

PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: February 26, 2013

REGULAR _____ CONSENT X EFFECTIVE DATE _____ N/A _____

DATE: February 20, 2013

TO: Public Utility Commission

FROM: Brian Bahr *BB*
F

THROUGH: Jason Eisdorfer, Bryan Conway, and Irv Emmons *BE*

SUBJECT: ROATS WATER SYSTEM INC: (Docket No. UI 326) Requests approval of an Affiliated Interest Agreement with W. K. Roats.

STAFF RECOMMENDATION:

The Public Utility Commission of Oregon (Commission) should grant a waiver of Oregon Administrative Rule (OAR) 860-036-0739(4)(e) and approve Roats Water System, Inc.'s (Company) application for approval of an Affiliated Interest Agreement (Agreement) with W. K. Roats, an affiliated interest, subject to the following conditions:

1. The Company will provide the Commission access to all books of account as well as all documents, data, and records that pertain to any transactions involving W. K. Roats.
2. The Commission reserves the right to review, for reasonableness, all financial aspects of this transaction in any rate proceedings or alternative form of regulation.
3. The Company will notify the Commission in advance of any substantive changes to the Agreement, including any material change in price. Any such changes shall be submitted in an application for a supplemental order (or other appropriate format) in this docket.
4. The Company will report to the Commission, as part of its annual affiliated interest report, a summary of the Company's transactions with W. K. Roats.

DISCUSSION:

The Company filed this application on July 31, 2012, pursuant to ORS 757.495 and OAR 860-036-0730. The Company is a water utility that provides water to approximately 1,609 customers near Bend, Oregon. The Company was incorporated in Oregon in 1963 and is entirely owned by W. K. Roats.

"Affiliated interest," as defined in ORS 757.015, includes every corporation and person owning or holding directly or indirectly five percent or more of the voting securities of such public utility. Because W. K. Roats directly owns 100 percent of the Company, he qualifies as an affiliated interest.

Certain properties currently used by the Company for operational and administrative functions are donated by the Company's owner, W. K. Roats. These properties include a Business Office, a Service Office, a Shop/Warehouse, and a lot where utility equipment is stored (collectively referred to as the Properties). The Properties have been owned by W. K. Roats for several decades. During that time, the rental expense of the Properties has not been included in the Company's revenue requirement used to set rates. In other words, ratepayers have enjoyed the benefit of the Company's rent-free usage of the Properties since the inception of the Company.

Given the opportunity for potential other revenue-producing uses of the Properties, W. K. Roats now wishes to begin charging the Company appropriate rent. In its application, the Company requests Commission approval of an affiliated interest agreement between the Company and W. K. Roats, an affiliated interest, for rental of the Properties.

Issues

Staff investigated the following issues:

1. Terms and Conditions of the Agreement
2. Waiver of OAR 860-036-0739(4)(e)
3. Transfer Pricing
4. Public Interest Compliance
5. Records Availability, Audit Provisions, and Reporting Requirements

Terms and Conditions of the Agreement

Staff reviewed the Agreement between the Company and W. K. Roats and did not observe any unusual terms or conditions in the Agreement. The Agreement appears similar to other property rental agreements typically used by water utility companies.

Waiver of OAR 860-036-0739(4)(e)

OAR 860-036-0001 provides that the Commission may waive its rules upon good cause shown. The rule at issue requires that affiliate transactions be priced at lower of cost or market. In this case, the calculated cost is significantly lower than market rates or opportunity costs. Additionally, the Company has given ratepayers the benefit of not previously including these costs in customer rates.

If the affiliated interest application were approved at cost, it may provide a disincentive for the Company to continue to utilize the property for the benefit of ratepayers and instead rent the property based upon its market value. Furthermore, a strict application of the rule could be interpreted as punishing the Company for its failure to charge customers for the cost of the Properties in the past.

Staff only supports waiver in this very specific instance because the Company is a water utility that has not previously included any costs of the Properties in rates. To use the past behavior of a water utility to disallow the future opportunity of receiving market rates for the Properties could incentivize the water utility to not use the property for water utility business. Finally, Staff notes that this does not constitute rate making treatment and that these costs will only be considered in context of overall fair and reasonable rates.

