STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

IN RE: PROVIDENCE WATER SUPPLY BOARD :
APPLICATION TO CHANGE RATES : DOCKET NO. 3163

REPORT AND ORDER

I. INTRODUCTION

On June 30, 2000, the Providence Water Supply Board ("PWSB") filed an application with the Rhode Island Public Utilities Commission ("Commission") seeking a general increase in its existing rate schedules. The PWSB requested an effective date of July 31, 2000 on its rate increase, which was designed to generate total revenue in the amount of $43,092,925, of which $5,416,622 (14.4%) would represent increased revenues.

The filing represents PWSB's fourth rate filing in the last six years. The following table provides a summary of the prior filings and rate relief granted:

Docket No.	Filing Date	Increase Requested	Increase Allowed
2961	June 30, 1999	$ 2,549,504	$ 2,073,709
2304 -IFR-	December 31, 1997	$ 2,000,000	$ 2,000,000
2304 -IFR-	November 27, 1996	$ 2,000,000	$ 2,000,000
2304	March 31, 1995	$ 11,270,666	$ 8,093,883
2222	June 30, 1994	$ 9,216,418	$ 1,735,692

There were several requests by third parties to intervene in this docket. The requests to intervene were approved by the Commission without objection. In addition to the Division of Public Utilities and Carriers ("Division"), an indispensable party, the following parties intervened: the Kent County Water Authority ("Kent"), the city of East Providence ("East Providence" or "EP"), the Greenville Water District ("Greenville"), and the city of Warwick ("Warwick"). The following attorneys entered appearances for the parties:

PWSB	Michael R. McElroy, Esq.
Division	Paul J. Roberti, Esq., Asst. Attorney General
Kent and EP	Francis X. Flaherty, Esq.
Greenville	Stephen E. Cicilline, Esq.
Warwick	Seth H. Handy, Esq.

II. PROPOSED RATE INCREASE AND RESPONSIVE TESTIMONY

A. The Applicant

The PWSB offered the prefiled direct testimony of the following five individuals in support of its rate increase application:

1. Mr. Paul Titzmann
   Deputy General Manager – Administration, PWSB

2. Ms. Jeanne Bondarevskis
   Director of Finance, PWSB

3. Mr. Alexander Prignano
   Finance Director, city of Providence

4. Mr. Paul Gadoury
   Director of Engineering, PWSB

5. Mr. Myron Olstein
   National Director for Utility Improvement Services,
   Black & Veatch Corporation

1. Cost of Service.

Mr. Titzmann testified that the additional revenues requested by the PWSB would be used for:

a. An additional $1,000,000 for IFR (infrastructure replacement) program funding;

b. An additional $648,000 for service level increases;

c. Funding and authorization for an investigation into an alternate source of supply;

d. The addition of rental expense and an increase in city service expenses; and

e. Known and measurable increases in expenses.

The additional funding would include an additional engineer who would support the CIP (capital improvement projects) and IFR programs, as well as an additional Commercial Meter Supervisor.

The PWSB provided the Commission with the rate filing data required by R.I. Gen. Laws §39-3-12.1 and the additional support data required under Section 2.9 of the Commission's Rules of Practice and Procedure, attached as an exhibit to the testimony of Mr. Titzmann.

PWSB's Deputy General Manager for Administration, Mr. Titzmann, testified that the PWSB still felt that "pay-as-you-go" funding was appropriate for IFR, and that bonding was appropriate only for (i) new capital projects that have significant costs, and (ii) unforeseen projects where there is insufficient IFR funding available and the project is urgently needed in order to respond to a threat to the water supply system. The PWSB requested that IFR funds be available for use with either pay-as-you-go funding or bond financing, using these guidelines.

Mr. Titzmann also discussed the PWSB's desire to have salaries charged to IFR. Salaries would be charged whenever employees were working on IFR projects.

Finally, Mr. Titzmann testified that the city of Providence should be repaid $402,534 that was withheld pending reimbursement to the PWSB by the State Emergency Management Agency, without waiting for reimbursement. This money is the final repayment to the city of Providence for a loan to the PWSB.

Ms. Bondarevskis, PWSB's Finance Director, testified that PWSB had used a September 30, 1999 test year for expenses. The following adjustments were made and were provided to the rate consultants:

a. Removed a nonrecurring audit adjustment.

b. Incorporated known salary and fringe benefit changes.

c. Updated the test year retirement figures to the actual amount for fiscal year 2001.

d. Updated the test year property tax figures to the actual amount for fiscal year 2000, and estimated a pro forma increase.

e. Updated the test year restricted fund figures to the amounts authorized in Docket 2961.

f. Updated the test year debt service figures to the known amounts.

Ms. Bondarevskis also testified that there were requested pro forma adjustments totaling $648,144, or 1.7%, of the approved revenues of $38,131,535 in Docket No. 2961.

Ms. Bondarevskis explained that , if approved, the proposed Commercial Water Supervisor position identified by Mr. Titzmann would focus on the 700 large meter accounts over 2”. This supervisor would work on meter downsizing/rightsizing, revenue reasonableness, and meter maintenance. The base salary would be $44,485, with fringe benefits of $20,l018 (45% fringe benefits), for a total of $64,503. The additional engineer requested would provide additional IFR and CIP support, and would have a base salary of $38,373, with fringe benefits of $17,268, for a total of $55,641.

Ms. Bondarevskis identified the following additional items for which funding was sought: $98,000 for water supply; $155,000 for additional engineering; $115,000 for support services; and $160,000 for finance.

Ms. Bondarevskis acknowledged that the PWSB was asking to change the use of IFR funds to allow them to be used for debt service with Division approval. The PWSB was also asking for the creation of two additional restricted funds. The first is the Alternate Source of Supply Fund, for which $300,000 would be set aside in a restricted interest bearing account. Unused funds would be carried over to subsequent years for financing of design and construction.

The PWSB also wants to establish a restricted Vehicle and Equipment Fund. Funds allocated for operating leases used to purchase vehicles and equipment would be placed in this fund, and be used to replace aging and obsolete vehicles and to improve the equipment ancillary to the water system. The PWSB proposed an additional $230,000 for this restricted fund, in addition to the $870,000 already committed for vehicles and equipment. To the extent possible, the PWSB would like to pay for vehicles and equipment on a current basis, eliminating interest and administrative expense. As lease expenses gradually were reduced, there would be cash available for increased direct purchases rather than leases.

Mr. Prignano, Finance Director for the city of Providence, testified regarding the amount of city services expense requested by the PWSB, as well as funds to pay the city of Providence rent for City property used by the PWSB. The total cost of these items included in the rate filing is $1,264,333, consisting of $967,393 for city services and $296,940 for City property rent. Schedule A to Mr. Prignano's testimony contains the amounts of current and anticipated city service expenses; Schedule B contains the City Finance Department allocations; Schedule C reflects allocated salaries and fringe benefits for City personnel providing services to the PWSB; and Schedule D shows how the PWSB calculated the amount of proposed City property rental payments. The principal methodology changes were the reduction of City purchasing department salaries and expenses to reflect the fact that the PWSB does most of its purchasing in-house, and reduction of the City Finance Director's allocation from 25% to 5% to reflect reduced time spent on PWSB matters. Mr. Prignano acknowledged the fact that the PWSB has previously requested funding for payment of City property rental expense, which the Commission has denied.

