

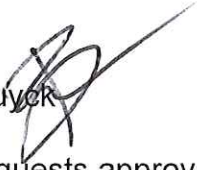
**PUBLIC UTILITY COMMISSION OF OREGON**  
**STAFF REPORT**  
**PUBLIC MEETING DATE: August 25, 2015**

REGULAR \_\_\_\_\_ CONSENT  X  EFFECTIVE DATE \_\_\_\_\_ N/A \_\_\_\_\_

DATE: August 17, 2015

TO: Public Utility Commission

FROM: Greg Miller 

THROUGH: Jason Eisdorfer, Bryan Conway, and Bruce Hellebuyck 

SUBJECT: SUNRIVER WATER, LLC: (Docket No. UI 355) Requests approval of an Affiliated Interest Agreement with Sunriver Environmental, LLC.

**STAFF RECOMMENDATION:**

The Public Utility Commission of Oregon (Commission) should grant a waiver of OAR 860-036-0739(4)(e) and approve Sunriver Water, LLC's (Sunriver Water or the Company) application for approval of two Affiliated Interest Agreements (Agreements) with Sunriver Environmental, LLC (Environmental), an affiliated interest, as modified in this memorandum and 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 Environmental.
2. The Commission reserves the right to review, for reasonableness, all financial aspects of these transactions 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 Environmental.

## DISCUSSION:

### Issues

Sunriver Water proposes to enter into the following two separate lease agreements with Environmental, an affiliated interest.

#### **Lease 1. North Reservoir Site**

This lease is for the North Reservoir Site (the Reservoir Site), which is owned by Environmental. Sunriver Water argues that based upon the topographical and proximity needs of the project; there is no practical alternative to siting the project on the Reservoir Site. In recognition of the importance of the North Reservoir project, the stipulation adopted by the Commission in Order No. 14-405 includes Construction Work in Progress (CWIP) treatment for this project.

#### **Lease 2. Shared Office, Shop, Storage, and Yard Space (together, Office Space)**

Sunriver Water argues the Office Space is necessary because it requires office space for its employees and shop, yard, and storage space for its operations.

### Applicable statutes, rules, and Commission orders:

On November 19, 2014, the Commission issued Order No. 14-405 regarding Sunriver Water's last general rate filing, in docket UW 160. Condition 1 to the stipulation approved in that order (Condition 1) states:

*Sunriver Water, LLC will file a new affiliated interest agreement within 90 days of the date of the final order. The application will address **all of the charges** (emphasis added) from affiliates that the Company plans to seek rate recovery of in its next rate application.*

On February 17, 2015, the Company filed a request asking for the filing date to be extended to March 2, 2015. On February 18, 2015, a ruling was issued granting that request.

On March 2, 2015, Sunriver filed an Affiliated Interest (AI) application addressing the two leases which are being addressed in this memo. The Company filed the application in compliance with Condition 1 described above and pursuant to ORS 757.495 and OAR 860-036-0730. In a separate filing, Sunriver will be filing its Management Contract with Sunriver Resort LP (Resort) as required by that same condition.

"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. Sunriver Water is wholly owned by Sunriver Resort Limited Partnership, and in turn, is the sole owner of Environmental. Consequently, Environmental has an affiliated interest with Sunriver Water. 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** (emphasis added) or market rate, whichever is lower. The affiliate's cost must be calculated using the water utility's most recently authorized rate of return.*

On June 19, 2015, Sunriver Water filed a request for waiver of OAR 860-036-0739(4)(e), the lower of cost or market rule. This is further discussed in the Analysis section below.

#### Analysis

The Company is a water utility that provides water to approximately 4,300 customers in a community consisting of full and part-time residences, multi-family condominiums, a resort hotel, commercial areas, golf courses, and recreation facilities. Sunriver Resort LP owns Sunriver Water. The Resort is organized as a limited partnership and holds 100 percent of the equity interest of Sunriver Water. The Resort also holds a 100 percent interest in Environmental, an unregulated wastewater utility.