Transfer Pricing

OAR 860-036-0739(4)(e) requires that affiliated interest transactions be priced at the lower of cost or market rate. The rule states:

When services or supplies are sold to a water utility by an affiliate, sales must be recorded in the water utility's accounts at the affiliate's cost or the market rate, whichever is lower. The affiliate's cost must be calculated using the water utility's most recently authorized rate of return.

In its application, the Company is requesting a monthly rent expense of \$10,756. This amount is based on the market rate as determined using the rental rate per square foot of comparable properties in the Bend area found in real estate listings. Staff verified these listings to ensure they represent accurate, reasonable market rates for the Bend area. Table 1 shows the calculation of the \$10,756 rent amount requested in the Company's application.

Table 1.

Property Description	Sq. Ft.	Rate per Sq. Ft.	Monthly Rent
Service Office	83,580 ¹	\$0.05	\$4,179
Shop/Warehouse	3,000 ²	\$0.50	\$1,500
Brookwood Lot	56,000 ³	\$0.05	\$2,800
Business Office	2,277	\$1.00	\$2,277
		TOTAL	\$10,756

The Company's application lists the square footage of the Business Office as 2,277; however, Deschutes County Tax Assessor records indicate the square footage to be 1,247. To resolve the discrepancy, Staff requested a Certified Public Accountant in the Bend area to certify the actual dimensions of the usable square footage of the Business Office building.⁴ The certified square footage amount is 2,024. Using this amount would change the total amount of monthly rent requested from \$10,756 to \$10,503, as shown below in Table 2.

Table 2.

Property Description	Sq. Ft.	Rate per Sq. Ft.	Monthly Rent
Service Office	83,580	\$0.05	\$4,179
Shop/Warehouse	3,000	\$0.50	\$1,500
Brookwood Lot	56,000	\$0.05	\$2,800
Business Office	2,024	\$1.00	\$2,024
TOTAL	144,604	TOTAL	\$10,503

Table 3 shows comparable properties and market rates based on information included with the Company's application and verified by Staff. The highlighted amounts are the properties that are most comparable to the Properties used by the Company, based on square footage.

¹ Per the Company's response to Staff Data Request No. 5, the entirety of the Service Office and Shop/Warehouse is used for purposes directly related to water utility operations.

² *Ibid.*

³ This amount is the square footage of the portion of the lot used specifically for utility purposes, not the square footage of the entire lot (4.14 acres, or 180,338 Sq. Ft.). See the Company's response to Staff Data Request No. 4.

⁴ The Certified Public Accountant certifying the dimensions was Wes Price, CPA, who is a partner of the firm Harrigan Price Fronk & Co. LLP.

Table 3.

Property Type	Sq. Ft.	Rate asked per Sq. Ft.	Asked Monthly Rent
Office	4,755	\$1.10	\$5,230.50
Office	1,500	\$1.25	\$1,875
Office	1,477	\$1.00	\$1,477
Office	2,492	\$1.10	\$2,741.20
Office	9,360	\$0.90	\$8,424
Office	1,749	\$0.87	\$1,521.63
	Mean	\$1.04	
	Median	\$1.05	
Shop/Warehouse	5,050	\$0.40	\$2,020
Warehouse	10,500	\$0.50	\$5,250
Warehouse	3,150	\$0.60	\$1,890
Warehouse	1,050	\$0.60	\$630
	Mean	\$0.53	
	Median	\$0.55	
Lot	141,868	\$0.05	\$7,093.40

Based upon the information presented in Tables 2 and 3, the rental rate of the Business Office requested by the Company (\$1.00 per Sq. Ft.) is less than both the mean and median rental rates for the properties listed in Table 3 (\$1.04 per Sq. Ft. and \$1.05 per Sq. Ft., respectively). It is also lower than the rental rate of the single most comparable property (\$1.10 per Sq. Ft.).