The prefiled testimony of Mr. Gadoury, PWSB's Director of Engineering, reviewed the anticipated decline in annual demand for water and the conclusion that overall system demand for 2001 would be 66.6 million gallons per day (MGD), including unaccounted for water. Based on the wholesale demand trend, 27.65 MGD of this amount is expected to be wholesale demand.

Mr. Gadoury testified that since 1996, when the PWSB started the IFR program, $60 million has been invested in improvements. For 2001, the PWSB has requested an additional $1 million for IFR. Exhibits PG-3 and PG-4 to Mr. Gadoury's testimony identify the projects that the PWSB hopes to begin in fiscal years 2001 - 2003. Included among the projects is immediate repair work on the 90” aqueduct that runs 4 miles out of the treatment plant. Loss of use of this aqueduct could cause loss of water supply to the entire system, which would represent a loss of water supply to approximately 60% of Rhode Island’s population. It was only recently that the PWSB was able to inspect the aqueduct and determine the extent of deterioration and the amount of remedial work needed. PWSB hopes to fund the CIP projects identified in Exhibit PG-4 through a combination of existing rate revenues and future revenues available from expiring debt service allowances.

PWSB has also commissioned an investigation into an alternate supply of water in addition to the Scituate Reservoir that could be used under emergency conditions. PWSB requested that $300,000 be allocated to begin work on this study, with additional funds to be requested once the need for funding is better known.

2. Rate Design and Demand Projections.

Outside consultant Myron Olstein also testified for the PWSB. He testified regarding: the test year cost of service for the 12 months ending September 30, 1999, and the adjustments made to income and expense items to develop a rate year cost of service for the 12 months ending December 31, 2001; cost allocation methodology and rate design; and the impact of the rates on ratepayers. Mr. Olstein commented that the PWSB had as one of its goals compliance with the Water Supply Management Act of 1991, which had been considered problematic because of lack of demand data and the possible effect on industrial customers.

Mr. Olstein observed that the new rate design complied with prior Commission directives that the PWSB's declining retail rate block structure be eliminated and a single flat rate be developed for different retail rate classes. Mr. Olstein developed flat rates for PWSB's three retail rate classes using rates that are proportionate using the base-extra capacity method, which creates a uniform commodity rate by customer class. The new rate structure retains the fixed customer service charge that recovers meter costs, service costs, and billing and collection costs based on meter size. This results in an increase of 12.79% for the average residential ratepayer. The wholesale rate was calculated by dividing the allocated cost of servicing this customer class by the projected usage, resulting in a wholesale rate of $1,188 per million gallons.

Mr. Olstein explained that fire protection charges were calculated in accordance with recent guidelines issued by the American Water Works Association, using a methodology completely different from the methodology previously used. The allocated costs for identified functional components were added to direct fire protection costs to establish total costs of $1,135,850. This total cost was then allocated between public and private fire protection. Using the new methodology without adjustment, however, would have produced some sizeable rate increases. Mr. Olstein explained that, in order to mitigate this result, PWSB has allocated indirect costs between public and private fire using a 60:40 ratio, and has proposed phasing in the increased public fire charges over three years.

Mr. Olstein testified that there was a definite long-term downward trend in water consumption. However, taking into account increased demand from Bristol County Water Authority ("Bristol") and Western Cranston, for fiscal year 2001 Mr. Olstein projected 15,480,000 hundred cubic feet ("hcf") of retail water demand and 13,500,000 hcf of wholesale water demand. Water that was produced but not billed for (i.e., non-accounted for water) was projected on average to be 11%.

Mr. Olstein explained that his overall goal was to use base-extra capacity methodology to allocate the cost of service into four primary cost components: (a) base costs; (b) extra capacity costs; (c) customer costs; and (d) fire protection costs. This methodology was applied to PWSB's four customer classes, consisting of one wholesale customer class and three retail customer classes (residential, commercial and industrial), as follows. First, demand factors by customer class were estimated by looking at similar water supply systems. Second, cost of service was allocated to cost components. The cost of service was broken down into (1) operation and maintenance expense; (2) capital expense; (3) city services expense; and (4) tax expense. The allocations are reflected in Exhibits CA-4a to CA-4e. Costs were then totaled by customer class, as reflected in Exhibit CA-5. Exhibit CA-7 shows the development of unit costs of service for retail customers for each of the various cost elements. Using the total unit costs of service from this exhibit, Mr. Olstein presented an exhibit with the total cost of service for each retail class (Exhibit CA-9).

Mr. Olstein testified that the overall proposed revenue increase was 13%, with the following impacts by customer class: an increase 25.7% in the wholesale rate; an increase of 12.79% for the typical retail residential customer; an increase of 6.78% for the retail commercial customer; and an increase of 4.67% for retail industrial customers. The proposed increase for fire protection costs was 10.4%.

B. <u>The Division.</u>

1. <u>Cost of Service.</u>

Thomas Catlin, a consulting economist hired by the Division, indicated in his prefiled testimony that he made certain adjustments to the operating and maintenance expenses, property taxes, and capital costs identified by the PWSB in its filing, resulting in the Division's adjusted revenue increase of $2,169,923. This represents a $3,246,700 reduction to the revenue increase requested by PWSB. In his revenue requirement, Mr. Catlin included an operating reserve of 1.5% of total expenses, which is the operating reserve previously approved by the Commission for the PWSB and other utilities, rather than the 2.5% proposed by Mr. Olstein in his testimony. Mr. Catlin disagreed with the justification offered by Mr. Olstein for increasing the operating reserve to 2.5%, concluding that there was no evidence that anticipated variations in revenues and expenses were any greater than experienced by PWSB in the past or than faced by other utilities.

Mr. Catlin further testified that he disagreed with Mr. Olstein's conclusion that there was a downward trend in water consumption. Adjusting for different levels of sales to Bristol County, Mr. Catlin observed that water demand had been stable from 1995 to 2000. Accordingly, Mr. Catlin recommended that water demand in fiscal year 2001 be set at the same level as in fiscal year 2000, and that the breakdown should be 15,569,612 hcf for retail sales, 13,779,257 hcf for wholesale sales, and 3,627,388 hcf for unaccounted for water based on an unaccounted for water rate of 11%.

Mr. Catlin calculated PWSB's rate year revenues at existing rates to be $38,751,030. This amount is $1,074,727 higher than that calculated by PWSB, because

Mr. Catlin used his projected water demand figures, and also split retail consumption between the first and second rate blocks in accordance with fiscal year 2000 consumption.

Mr. Catlin also disagreed with the PWSB's cost of service increase to reflect the addition of an IFR/CIP engineer. Although Mr. Catlin agreed that such an engineer should be hired, he argued that the associated costs should be offset by cost savings of not having to hire outside contractors, and that such cost savings would be captured in the IFR/CIP accounts. Mr. Catlin also disagreed with PWSB's request for an additional meter supervisor. Mr. Catlin testified that existing staff levels are sufficiently high to ensure that accounts with large meters are properly sized and meters replaced as needed. The overall effect of these Division adjustments would be to reduce the rate year cost of service by $120,144.

With respect to other Division adjustments to PWSB's cost of service, Mr. Catlin testified that PWSB had incurred computer upgrade expenses during the test year to meet Y2K requirements that should not be carried over and embedded in the rate year cost of service. Normal levels of computer upgrade expenses were already included in the cost of service. This change would reduce the test year cost of service by $91,619.