The Sunriver Owners Association (SROA) filed written comments on April 29, 2015, and July 8, 2015. As discussed below, SROA's concerns are addressed in Staff's analysis.

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
6. Other issues raised by SROA

#### *1. Terms and Conditions of the Agreement*

Staff reviewed the Agreements between Sunriver Water and Environmental and does not see any concerns at this time. SROA expressed concerns regarding a number of contract terms. Should the terms or conditions of the Agreements significantly change

or prove unreasonable to customers; Staff will be able to address the impacts in the Company's next rate application as outlined in ordering condition 2.

*2. 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 under consideration requires that affiliate transactions be priced at the lower of cost or market. In this case, the calculated cost is significantly lower than market rates or opportunity costs.

In its application, Sunriver Water states that the water utility employees are also employees of Environmental and the most efficient solution to providing Office Space is to locate the Office Space at the same location as Environmental. The only other alternative is to seek comparable space in the Sunriver Business Park. Sunriver Water contends that locating the Office Space away from the water utility's plant would be inefficient and more expensive.

In its response to requests for information and its request for waiver, Sunriver Water asserts that the Office Space has been used by the Company for many years without payment of rent and rent has not been included in their previous rate cases to set rates, resulting in a benefit to rate payers. The Resort has indicated that in the absence of rent, it may seek other revenue-producing uses for the properties as they are always looking for the highest and best use of their property and assets.

The Commission previously granted a waiver in Order No. 13-066, Docket No. UI 326, to Roats Water System Inc. (Roats). Circumstances in this case are similar to Roats in that if the lease agreements were priced only at cost, it would provide a disincentive to continue to utilize the property for the benefit of water ratepayers and instead may incent the Company to rent or even sell the property to others based upon its market value. A waiver of the cost element in these circumstances provides the Company the appropriate incentive to continue to devote the assets to serving customers provides the good cause necessary to waive OAR 860-036-0739(4)(e).

Staff notes that approval of the contract in this docket does not constitute rate making treatment and that these costs will only be considered in the context of overall fair and reasonable rates in the Company's next rate setting proceeding. Sunriver Water would be required to demonstrate the existence of those other uses as part of the reasonableness review of the transaction for inclusion in rates laid out in condition 2.

SROA does not believe good cause has been shown necessary to grant the waiver of OAR 860-036-0739(4)(e). Staff believes that the purpose of the lower of cost or market rule is to guard against subsidies flowing to non-regulated entities from regulated

entities. The rule generally does this by not allowing affiliates to generate undue profits by recovering more than their cost of providing the service.

In this case, as demonstrated below, the affiliate's cost is extremely low due to the unique circumstances underlying those costs. As a result, Staff was required to consider whether or not the facts supported waiver of the application of the rule and the likely impact of that application on the behavior of the affiliate.

The waiver is necessary to avoid incenting the affiliate (Environmental) to take actions which may harm customers. Environmental is unregulated by the Commission and free to do as they choose with these properties without Commission approval. They have also stated that they may have options for alternate uses of the property. If they have options, it is possible that they will take advantage of those options rather than allowing Sunriver Water to use the facilities at the extremely low costs. SROA has questioned Environmental's ability to put those assets to other uses. However, parties may examine the viability of those options as part of the reasonableness review of the transaction for inclusion in rates laid out in condition 2 above. Finally, similar to Roats, Sunriver customers have enjoyed free use of the Office Space for a considerable period of time.

### *3. Transfer Pricing*

The Company has represented "cost" in its application to be the price which it will be charged by the affiliate under the lease. Page 4 of the Application contains the following statement:

*For all locations being leased pursuant to the affiliated contract, the cost paid by the water utility is the actual cost charged to the utility...*

This is an error in the application of the term cost. As described above, OAR 860-036-0739(4)(e) specifies the relevant cost is the cost to the affiliate of providing the service. The relevant cost is not simply the amount the affiliate is charging the Company, as relied upon by the Company in the Application.

The principal driver behind Environmental's low cost of providing the North Reservoir Site lease is the fact that the site is a small portion of a piece of property which was acquired at a very attractive price in January, 2000.

