

**PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: March 8, 2016**

REGULAR _____ CONSENT X EFFECTIVE DATE _____ N/A _____

DATE: February 16, 2016

TO: Public Utility Commission

FROM: Greg Miller

THROUGH: Jason Eisdorfer, Bryan Conway, and Bruce Hellebuyck

SUBJECT: SHADOWWOOD WATER SERVICE, WILDERNESS CANYON, HILLVIEW ACRES, ILLAHE GOLF CLUB ESTATES, and WESTWOOD VILLAGE WATER: (Docket Nos. UI 362, UI 363, UI 364, UI 365, and UI 366) Requests approval of an affiliated interest agreement with Hiland Water Corp.

STAFF RECOMMENDATION:

The Public Utility Commission of Oregon (Commission) should approve Shadowwood Water Service, Wilderness Canyon, Hillview Acres, Illahe Golf Club Estates, and Westwood Village Water's (Companies) application for approval of a Master Service Affiliated Interest Contract (Contract) with Hiland Water Corp. (Hiland or Affiliate), an affiliated interest, subject to the following conditions:

1. The Companies will provide the Commission access to all books of account as well as all documents, data, and records that pertain to any transactions involving Hiland.
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 Companies will notify the Commission in advance of any substantive changes to the Contract, including any material change in price. Any such changes shall be submitted in an application for a supplemental order (or other appropriate format) in these dockets.
4. The Companies will report to the Commission, as part of their annual affiliated interest reports, a summary of the Company's transactions with Hiland.

ISSUE:

Whether the Commission should grant the Companies' request to enter into a Contract with Hiland, an affiliated interest, for goods and services necessary for the administration, management, and operation of the five Companies.

RULE:

A corporation or person has an "affiliated interest" with a public utility when it owns or holds, directly or indirectly, at least five percent of the voting securities of that public utility. See ORS 757.015. When a public utility enters into a contract with an affiliated interest, it must seek Commission approval of the contract within 90 days of execution of the contract. See ORS 757.495. Further, OAR 860-036-0739(4)(e) requires that affiliated interest transactions be priced at the lower of cost or market rate.

The Commission will review and approve affiliated interest agreements if the terms are fair and reasonable and not contrary to the public interest. See ORS 757.495(3). However, the Commission need not determine the reasonableness of all financial aspects of the agreement for ratemaking purposes, and may reserve that issue for subsequent proceedings. See Order No. 11-071 (Docket No. UI 306).

ANALYSIS:

The five Companies seeking to enter into the Contract with Hiland are small water utilities located throughout western Oregon that, when combined, provide water service to approximately 650 customers. The Companies are wholly-owned by Hiland, creating an affiliated interest.

Hiland specializes in operating small water systems. It wholly-owns 20 water systems, five of which are rate-regulated, and contracts to provide services to ten additional systems. Of the 30 total water systems, 27 receive full operation, management, and administrative services from Hiland, which include but are not limited to, experienced and knowledgeable office staff, managers, certified operators, field operators, labor personnel, and meter readers; billing and collection; customer service; accounting and bookkeeping; computer services; tools and equipment; system repair and improvement; general liability and vehicle insurance; and compliance with all regulatory requirements and industry standards.

Pursuant to ORS 757.015 and ORS 757.495, the five Companies filed a combined affiliated interest application on December 15, 2015. The application was filed in the manner and form required by OAR 860-036-0730.

Staff investigated the following issues in determining whether the Contract is fair, reasonable, and not contrary to the public interest:

1. Terms and Conditions of the Agreement;
2. Transfer Pricing;
3. Public Interest Compliance; and
4. Records Availability, Audit Provisions, and Reporting Requirements.

Terms and Conditions of the Agreement

Staff has no issues or concerns with the Contract between the Companies and Hiland at this time. Should the terms or conditions of the Contract significantly change or prove unreasonable to customers, Staff will be able to address the impacts to customers in the next rate case as recommended in condition 2.

Transfer Pricing

In the Companies' application, the Affiliate's costs are separated into "direct costs" that are system specific and billed directly to the appropriate system, and "indirect costs" that benefit all systems and customers receiving service from the Affiliate, and are billed across all systems. The Affiliate calculates the indirect expense allocation for each of the 27 full-service systems by determining the cost per customer for each expense category (dividing the expense by the total number of customers of all systems), then multiplying that figure by the number of customers in each system. Staff agrees with this allocation method based on the circumstances in the application.

Staff reviewed all costs associated with the Contract to determine if the amount paid by the Companies to the Affiliate was the lower of cost or market rate as required by OAR 860-036-0739. Staff agrees with the Affiliate that the Companies will experience cost savings through two different avenues. First, the Companies will benefit from economies of scale because the Affiliate's cost of service is spread across a larger customer base (approximately 2,500 customers). For example, all billing and administrative functions are performed in one central office, and field technicians serve multiple water systems, so the Companies will receive the benefit of Hiland's entire crew and expertise without bearing the entire cost. Second, Staff reviewed all administrative and general expenses and confirmed that they were charged to the Companies at cost, with no profit margin, which would not be the case if the Companies used outside contractors. Vendor and supplier invoice documentation confirmed these expenses.

Staff requested additional information from the Companies, including information on wages paid to the Affiliate's employees and office and warehouse lease expenses. For analysis of wage expenses, the Companies provided an exhibit of wages paid to every Affiliate employee, as well as Oregon Employment Department's Oregon Labor and

Market Information System (OLMIS) comparison figures. Staff used the OLMIS and American Water Works Association (AWWA) Water Utility Compensation Survey as a proxy to determine the market rate for individual employee wages. Staff found that wages for hourly and salaried Affiliate employees are very similar to average or median rates for the Oregon area and all closely align with the OLMIS and AWWA percentile levels. Therefore, Staff finds that the Affiliate wages are fair and reasonable.

To evaluate office and warehouse expenses, Staff examined the cost of market alternatives to the office and warehouse that the Affiliate currently occupies. Staff found that comparable 'for lease' properties in the same general area as the Affiliate are leased at very similar costs per square foot to what the Affiliate presently pays. Staff is satisfied that the Affiliate's office and warehouse expenses are consistent with market rates for the area, and are fair and reasonable.

Public Interest Compliance

The Commission customarily uses a "no harm" standard to determine whether an affiliated interest agreement is contrary to the public interest. Staff finds that customers of the five Companies will benefit from the Contract by taking advantage of administrative and management efficiencies created by economies of scale; alternatively, customers could potentially be harmed if the Contract were not approved and the Companies pursued higher cost external management services. Therefore, Staff believes the Contract is consistent with the public interest.

Records Availability, Audit Provisions, and Reporting Requirements

Staff notes that the Commission retains the ability to review all affiliated transactions of the Company through its annual affiliated interest report and general rate case filings. Staff's recommended conditions allow Commission examination of the Companies' records concerning the Contract.

CONCLUSION:

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

1. With inclusion of Staff's recommended ordering conditions, the proposed affiliated interest agreement is fair and reasonable and not contrary to the public interest; and
2. Necessary records are available.

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PROPOSED COMMISSION MOTION:

The Companies' application for approval of the Contract with Hiland be granted subject to Staff's recommended conditions and reporting requirements.

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