Id. at 35. This is particularly true when the utility "can control increases in personnel costs, especially for its non-union employees . . . [which in NBC's case] compose roughly half of its workforce." Id. The

Commission, therefore, set NBC's ORA at 1.5% operating expenses, rather that 1.5% of total expenses sought by NBC. Id. at 36.

In City of Newport, Utilities Department Water Division Application to Change Rates, Docket No. 3818, Order No. 19240 (March 24, 2008) at 40, Newport Water sought an ORA of about 4.3% of total expenses. Even in the face of alleged declining revenues, the Commission found that there was "no reason to depart from the norm of allowing 1.5% of all expenses to create an operating reserve, as has been the historical practice of the Commission..." Id.

Most recently, in Narragansett Bay Commission Application to Change Rates, Docket No. 3905, Order No. 19380, at 16, the Commission voted 2-1 to fund NBC's ORA at a mere 1% of operating expenses. The Commission considered 1% appropriate, rather than 1.5% of operating expenses, even though the "utility experience[d] a revenue shortfall." NBC "continues to show that it can find savings" through personnel costs that are "within the control of NBC" (*e.g.,* co-sharing healthcare premiums, salary freezes or layoffs). Id. See also In Re: Kent County Water Authority Abbreviated Application to Change Rates, Docket No. 3660, Order No. 18316 at 27 ("personnel costs . . . can be controlled by an employer through co-sharing of premiums, salary freezes or lay-offs"). Accordingly, calculating the reserve at 1% of operating expenses "will incentivize NBC to keep such costs low."[3]

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[3] In Re: Providence Water Supply Board's Application to Change Rate Schedules, Docket No. 3832, Order 19145 (December 13, 2007) is distinguishable from this line of precedent. Providence Water's labor force was almost entirely unionized; its personnel costs were fixed by "a new labor contract entered into between the City of Providence and Public Employees' Local 1033." Id. at 73. Such "*personnel expenses resulting from labor contracts*" were "not within the control of the water utility management" and do not decrease. Id. at 75 (emphasis added). Moreover, the Commission was "requiring" Providence Water "to file a rate proposal on or before July 1, 2009 which includes proposed conservation rates." Id. at. 74. Under these unique circumstances, an ORA of 3%, with 2% restricted to cover revenue shortfalls resulting from reduced

KCWA does not possess a unionized labor force. By contrast, only one-half of NBC's labor force is unionized. KCWA, therefore, possesses even greater ability than NBC to control personnel expenses. Hearing dated September 24, 2008 at 81-82. The Division's recommendation—to set the ORA at 1.5% of rate revenues, rather than operating expenses—will provide a more than adequate reserve to enable KCWA to address revenue fluctuations.[4] At the same time, an ORA set at 1.5% of rate revenues, like NBC, will "incentivize" KCWA to keep its non-fixed personnel costs low through "co-sharing healthcare premiums, salary freezes or layoffs" even in the face of revenue fluctuations. Narragansett Bay Commission Application to Change Rates, Docket No. 3905, Order No. 19380 at 16.[5]

Three other factors counsel against affording KCWA an ORA in excess of 1.5% of rate revenues. The evidence reflects that in "developing rate year expenses," KCWA not only "made adjustment for known and measurable changes to bring expense to rate year levels" but also "applied an inflation factor to all other expenses for which known and measurable changes were not made." Direct Testimony of Thomas S. Catlin at 26. Secondly, "amounts included as contributions to the O&M Reserve and R&R Reserve include amounts in excess of the normal annual requirements in order to bring those reserves to the required levels." Direct Testimony of Thomas S. Catlin at 26. Lastly, it is

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consumption and expressly contingent on the filing of conservation rates by July 1, 2009, was appropriate. Id. at 74.

[4] On September 17, 2008 at an open meeting, the Commission approved a settlement agreement in In Re Pawtucket Water Supply Board Application to Change Rates, Docket No. 3945. Paragraph No. 17 of the settlement provides, in pertinent part, that Pawtucket Water "agrees to the [ORA] of one and a half percent (1.5%) of rate revenues ($272,178) provided for in this settlement."

[5] Should the Commission set KCWA's ORA at 3%, the Division recommends that the Commission establish the reserve in accordance with the findings set forth in footnote 1, supra.

undisputed that KCWA's test year sales were already below sales in any of the last five years. These sales, however, were "reduced to reflect the full annual revenue loss of a major customer even though that customer is not scheduled to discontinue service until after the first two months of the rate year." Direct Testimony of Thomas S. Catlin at 26.

Each of these items reflects additional sources of funds, which KCWA may access, should the utility encounter continued revenue fluctuations. An ORA in excess of 1.5% rate revenues, therefore, is completely unnecessary.

III. Conclusion

For all of the foregoing reasons, the Division requests that the Commission enter an Order consistent with the Proposed Findings contained in this memorandum of law, the Division's Direct and Surrebuttal Testimony, as well as the testimony of Mr. Catlin at hearing.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that a copy of the within memorandum of law was forwarded by e-mail to the individuals designated on the Docket's Service List on October 17, 2008.