The principal driver behind Environmental's low cost of providing the Office Space lease is the fact that the related net book value is a little over \$15,000. That amount is significantly less than even the \$44,276 annual charge requested by the Company. The

\$1,960 shown below is the amount required to provide a return on and a return of the net book value to Environmental (i.e., to cover the affiliate's cost).

The following table shows the charges asserted by the Company versus the costs as calculated under the definition contained in OAR 860-036-0739.

<u>Lease</u>	<u>Annual Charges per Application</u>	<u>Annual Cost per OAR 860-036-0739</u>
1. North Reservoir Site	\$15,350.40	\$125
2. Office Space	\$44,276.28	\$1,960

Sunriver Water acknowledged in its response to requests for information that the cost of Environmental providing leased space to them is extremely low – if not zero, and significantly below market rate.

Staff also examined the Company provided market alternatives. The monthly amounts requested are based on the market rate, as determined using the rental rate per square foot for comparable properties in the Sunriver and Bend areas found in real estate listings. Staff verified these listings to ensure they represent accurate, reasonable market rates in both areas. Staff also expanded on the list of comparable properties by locating some additional supporting comparable listings. Table 1 shows the calculation of the \$4,968.89 monthly rent amount requested in the Company's application.

Table 1

<b>Property Description</b>	<b>Sq. Ft.</b>	<b>Requested Rate per Sq. Ft.</b>	<b>Monthly Rent</b>
Office	1,305	\$1.00	\$1,304.70
Warehouse	2,760	\$0.77	\$2,125.55
Land (Office Site)	8,648	\$0.03	\$259.44
Land (Reservoir Site)	42,640	\$0.03	\$1,279.20
		<b>Total Monthly Rent</b>	<b>\$4,968.89</b>
		<b>Total Annual Rent</b>	<b>\$59,626.68</b>

Table 2 shows comparable properties and market rates based on information included with the Company's application as well as Staff's investigation.

Table 2

Property Type	Sq. Ft.	Listing Rate per Sq. Ft.	Asking Monthly Rent
Office	1,108	\$0.30	\$332.40
Office	1,438	\$0.38	\$546.44
Office	1,590	\$0.48	\$763.20
Office	1,630	\$0.60	\$978.00
Office	1,187	\$0.65	\$771.55
Office	1,500	\$0.80	\$1,200.00
	<b>Median</b>	<b>\$0.54</b>	
Warehouse	2,500	\$0.50	\$1,250.00
Warehouse	3,085	\$0.55	\$1,696.75
Warehouse	2,478	\$0.60	\$1,486.80
Warehouse	2,700	\$0.60	\$1,620.00
	<b>Median</b>	<b>\$0.575</b>	
Land	27,000	\$0.04	\$1,080.00

Based upon the information shown in Tables 1 and 2, the rental rate requested by the Company for both the Office and Warehouse is above the median rental rate for the properties listed in Table 2. Conversely, the rental rate requested by the Company for the Office and Reservoir Site Land is less than the median rental rate. Staff also computed the mean rental rate, which was almost identical to the median rental rate calculations.

Table 3 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 3

Property Description	Sq. Ft.	Median Market Rate	Median Market Rent	Requested Rate	Requested Monthly Rent
Office	1,305	\$0.54	\$704.70	\$1.00	\$1,304.70
Warehouse	2,760	\$0.575	\$1,587.00	\$0.77	\$2,125.55
Land (Office Site)	8,648	\$0.04	\$345.92	\$0.03	\$259.44
Land (Reservoir Site)	42,640	\$0.04	\$1,705.60	\$0.03	\$1,279.20
<b>Total</b>			<b>\$4,343.22</b>		<b>\$4,968.89</b>

Table 4 shows Staff's proposed market rates and proposed monthly and annual rent amounts. As you can see on that Table, Staff recommends lowering the rent to the median price for the Office and Warehouse space and using the lower price requested by the Company for the Land for both the Office Site and Reservoir Site.