Mr. Catlin also proposed certain adjustments to the city services expenses claimed by PWSB. Rather than an increase from $659,219 to $967,393,as requested by the PWSB, Mr. Catlin concluded that the appropriate city services expense amount was $664,007, a difference of $303,386. Mr. Catlin also recommended that the requested $296,940 in rental property expense to be paid to the city of Providence be rejected, as it has been in past dockets.

Mr. Catlin further testified that the PWSB should focus on replacing, repairing and maintaining its current system, rather than spending substantial funds to investigate supply alternatives. On that basis, he recommended that the Commission reject the PWSB's request for $300,000 to identify an alternate source of water supply.

Mr. Catlin noted that the PWSB sought $1,000,000 to install 102" butterfly valves on either side of Warwick's Natick Avenue connection, if the Division grants permission for this work. Mr. Catlin recommended that this expenditure be spread over two years, thereby reducing the cost of service by $500,000 in fiscal year 2001. Mr. Catlin further recommended that the costs of this project be added to the PWSB's other capital costs and be allocated over all customer classes, as this method is used with respect to PWSB's other capital expenses.

Finally, Mr. Catlin testified regarding a series of smaller adjustments he would make to PWSB's cost of service. In total, these adjustments would reduce the cost of service by $128,445. The accounts he adjusted are: rate case expense (amortization period is changed to two years); an insurance expense reduction of $58,074; and other adjustments to purchased power, chemicals and property taxes.

2. Rate Design.

In his prefiled testimony, Jerome Mierzwa, a utility rate design consultant hired by the Division to analyze the PSWB application, proposed numerous technical modifications to the cost allocations reflected in the PWSB's cost of service study. Exhibit JDM-1 summarizes the various changes that Mr. Mierzwa believes are appropriate to the cost allocations.

Mr. Mierzwa agreed with the PWSB's proposal to continue its current rate structure for service charges and to adopt uniform consumption rates by customer class. He also concluded that the existing rate structure for wholesale, public fire and private fire services should be maintained.

Mr. Mierzwa testified that the results of the Division's cost of service study utilizing PWSB's and Kent's demand factors were as follows:

CLASS	**INDICATED INCREASE/DECREASE <u>PWSB</u> FACTORS**	**INDICATED INCREASE/DECREASE <u>KENT</u> FACTORS**
Residential	2.8%	3.7%
Commercial	-7.8%	-5.3%
Industrial	-10.9%	-25.7%
Fire Protection	19.8%	17.7%
Wholesale	16.1%	15.0%
TOTAL	**4.2%**	**4.2%**

From this information, Mr. Mierzwa concluded that the wholesale class was currently contributing significantly less than his indicated cost of service, and he recommended that wholesale rates be increased by slightly less than 9%, which is approximately one-half the indicated percentage increase. Mr. Mierzwa recommended no increase in overall fire protection rates, although current public fire protection rates would be increased by 10% and current private fire protection rates reduced by 10% to achieve this goal. The reason for this distinction is that public fire protection rates are recovering significantly less than the indicated cost of service, but private fire protection rates are recovering significantly more than the indicated cost of service. He further recommended that the cost-based service charges for the residential, commercial and industrial classes be adopted, with consumption rates for the commercial and industrial blocks at the current first block rates. Residential consumption rates would then be adjusted to recover the remaining revenue deficiency. Mr. Mierzwa's proposed rate recommendations are detailed in Exhibit JDM-3.

C. <u>Kent County Water Authority ("Kent")</u>

Christopher Woodcock, a consultant specializing in water rates, testified that he was hired by Kent, a wholesale customer of PWSB, to review the revenue requirements, cost allocations, and proposed rates and charges contained in PWSB's application. In his prefiled testimony, Mr. Woodcock concluded that:

(a) PWSB's proposed cost allocation methodology represents a significant deviation from previous Commission approvals and does not follow generally accepted cost allocation methods;

(b) PWSB overstated its revenue requirements; and

(c) PWSB's proposed wholesale rate is far in excess of the wholesale cost of service.

1. <u>Cost allocation methodology.</u>

According to Mr. Woodcock, PWSB's proposed cost allocation methodology is based upon (a) examples of allocations in an outdated manual that contained disclaimers that the information provided was illustrative only, and (b) rate design determinations supposedly approved by the Commission, but were merely determinations made in an expedited rate docket in which significant changes to rate design were not permitted. Mr. Woodcock prepared his own schedules in which he allocated the adjusted revenue requirements to each of nine identified categories (Schedule 3.0). Using this information, Mr. Woodcock calculated wholesale rates (Schedule 4.0) and proposed retail rates and charges (Schedule 5.0). Mr. Woodcock then provided a comparison of these "cost based" rates with existing rates (Schedule 6.0) and gave examples of the impact of these cost based rates on several typical customer types (Schedule 7.0). Finally, Mr. Woodcock presented a calculation of revenues at current and new rates (Schedule 8.0).

Mr. Woodcock maintained that the new rates he developed follow Commission guidelines, in that declining block rates are eliminated and a uniform rate for each customer class is established. Also, IFR costs are recovered on a per unit basis from all users. The largest rate increases are associated with increased service charges for smaller size retail meters.

Mr. Woodcock criticized the substantial change in cost allocation methodology proposed by PWSB as not properly conducted in accordance with generally accepted standards. Many of the allocations are based upon demand factors from each customer class that are claimed to represent the non-coincidental demands of each class. Mr. Woodcock testified that PWSB misapplied the data, and that revenue requirements using the base-extra capacity method should use the overall (coincidental) system demands with allocations of those costs to the classes based on non-coincident demands. In Mr. Woodcock's opinion, PWSB's use of non-coincident demands overstated the system demands and resulted in improper allocations of costs to the various categories.

More importantly, Mr. Woodcock testified, the base-extra capacity method was applied only to retail customers, and not to the respective load factors of all rate classes. According to Mr. Woodcock, despite the derivation of demand factors for the wholesale rate class, this information was totally ignored in cost of service allocations. The allocations between wholesale and retail customers were based solely on total use, not on average day, maximum day, and peak hour demands of the wholesale class. Mr. Woodcock testified that this skewed the analysis and was inconsistent with the base-extra capacity allocation method.

Notwithstanding these concerns, Mr. Woodcock adopted the base-extra capacity method proposed by PWSB, but allocated the items that were claimed to be dependent on maximum day and/or peak hour requirements to the various functional categories based on overall (coincident) system demands. The allocations between retail and wholesale classes were based on the respective shares of "peak to average use requirements" of the retail and wholesale classes, as Mr. Woodcock believes the Commission requires.

Mr. Woodcock accepted the 11% unaccounted for water rate and assigned unaccounted for water to retail and wholesale use based on procedures approved by the Commission in recent dockets. For allocation between retail and wholesale use, he also included an adjustment to eliminate PWSB's decision to reduce retail sales for "policy reasons."

There also was an adjustment to the fire service accounts based on significant increases reflected in the June 30, 1999 Annual Report.

Mr. Woodcock calculated new demand factors for the various customer classes, as presented in Schedule 2.1. Mr. Woodcock used data provided by PWSB on average day, maximum day, and peak hour demands for most of its wholesale customers, reflecting 90% of wholesale water use. Weighting the demand data by flow results in a wholesale maximum day factor of 1.9 times average day demand, and a peak hour factor of 2.3 times average day demand. In contrast, the maximum day factor for Kent over the past 5 calendar years was 1.5 times average day demand. Mr. Woodcock used the higher values reflected in the actual data rather than the lower values contained in studies supplied by PWSB in response to data requests. For retail customers, Mr. Woodcock used the information that PWSB provided in response to Kent's data requests, which was not the same data used by PWSB and Mr. Olstein (Schedule CA-6).