The requested rental rate of the Shop/Warehouse (\$0.50 per Sq. Ft.) is also lower than both the mean and median rates of the listed properties (\$0.53 per Sq. Ft. and \$0.55 per Sq. Ft., respectively) and of the single most comparable property (\$0.60 per Sq. Ft.). The rental rate requested by the Company of the Brookwood Lot and the Service Office (\$0.05 per Sq. Ft.) is the same as that of the listed property.

Table 4 shows the comparison between the rental rates requested by the Company and the mean market rates, as shown in Tables 2 and 3, respectively.

Table 4.

Property Description	Sq. Ft.	Mean Mkt. Rate	Mean Mkt. Rent	Requested Rate	Requested Rent
Service Office	83,580	\$0.05	\$4,179	\$0.05	\$4,179
Shop/Warehouse	3,000	\$0.53	\$1,590	\$0.50	\$1,500
Brookwood Lot	56,000	\$0.05	\$2,800	\$0.05	\$2,800
Business Office	2,024	\$1.04	\$2,105	\$1.00	\$2,024
TOTAL	144,604		\$10,674		\$10,503

Table 5 shows the comparison between the rental rates requested by the Company and the median market rates, as shown in Tables 1 and 2, respectively.

Table 5.

Property Description	Sq. Ft.	Median Mkt. Rate	Median Mkt. Rent	Requested Rate	Requested Rent
Service Office	83,580	\$0.05	\$4,179	\$0.05	\$4,179
Shop/Warehouse	3,000	\$0.55	\$1,650	\$0.50	\$1,500
Brookwood Lot	56,000	\$0.05	\$2,800	\$0.05	\$2,800
Business Office	2,024	\$1.05	\$2,125	\$1.00	\$2,024
TOTAL	144,604		\$10,694		\$10,503

Table 6 shows the comparison between the rental rates requested by the Company and those of the most comparable properties, as shown in Tables 1 and 2, respectively.

Table 6.

Property Description	Sq. Ft.	Comparable Rate	Comparable Mkt. Rent	Requested Rate	Requested Rent
Service Office	83,580	\$0.05	\$4,179	\$0.05	\$4,179
Shop/Warehouse	3,000	\$0.60	\$1,800	\$0.50	\$1,500
Brookwood Lot	56,000	\$0.05	\$2,800	\$0.05	\$2,800
Business Office	2,024	\$1.10	\$2,226	\$1.00	\$2,024
TOTAL	144,604		\$10,795		\$10,503

Tables 4, 5, and 6 all indicate that the Company is requesting less than comparable market rates. However, OAR 860-036-0739(4)(e) requires the expense be not just lower than market rates, but at the lower of cost or market. Additionally, the rule states that the affiliate's cost must be calculated using the water utility's most recently authorized rate of return.

To calculate the cost, Staff multiplied the market value of the land by the Company's most recently authorized rate of return, 3.99 percent.⁵ This calculation results in a monthly cost of \$1,534.

Staff recommends the Commission approve a monthly rental amount of \$10,503, which is lower than comparable market rental rates and is based on the Company's application, adjusted for a square footage difference.

Public Interest Compliance

The Commission customarily applies a no harm standard to affiliated interest agreements. Customers could potentially be harmed by not approving this Agreement as this could result in increased expenses to ratepayers and the potential disruption of service.

Records Availability, Audit Provisions, and Reporting Requirements

Order Conditions numbers 1 through 4, listed above in Staff's recommendations, afford the necessary Commission examination of the Company's records concerning the Agreement with W. K. Roats.

Based on the review of this application, Staff concludes the following:

1. The application regards an affiliated interest agreement that is fair and reasonable and not contrary to the public interest, with the inclusion of proposed ordering conditions.
2. Necessary records are available.

PROPOSED COMMISSION MOTION:

Roats Water System, Inc.'s application for approval of the Affiliated Interest Agreement with W. K. Roats, an affiliated interest, be approved in the monthly expense amount of \$10,503 and subject to the four recommended conditions. In order to grant this recommendation, Staff further recommends that the Commission waive the requirements of OAR 860-036-0729(4)(e).

⁵ Approved by Commission Order No. 05-811.