Table 4

Property Description	Sq. Ft.	Proposed Market Rate	Proposed Market Rent
Office	1,305	\$0.54	\$704.70
Warehouse	2,760	\$0.575	\$1,587.00
Land (Office Site)	8,648	\$0.03	\$259.44
Land (Reservoir Site)	42,640	\$0.03	\$1,279.20
<b>Total Monthly Rent</b>			<b>\$3,830.34</b>
<b>Total Annual Rent</b>			<b>\$45,964.08</b>

Staff recommends that the Commission grant the waiver of the cost component of the lower of cost or market standard and approve a monthly rental amount of \$704.70 for the Office, \$1587 for the Warehouse, \$259.44 for the Office Site Land, and \$1279.20 for the Reservoir Site, with total annual rent being \$45,964.08. This approach represents a reasonable outcome for both the Company and its customers. Customers would receive a 23 percent reduction (from \$59,627 to \$45,964) in Company proposed AI charges. They would also retain the use of these properties for which, absent reasonable compensation, Environmental may seek other uses. The Company would be appropriately compensated for use of the assets based upon a review of market comparables.

As an alternative, if the Commission does not grant the waiver and approve the above amounts in Table 4, Staff proposes an annual charge of \$125 for the Reservoir Site and an annual charge of \$1,960 for the Office Space, previously discussed as the cost to the affiliate.

*4. 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 incent the Company to seek other uses for these properties and result in higher cost alternatives for ratepayers. Staff does not want the regulatory treatment to cause the Company to act in a manner which will be detrimental to ratepayers. Given the prices which will be incorporated into the Agreements and the further review that may occur before these expenses are allowed into rates, customers will not be harmed by approval of the Agreements.

*5. Records Availability, Audit Provisions, and Reporting Requirements*

Conditions numbers 1 through 4, listed above in Staff's recommendations, afford the appropriate Commission examination of the Company's records concerning the AI agreements with Environmental.



#### *6. Other Issues Raised by SROA*

SROA also raised issues associated with A) the treatment of Customer Advances addressed in UW 29, and B) the allocation of assets in compliance with Commission Order No. 98-110.

##### *A. Treatment of Customer Advances addressed in UW 29*

The SROA states that the developer of Sunriver Properties, Inc. (Developer), built and paid for the water and sewer plants. The Commission concluded in Order No. 90-1413 (Docket UW 29) that the Developer recovered its cost of water plant through lot sales and that rate base should be reduced to reflect amounts recovered through lot sales. Accordingly, the rate base was reduced by approximately \$3.8 million to reflect the plant paid for by customers in their lot price. The unamortized portion of that \$3.8 million and the associated reduction in depreciation expense has been reflected in subsequent rate cases through exclusion of specific assets on properties assumed to be paid for by customers. As a result, customers have been and are still receiving the benefits of amounts deemed as 'included in the lot price' since the UW 29 rate case.

##### *B) The allocation of assets in compliance with Order No. 98-110*

In Order No. 98-110, the Commission approved the application of Sunriver Utilities Company (Docket UP 148) to transfer certain assets to a newly formed limited liability corporation (LLC) known as Sunriver Water, LLC. SROA questioned the allocation of assets between Sunriver Water and Environmental which resulted from approval of that application. They questioned whether or not the Office Space should have been assigned to Sunriver Water rather than Environmental, or possibly even have been split between the two entities. In Order No. 98-110, the Commission adopted a Staff recommendation which indicated Staff's concerns regarding the asset allocation could be addressed in the utility's next rate case, if necessary. The allocation was not raised as an issue by any party in the rates cases since that time.

In addition, because the Office Space was assigned to Environmental, Sunriver Water customers have avoided payment for use of that space through inclusion in rates over the last 13 years.

#### Conclusion

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:**

Sunriver Water's application for approval of the AI agreements with Environmental should be approved, subject to the four recommended conditions. In order to grant this recommendation, Staff further recommends that the Commission waive the cost requirement of OAR 860-036-0739(4)(e).