Mr. Woodcock also revised the meter equivalency factors as ordered by the Commission in PWSB's last full rate filing docket, a requirement with which PWSB had not complied (Schedule 2.2).

Mr. Woodcock included a specific allocation for capitalized labor, based on actual allocations of the payroll clearing accounts that make up the capitalized labor, rather than using surrogate allocations. He noted that these costs must be recovered based on flow volume and not through fixed service charges or fire protection charges, according to earlier Commission rulings on IFR costs. Accordingly, Mr. Woodcock reassigned retail metering, billing and fire protection costs to the retail base function.

Mr. Woodcock also testified that it was unfair to allocate the costs related to installation of 102" butterfly valves solely to wholesale customers, as proposed by PWSB, although these valves will primarily benefit wholesale customers. Mr. Woodcock explained that capital improvements over the last decade that have benefited retail customers and not wholesale customers had been allocated on a system-wide basis, so that wholesale customers had been paying for these capital improvements. Examples of such capital improvements were retail distribution improvements, debts associated with the Fruit Hill leases, and acquisition of the Western Cranston system, all of which primarily or exclusively benefited retail customers and were charged on a system-wide basis. It was unreasonable, Mr. Woodcock maintained, to change that procedure at this point to allocate 100% of capital improvement costs for 102" valves exclusively to wholesale customers.

In contrast, the Construction Work in Progress is an asset related to the Fruit Hill Extra High Service area and is not a specific capital expense. Asset items are allocated by customer category, so that this amount should be allocated to retail customers, and not to the system as a whole. Mr. Woodcock pointed out that by way of comparison, after the 102" valves are installed, the cost of the valves should be allocated to wholesale customers because the 102" valves will be an asset once they are installed, and not a capital expense.

Mr. Woodcock also testified regarding pumping costs. He observed that the allocations are based on factors that were developed one or more decades ago and should be re-analyzed in accordance with the new cost allocation methodology proposed by PWSB. Mr. Woodcock requested and received data regarding the function, capacity, actual volume pumped, and power use at each pumping station, and used this data to reallocate pumping costs. Mr. Woodcock proposed allocating all but the power costs based on the capacity of the pumps at each station and the function of each station. Mr. Woodcock also proposed that power costs be allocated based on actual power costs and the function of the pumping station.

Mr. Woodcock also made an adjustment to the proposed debt service costs associated with the IFR program. He removed these costs from total debt costs and assigned them so that such costs would be recovered solely through the commodity rates and not through service charges or fire protection charges. Mr. Woodcock maintained that this treatment of IFR debt service costs is required under State law and prior Commission rulings regarding recovery of IFR expenses.

Mr. Woodcock pointed out that PWSB's costs for billing and metering are significantly higher than comparable costs reflected in rate filings by Kent and the city of Newport, resulting in comparatively high service charges for PWSB customers. As a result, the implementation of fully cost-based service charges would produce an increase of approximately 25% to the smallest volume retail customers. Mr. Woodcock recommended that these increases be phased in, in order to afford an opportunity to better control billing and metering costs in the future. However, Mr. Woodcock suggested that any costs removed from the cost-based retail service charges should not be assigned back to wholesale customers, because wholesale customers should not be required to subsidize the retail service. Rather, such costs could be recovered through public fire protection charges, where an increase in rates is indicated.

2. <u>Revenue Requirements</u>

Mr. Woodcock testified that PWSB's claimed revenues under existing rates were inaccurate. For example, he noted that revenues were calculated by PWSB by multiplying all projected retail, commercial and industrial sales by the second block rate, with no projected sales calculated at the first block rate. Schedule 8.0 presents Mr.

Woodcock's calculation of actual revenues using existing rates, a number that is substantially higher than PWSB's calculation.

Mr. Woodcock also changed the Units of Service, as reflected on Schedule 2.0 to his testimony. Mr. Woodcock recommended that sales for fiscal year 2000 be used as the most accurate estimate of sales for fiscal year 2001. He also used fiscal year 2000 data for metered use for wholesale accounts, which reflects adjustments caused by acquisition of the Western Cranston system and a full year of purchases by the Bristol. Mr. Woodcock disagreed with PWSB's suggestion that water demand was decreasing, and concluded that demand for fiscal year 2000 was most representative of expected annual consumption for fiscal year 2001.

3. Cost of Service.

Mr. Woodcock concluded that PWSB's cost of service was overstated.

One adjustment Mr. Woodcock made was reducing the operating reserve from 2.5% to 1.5%. He testified, as had Mr. Catlin for the Division, that there simply was no justification for using the higher operating reserve figure in place of the traditional 1.5% figure.

A second, significant adjustment was the reduction of city service expenses to approximately their existing level. Mr. Woodcock eliminated the proposed rental payments to the city of Providence because the properties for which rent would be paid already were assets of PWSB. He reduced the allocation of City purchasing charges to PWSB, because PWSB has its own purchasing group. Mr. Woodcock also reduced allocated expenses from the City Law Department and the City Personnel Department, because PWSB has its own significant expense for these functions. Mr. Woodcock also amortized the expenses for the instant rate case over three years (cost of service study) and two years (other rate case expenses), as reflected on Schedule 1.7, rather than over one year, as proposed by PWSB. Mr. Woodcock's rationale is that these expenses are not likely to recur in one year and therefore, recovery should be spread over a longer period.

Finally, Mr. Woodcock adjusted property tax figures to match the fiscal year 2001 bills and updated asset values to reflect the most recent information available (PWSB's Annual Report for the year ending June 30, 1999).

D. City of Warwick

The city of Warwick ("Warwick") offered the prefiled testimony of consultant Gary Shambaugh, Executive Vice President of AUS Consultants, regarding PWSB's proposal to spend $1 million to construct two 102" butterfly valves in the 102" aqueduct. Mr. Shambaugh stated that these valves are a capital improvement to an aqueduct that benefits wholesale customers only, including Warwick, Kent and East Providence. Mr. Shambaugh testified that all of PWSB's wholesale customers should pay a proportionate share of costs to improve the 102" aqueduct. He claimed that it is inappropriate for PWSB to recover these costs over a two year period, as it proposes, because the construction is an extraordinary capital expense with a very long (80 year) useful life. Mr. Shambaugh testified that the cost recovery period should be in the range of 10 to 20 years. He observed that there may have been low interest loans available for this construction, and that this should have been investigated by PWSB. The method of cost recovery he proposed would help mitigate the rate impacts to wholesale customers of such projects.

E. **PWSB Rebuttal and Clarification Testimony**

1. Myron Olstein.

In his rebuttal testimony, Mr. Olstein disagreed with the testimony of Mr. Catlin and Mr. Woodcock that future water demand would be equal to water demand in fiscal year 2000. Mr. Olstein testified that fiscal year 2000 was an unusual year unlikely to be replicated, and that there was substantial evidence to support a declining demand forecast. Fiscal year 2000 had unusually prolonged hot, dry weather that increases demand.

Important factors in Mr. Olstein's declining demand forecast are: (a) increased use of more efficient water fixtures; (b) reduced demand because of increased cost; and (c) extrapolation of demand data from the last six years for which demand data exists. The calculations performed by Mr. Olstein showed demand reduction of 4.89% from 1999 to 2001. He noted that Mr. Gadoury had calculated a long term demand reduction of 4.49% from 1990 to 2000. Both of these figures exceeded the 3.7% reduction presented in Mr. Olstein's initial testimony. According to Mr. Olstein, if there is a typical weather year, using the demand data proposed by Mr. Catlin and Mr. Woodcock would result in a revenue shortfall of $3.3 million.

Mr. Olstein would adjust his demand forecast to reflect new information from Bristol that would bring plant output to 66.2 MGD. He testified that the differences in revenues between the testimony of Mr. Catlin and Mr. Woodcock, on the one hand, and PWSB, on the other hand, result almost entirely from the difference in demand forecasts, with all other factors creating relatively minor differences in revenue. This includes an assumption that was made regarding usage within rate blocks.

Mr. Olstein stated that Mr. Catlin and Mr. Woodcock assumed substantial private fire revenue that does not exist. They double-counted the service revenue from private fire meters by including it in meters and services revenue and also in private fire revenue. He also corrected a misimpression that public fire revenues represented a "plugged" value and explained how that figure was calculated.

With regard to the operating reserve, Mr. Olstein agreed that a reduction from 2.5% to 1.5% was appropriate, but proposed that the reserve be applied only to the wholesale customers' revenue requirement as a recognition of the substantial economic benefits received by wholesale customers as a result of their participation in PWSB's system.

Mr. Olstein disagreed that the cost of the 102" butterfly valve capital improvements should be allocated to all customers. He testified that capital improvements have not always been allocated on a system-wide basis. Mr. Olstein noted that it was incorrect that the Western Cranston acquisition did not benefit all customers. Although the 102" valve project would be completed in one year, Mr. Olstein did not object to recovery of the capital charges over two years.

Mr. Olstein testified that he disagreed with Mr. Shambaugh regarding long-term debt financing of projects such as the 102" valve capital improvements. The small size of the project does not justify incurring unnecessary financing costs and increasing the overall ratepayer impact.

Mr. Olstein observed that the objection of Mr. Catlin and Mr. Woodcock to a study of an alternate source of supply reflected a misunderstanding regarding its purpose. The purpose of the study is to create redundancy in the system so that water could still be delivered if the connection to the Scituate plant and reservoir was disrupted. The need for this study was recognized by the Rhode Island Water Resources Board, which has already agreed to pay for one-half of the cost of the study.

Mr. Olstein testified further regarding the need for an additional project engineer. He stated that the need has been created by an additional work load caused by PWSB's massive IFR responsibilities. However, funding of this position from the IFR/CIP funds is currently prohibited by prior Commission rulings.

Mr. Olstein pointed out that PWSB would be willing to agree on a two-year amortization period for rate case expenses, as proposed by Mr. Catlin, but not the three-year period proposed by Mr. Woodcock. Mr. Olstein noted that a review of rate case expenses incurred by PWSB since 1995 shows that it is unreasonable to expect that the expenses will cover a three-year period.

Mr. Olstein rejected Mr. Mierzwa's proposal that the cost-based rate increase calculated for wholesale customers be cut in half. He also rejected Mr. Woodcock's suggestion that many expenses be amortized over two years rather than one. Mr. Olstein's rationale was that many of these expenses would be incurred annually, and therefore, two-year amortization would not be appropriate.

Mr. Olstein vigorously disagreed with Mr. Woodcock's testimony that PWSB had deviated from generally accepted cost allocation methods to produce a wholesale rate that was far in excess of cost of service. Mr. Olstein stated that the figures he used to establish demand factors were gathered from a variety of sources and were appropriately used. One of the weaknesses in the base-extra capacity method is the lack of demand data, particularly in older systems, which allows interested parties to come to very different estimates. Recognizing that the wholesale demand factors that were calculated needed to be consistent with the overall system demands, PWSB ran a validity check, as explained in his initial testimony. Mr. Olstein disagreed with Mr. Woodcock's assertion regarding the use of non-coincidental demand factors. PWSB complied with the Commission's order in Docket No. 2049, which states that "each utility [should] adopt a costing methodology which most appropriately reflects their water system's supply, service and cost characteristics and is based upon underlying system data." This, according to Mr. Olstein, is what was done.

Mr. Olstein testified that Mr. Woodcock's approach was intended to benefit wholesale users, not to be fair. For example, between fiscal years 1997 and 1999, wholesale water use ranged from 43% to 49%, but Mr. Woodcock allocates less than 41% to wholesale use. The wholesale rate Mr. Woodcock recommends is 8.9% less than the current wholesale rate that Kent and East Providence agreed to in December 1999 in Docket No. 2961. Mr. Olstein agreed that the base-extra capacity method should be extended to wholesale customers, but rejected Mr. Woodcock's demand estimates in favor of those established by Mr. Mierzwa. A new schedule, MAO-1, shows the calculated revenues and proposed rates, as revised. The concept is similar to that developed by Mr. Mierzwa, except that Mr. Olstein proposes to keep cost-based rates for all categories except public fire and retail consumption. The proposed rates would phase in smaller increases in public fire rates by slightly increasing retail consumption rates. The same customer base would be affected by the slight shifting in charges.

2. <u>Paul Gadoury.</u>

Mr. Gadoury testified on rebuttal solely on the issue of projected water demand. He disagreed in particular with the use of fiscal year 2000's water demand as typical in view of the unusually severe summer weather conditions that caused excessively high water use for that year. He cautioned that if the FY 2000 demand figure were used to predict water consumption in future years, a year with normal weather conditions would produce revenues that would fall dramatically below PWSB's needs.

Mr. Woodcock's water production figures for the years 1994 through 2000, which purport to show no evidence of a downward trend, are flawed, according to Mr. Gadoury, because they ignore the fact that Bristol was added to the system in recent years. If one takes a consistent service area over the years, then a different picture exists. Mr. Catlin made this adjustment, but ignored the unusual weather pattern in fiscal year 2000.

Mr. Gadoury pointed out that using calendar year data, rather than fiscal year data, appears to significantly improve the ability to analyze the data, because it flattens out year-to-year variations and creates a more definitive trend line. His calculations, revised to include Bristol's latest projected annual demand of 1.3 MGD, create a total demand projection of 65.9 MGD for calendar year 2001, which is nearly the same as the 66.1 MGD projection included in his original testimony.

3. <u>Alexander Prignano.</u>

Mr. Prignano testified on rebuttal regarding several adjustments to PWSB's expenses.

Mr. Prignano acknowledged that there had been an error in his original testimony in the calculation of city service expenses. Correction of that error reduced the expenses by $113,000, plus an inflation adjustment of $4,598.

Mr. Prignano also testified regarding the rental payments that PWSB proposed to pay to the city of Providence for the Academy Avenue and Bath Street properties. He reasoned that if rental payments were not going to be approved, the Commission should authorize PWSB to pay taxes to the City for the properties. Since PWSB pays taxes to other municipalities, it is logical for PWSB to make the same type of payments to the city of Providence.

Mr. Prignano rejected Mr. Woodcock's rationale for disallowing purchasing expenses incurred by the city of Providence. Mr. Prignano pointed out that PWSB was required by law to use the City's Purchasing Department for all purchases over $5000, regardless of how many employees PWSB had in its purchasing area. On that basis, Mr. Prignano testified, PWSB should pay its portion of City Purchasing Department expenses, an amount that would be almost $25,000, not just the $11,340 originally requested by PWSB.

Similarly, to the extent that the used City Personnel Department and Law Department employees, Mr. Prignano testified that PWSB should pay the city of Providence for its employees. Mr. Prignano reviewed the extensive services provided to PWSB by these City employees. Similarly, PWSB received extensive services from the City Data Processing Department, and Mr. Prignano testified that the $116,000 requested was certainly fair considering the high level of data processing work performed by the City for PWSB.

Mr. Prignano also observed that it was unfair to suggest that from 1996 to 2001 the City Services number was essentially unchanged. Mr. Prignano noted that inflation over the 5 year period was significant and should not be ignored.

4. Jeanne Bondarevskis.

Ms. Bondarevskis submitted clarification testimony at the request of the Division regarding fire supply services and general water services.

She explained that PWSB had historically billed private fire customers a service charge based on meter size and a consumption charge. Over time, many private fire service customers installed a special meter that allowed water to flow around the meter when high water flow was needed.. As a result, metering occurred only during low flow periods; during high flow periods, water was not metered. This was addressed in PWSB's filing by calculating service charges for all customers, including private fire customers, based on the total number of bills and total equivalent meters. Private fire charges (both direct and indirect costs) were based on the equivalent service size and not on meter size. Ms. Bondarevskis provided the billing determinants that PWSB proposed to use for its calculations.

F. Surrebuttal Testimony of Kent and East Providence.

Mr. Woodcock testified as a surrebuttal witness for Kent and East Providence. He pointed out that the revised data submitted by PWSB regarding projected water sales and units of service were compelling and should be accepted, which would affect the exhibits he had offered in his earlier testimony. Mr. Woodcock therefore offered revised schedules that were otherwise the same as the earlier schedules.

Mr. Woodcock testified that he did not agree with many of the adjustments and comments reflected in PWSB's rebuttal testimony. He was concerned about the number of estimated bills and bills adjusted for errors, which he believed made PWSB's analysis of weather patterns irrelevant. However, Mr. Woodcock conceded that he had failed to take the unusually hot and dry summer of 1999 and sales to Bristol into account in his earlier testimony.

In light of the higher demands during the summer of 1999 and the inaccuracies of PWSB's retail sales information, Mr. Woodcock supported the Division's use of historic production data to derive reasonable sales projections. To derive retail sales within the current blocks and by rate class, Mr. Woodcock calculated projected retail sales in the same proportion as PWSB had presented them. This is reflected in Mr. Woodcock's revised Schedule 2.0. His total water pumped value decreased from 35,260,104 hcf to 32,744,925 hcf.

Mr. Woodcock testified that he was in substantial agreement with the Division with regard to city services expenses. However, he believed that a 67% reduction, rather than the 50% reduction proposed by the Division, was appropriate with regard to City Law Department and Personnel Department expenses, and that City Purchasing Department expenses proposed by PWSB should be reduced by $10,428.

With regard to changes made by PWSB to its cost allocation study, Mr. Woodcock observed that while such revisions reflect cost allocation modifications suggested by Mr. Mierzwa and himself, the cost allocation study still retains the demand factors with which he and Mr. Mierzwa had disagreed. The differences were identified in Mr. Mierzwa's testimony.

There continue to be miscellaneous issues in PSWB's proposal with which Mr. Woodcock disagrees. He did not believe that taxes allocated to the Western Cranston system acquisition should be allocated to wholesale customers, because they provide little benefit to these customers.

Of great concern was the reduction of asset values for contributed capital. Capital costs (which represent one-half of PWSB's total revenue requirement) are assigned on the basis of asset values. Mr. Woodcock agreed with the Division that assets contributed by others and assets that are fully depreciated should not be included for the purposes of allocating debt. However, with regard to allocation of IFR costs, which represent one-third of the total revenue requirement, Mr. Woodcock concluded that all assets should be included. For example, all system assets other than land may require IFR funding, including contributed assets. Mr. Woodcock prepared an allocation schedule to derive allocation factors based on both gross assets (Schedule 3.5A) and net assets less contributions and accumulated depreciation (Schedule 3.5). These schedules were used to derive different allocations for debt and non-IFR cash financed items, on the one hand, and IFR, on the other hand. The schedule of allocation of capital items was revised to reflect these two different allocation bases. The allocation percentages were adjusted to remove any allocation for IFR items from services, meters, and fire service items, because State law requires IFR cost recovery on the basis of water use.

III. THE SETTLEMENT AGREEMENT

PWSB, Division, Kent, East Providence, Greenville and Warwick reached a stipulated agreement on PWSB's rate filing, and on December 4, 2000, they filed a Settlement Agreement (the "Settlement," a copy of which is attached as Appendix A and incorporated by reference herein) with the Commission. The principal terms of the Settlement were:

1. A settled annual cost of service of $41,147,456, constituting an increase of $2,813,974 or 7.34% over PWSB's present cost of service. The overall increase over current rate revenue is 7.6%, with miscellaneous revenues of $1,150,000 in addition to rate revenues. The settled cost of service reflects an agreement that there will be lower consumption in the rate year (paragraph 5), as PWSB's witnesses testified. This reduction in projected consumption results in a $417,000 increase in the Division's proposed revenue requirements. PWSB accepted an adjustment of $160,624 to city services expenses, resulting in an annual city services allowance of $806,769. PWSB also agreed to reevaluate and restudy these expenses in its next rate filing (paragraph 11). The $296,940 requested for rental of city properties was eliminated.

It was agreed that PWSB's request for $1 million to fund the 102" butterfly valve project would be funded over two years, resulting in a reduction of $500,000 in the annual cost of service. Other Division adjustments to operations and maintenance expenses accepted by PWSB were: elimination of the cost of two new employees ($120,144); computer system upgrades ($91,619); purchased power costs ($23,253); insurance expense ($58,074); chemical costs (an increase of $17,236); and amortization of rate case expense over two years ($62,305).

The Settlement also provides $150,000 in annual funding for a study of alternate sources of water supply, which is one-half of the annual amount requested by the PWSB. Property taxes were reduced by $67,557. The 1 ½% operating reserve allowance, adjusted to reflect the agreed-upon cost of service, amounts to $591,095.

2. With regard to rates and rate design, the Settlement provides for a separate flat rate for each of the three proposed retail rate classes. This effectively eliminates the existing two-step, declining block rates previously used for all retail consumption, and conforms to previous orders of the Commission that directed the PWSB to file a rate design with a single flat rate for different rate classes.

The Settlement includes the proposed rates and tariff sheets for the PWSB. The following table describes the rate changes:

	CURRENT RATE	**SETTLEMENT RATE**
Residential, 5/8" meter	$9.81/qtr	$10.00/qtr
Residential, commodity	$1.44/hcf first block $1.37/hcf second block	$1.61/hcf
Commercial, commodity	$1.44/hcf first block $1.37/hcf second block	$1.54/hcf
Industrial, commodity	$1.44/hcf first block $1.37/hcf second block	$1.50/hcf
Wholesale rate	$945/million gallons	$1,017/million gallons
Public fire	$170.24/hydrant/year	$188.97/hydrant/year
Private fire	Multiple rates	Rates will decrease by an average of 8%.

The overall rate increase for general water service (exclusive of fire protection) will be 7.85%; retail rates will increase 7.94%; and wholesale rates will increase 7.62% (paragraph 6). Total fire protection rates will increase by an average of 2.11% (paragraph 7).

3. The Settlement allows PWSB to use IFR funds for debt service and related borrowing expenses on the $5 million loan for rehabilitation of the 90" aqueduct (which borrowing was approved by the Division in Docket No. D-00-17). The Settlement also proposes to allow the PWSB to use restricted IFR funds for debt service on any borrowings for IFR purposes approved by the Division (paragraph 12). In addition, the Settlement proposes to allow PWSB to use IFR and CIP funds to pay for in-house IFR and CIP labor costs and overheads, including labor costs for the new project engineer position requested by PWSB in this filing (paragraph 13).

4. In its next full rate case, or in any event no later than four years from the date of the Commission's Report and Order in this case, the PWSB will file a review of its plant investment numbers with the Division and the Commission in order to verify them and determine that new plant and investment numbers are properly accounted for (paragraph 8). Demand factors for residential, commercial, industrial and wholesale customers will be reevaluated by the PWSB in its next full rate filing (paragraph 9). The PWSB further agrees that in its next rate filing (abbreviated or otherwise), it will submit a study of the recommended level of insurance premiums and injuries and damage expenses to be included in rates (paragraph 10).

The Commission held a public hearing on the Settlement on December 5, 2000, at the offices of the Commission, 100 Orange Street, Providence, Rhode Island. The

Commission's cross-examination of the Division and PWSB's witnesses primarily focused on two issues arising under the Settlement -- the first, being elimination of the restriction on the use of restricted IFR funds for debt service on any borrowings for IFR purposes approved by the Division (paragraph 12), and the second, being the elimination of the prohibition on the use of IFR and CIP funds to pay for in-house IFR/CIP labor and overhead expenses (paragraph 13), sometimes also referred to as "capitalized" labor costs.

Under cross-examination with regard to the first issue, the Division's witness, Mr. Catlin, acknowledged that absent specific Commission approval, PWSB could not use "pay-as-you-go" or cash IFR funds for debt service on IFR projects. (T., p. 81). The Division supported lifting the restriction on using pay-as-you-go IFR funds for IFR debt service, Mr. Catlin explained, for two reasons. First, it would afford PWSB greater discretion to use long-term debt financing for IFR projects; second, it would enable PWSB to leverage the proceeds of long-term financing to pay for additional IFR project costs without the need for rate increases. (T., pp. 83-85). Mr. Catlin also opined that long-term debt financing was particularly appropriate to pay for large, single IFR projects with long-term benefits to customers, such as repair and improvements to the 90" aqueduct or treatment plant improvements, while pay-as-you-go funding was more appropriate to pay for ongoing, annual IFR expenditures for work on mains, hydrants, meters and valves, etc. (T., p. 80). He confirmed that under the Settlement, $2.2 million of IFR cash funding would be available for IFR debt service, in addition to the $10.285 million available in cash funding for pay as you go IFR projects, bringing the total amount payable from the restricted IFR account to $12.5 million. (T., p. 27).

With regard to the second issue of permitting in-house IFR and CIP costs to be capitalized and charged to the restricted IFR and CIP accounts, Mr. Catlin testified that the Settlement's cost of service reflected the addition of $524,739 in capitalized labor costs to the restricted IFR/CIP account totals. While conceding that the Commission had previously prohibited the charging of such costs to the restricted IFR/CIP accounts, Mr. Catlin pointed out that no additional costs would be added to PWSB's cost of service as a result. Rather, the Division expected that savings from the use of in-house IFR/CIP labor, in lieu of hiring an outside engineer, would effectively offset capitalized labor expenses. (T., p. 32). He also indicated that, although the $525,000 allowance .was not intended to constitute a cap or limit on the number of in-house personnel that could potentially be charged to the IFR/CIP accounts, the Division was not allowing for the addition of any employees other than an IFR engineering position in the Settlement. (T., p. 33).

Mr. Catlin testified that the primary reason for allowing the capitalization of such costs as part of the IFR/CIP programs was to more accurately reflect, for accounting purposes, the IFR/CIP program costs, including the costs of in-house IFR/CIP labor performed by PWSB's employees. (T., pp. 34-37). Mr. Catlin estimated that the $525,000 capitalized labor allowance would cover the costs of 8 – 10 existing full-time employees currently associated with IFR/CIP projects. (T., p. 37). However, under subsequent cross-examination, PWSB's Deputy General Manager, Mr. Titzmann, conceded that he had no idea how many positions in the rate year would be charged to the IFR account. (T., p. 109). On redirect examination, Mr. Titzmann committed PWSB to providing IFR/CIP reports that identify exactly how much capitalized labor would be charged to the IFR/CIP accounts. (T., p. 114).

IV. COMMISSION FINDINGS

At an open meeting conducted on December 6, 2000, the Commission considered the evidence presented in the case and found that, with certain modifications, the proposed Settlement was just and reasonable and in the best interest of ratepayers.

In particular, the Commission approved a cost of service of $41,147,456, which represents a $2,813,974, or 7.34%, increase in PWSB's total revenues. The Commission also approved the establishment, in accordance with prior Commission directives, of separate flat rates for each of PWSB's three retail rate classes, thereby eliminating the current two-step, declining block rates for all retail consumption. In light of long-standing Commission policies and directives established in prior PWSB dockets, however, the Commission majority[1] adopted certain modifications to the provisions of Paragraphs 12 and 13 of the proposed Settlement.

The Settlement cost of service provides $12.5 million in "pay-as-you go" funding for IFR projects, an increase of $1.5 million. Previously, the cost of service provided $2.2 million (20% of the IFR allowance) for debt service supporting IFR projects and $8.8 million (the remaining 80%) for pay-as-you-go IFR capital expenditures. In Paragraph 12 of the Settlement, the parties have agreed that PWSB can use restricted IFR funds for debt service on *any* Division-approved borrowings for IFR purposes. However, the Commission believes that such a blanket change in long-standing Commission policy

[1] The Commission majority in this Docket consisted of Commissioners Racine and Gaynor (Chairman Germani dissenting).

regarding the use of restricted IFR funds is not in the best interest of ratepayers at this time.

In Docket No. 2304[2], PWSB initially requested funding for its IFR program through a combination of available bond funds and $4.4 million in annual rate revenues. The IFR program as originally filed identified some $50 million of projects over the initial 5 years, and indicated that PWSB would be seeking some $10 million per year for IFR projects over the next 20 years. PWSB contended at the time that fully funding the IFR costs in annual rate revenues would be appropriate because, over time, cash or "pay-as-you-go" IFR funding would be less costly for ratepayers. At that time, the Commission took into account two compelling factors in approving the request for IFR funding on a pay-as-you-go basis. First, pay-as-you-go funding for a $10 million per year IFR program would clearly be less costly to rate payers in the long run than floating bonds on an annual basis. Second, PWSB had been, and was likely to continue to be, unable to obtain long-term financing through the city of Providence on a regular basis. Because of the magnitude of the IFR costs involved and the frequency with which PWSB would be required to float bonds, the Commission determined that pay-as-you-go funding was reasonable and in the best interest of ratepayers in carrying out the IFR program.[3] Since the issuance of the 1995 Order in Docket No. 2304, restricted IFR funds have not be used for debt service without prior Commission approval.

The Commission continues to be concerned with the impact on rates that would result from long-term bonding of all, or a substantial portion of, IFR program costs, which currently exceed $12 million per year.

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2 Report and Order No. 14881 (issued December 26, 1995).
3 Id., pp.116-18.

Mr. Catlin testified that long-term financing of IFR costs would allow the PWSB to leverage its IFR funding and undertake more IFR work without the need for another IFR rate increase. In particular, he was concerned that certain large IFR projects, such as the $5 million aqueduct project, take significant current dollars away from the IFR funding, leaving less cash or pay-as-you- go funding available for other required IFR projects. The Division, therefore, recommended that PWSB be allowed more discretion, subject to the Division's approval, regarding the use of current IFR funding for debt service on long-term financing, in order to enable PWSB to maximize the use of available IFR funds. (T., pp. 84-85).

The Commission is mindful that pay-as-you-go or cash funding of large IFR projects through the annual IFR allotment may deplete the funds needed to pay for ongoing smaller IFR projects that are scheduled to be completed in each year of PWSB's IFR Plan. We note that PWSB's three-year IFR program for fiscal years 2001 through 2003, presented in Mr. Gadoury's prefiled testimony, reflects over $10 million in annual IFR expenditures, a substantial portion of which will be for smaller, ongoing IFR projects of the type that would be scheduled for completion in each year of the IFR. We also agree with Mr. Catlin that debt-financing of larger IFR/CIP projects is appropriate. For example, the CIP program presented by Mr. Gadoury indicates the need to construct a $7 million parallel supply line to the Neutaconkanut Reservoir. Because this major project will provide long-term benefit to the system, it would be an appropriate subject for long-term debt financing. However, the Commission believes that, as a general matter, PWSB should continue to be required to file for its specific debt service requirements for such major projects, either in the context of a general rate filing or through the Commission's abbreviated rate filing process available to non-investor owned water companies, such as PWSB, for this express purpose.[4] This will ensure that, in accordance with established Commission policy, PWSB's rate revenues will continue to be sufficient to fund both its debt service requirements and its cash funding requirements for IFR projects required to be completed each year.

Notwithstanding the foregoing , the Commission finds it appropriate at this juncture to allow for some latitude in the use of IFR funds to service long-term debt. PWSB advises that it now expects to secure some low-rate, long-term financing from sources other than the City (i.e., loans from the Drinking Water State Revolving Fund). To minimize the rate impact of such allowance on ratepayers, as well as to ensure that adequate cash funding remains available for required IFR projects, however, the Commission will require that a significant portion of the current IFR funding continue to be restricted to cash funding of IFR projects, as originally requested by the PWSB in Docket No. 2304. Accordingly, the Commission will limit the amount of Division-approved annual debt service to be paid from IFR funds (inclusive of debt service on the $5 million loan for rehabilitation of the 90" aqueduct provided for in Paragraph 12 of the Settlement) to not more than 30% of the total annual IFR allowance of $12,500,000, or $3.75 million. This will ensure that a minimum of $8.75 million in annual cash funding remains available for IFR projects, and achieves a reasonable balance between PWSB's debt service requirements and the substantial cash funding requirements of its IFR programs.

In Paragraph 13 of the Settlement, the parties have agreed to allow PWSB to use IFR and CIP funds to pay for capitalized *in-house* IFR and CIP labor costs. Here again,

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[4] See §2.10 of the Commission's Rules of Practice and Procedure (May 1, 1998).

the Commission believes that a wholesale change in long-standing Commission policy regarding the use of restricted IFR/CIP funds is not in the best interest of ratepayers at this time. Five years ago, in Docket No. 2304, we rejected the Division's recommendation that PWSB be allowed to capitalize the portion of its in-house labor costs relating to capital projects. Instead, we endorsed PWSB's proposal to fully fund all wages and overheads from annual rate revenues, because we agreed with PWSB that capitalizing these costs through long-term bonding would impose additional financing costs on PWSB's ratepayers.[5] We also note that, in the five years since that decision, funding 100% of wages and overheads in rates has facilitated more explicit identification and tracking of the actual number of employees on the PWSB payroll, as compared the number of funded positions allowed in PWSB rates. This has been a matter of continuing concern to the Commission. While funding of wages and overheads through IFR would still allow for current charges against rate revenues, the Commission is concerned that permitting PWSB to capitalize any and all labor and overheads associated with IFR and CIP projects, as recommended by Mr. Titzmann at the hearing (T., p. 108), would make it more difficult for the Commission to track the number of actual employees vs. authorized positions. This concern is heightened by Mr. Titzmann's testimony at the hearing that he had no idea how many positions might be charged to IFR in the rate year. (T., p. 109).

However, in view of the testimony of the Division and PWSB that savings will be achieved through the use of in-house IFR engineers in lieu of outside consultants and that the cost of service will not be increased thereby, the Commission will permit the PWSB,

[5] In Docket. No. 2304, the Commission specifically directed that "no wages (nor related fringe benefit costs) be charged to the IFR funds. . . All wages and fringes shall, without exception, continue to be funded from revenues derived from rates." Report and Order (14881), at p.119. PWSB has confirmed in the

on a trial basis, to charge the labor and overhead costs for up to *three* in-house *professional* IFR and/or CIP positions to the IFR/CIP allotments. The Commission further directs that the PWSB file semi-annual reports detailing the savings that are being achieved by using in-house labor that is charged to IFR/CIP allotments. In addition, the semi-annual IFR / CIP reports shall identify the number of positions, as well as account for the amount of wages and overheads, charged to the IFR/CIP programs.

The Commission approves the continuation of the current restrictions on accounts, as provided in Paragraph 15 of the Settlement, and will restrict two additional accounts. The new restricted accounts are the Alternate Supply Source Study account ($150,000)[6] and the 102" Butterfly Valves account ($500,000). Any unused funds remaining in the latter account after completion of the project will revert to the restricted IFR account. The restricted accounts are as follows:

RESTRICTED ACCOUNTS	**AMOUNTS**
Meter Replacement/AMR Fund	$400,000
Alternative Supply Source Study	$150,000
Capital Improvements	$600,000
Vehicles and Equipment	$1,100,000
Debt Service:	
IFR	$2,215,055
Non-IFR	$2,001,333
IFR Pay-As-You-Go/Cash Funding	$10,284,944
Insurance	$359,000
102" Butterfly Valves	$500,000
TOTAL	**$17,610,332**

instant docket that it does not charge any employee labor or overheads to the restricted IFR or CIP accounts. (T., p. 108).

6 In view of the fact that the Alternative Supply Source Study is envisioned as a statewide study with statewide impact, the Commission at the hearing directed PWSB to distribute its preliminary position paper to PWSB's wholesale customers and to permit their participation in the study. (T., p. 44).

The PWSB shall continue to file semi-annual reports on its IFR/CIP program, restricted accounts, and fiscal operations (for periods ending June 30 and December 31 of each year). Also, reporting to the Commission and Division on the progress of AMR installations shall continue on a quarterly basis.

Finally, the Commission notes that the Division has recently opened a docket (Docket No. DD-00-21) to fully investigate PWSB's meter reading problems which affect not only the billings of PWSB but also those of the Narragansett Bay Commission. We note that at the hearing, PWSB acknowledged that promoting meter readers to the position of meter reader/technician has resulted in more AMR installations, but fewer meter reads. (T., p. 55). In the Settlement, the parties agreed that issues relating to PWSB's meter program will be addressed in the Division docket. In view of the fact that the Division's investigation has just begun, the Commission will defer consideration of matters relating to the AMR installations and meter reading practices pending the outcome of the Division's investigation. The Commission will review the Division's findings and recommendations and address issues relating to meters, billing, and expenses associated with the meter program in PWSB's next general rate filing.

Kate F. Racine, Commissioner

Brenda K. Gaynor, Commissioner