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APPLICATION OF

VIRGINIA-AMERICAN WATER COMPANY **CASE NO. PUE970523**

For a general increase in rates

REPORT OF HOWARD P. ANDERSON, JR.

HEARING EXAMINER

August 27, 1998

HISTORY OF THE CASE

On June 6, 1997, Virginia-American Water Company ("Virginia-American" or "the Company") filed an application with the State Corporation Commission for a general increase in rates. The Company's proposed rates are designed to produce additional annual revenues of $1,838,979, based on the Company's operations for the test year ending December 31, 1996.

By order dated June 27, 1997, the Commission suspended the Company's proposed rates; scheduled a public hearing on the application; and established a procedural schedule for the filing of pleadings, prepared testimony and exhibits.

Protests were filed by the City of Hopewell ("Hopewell" or "City") and the Hopewell Committee for Fair Water Rates ("Hopewell Committee" or "Committee"). At the request of the Prince William County Board of Supervisors, a local hearing was held in Prince William, Virginia, on December 10, 1997. The evidentiary hearing was convened on January 21, 1998, in Richmond. Counsel appearing were Richard D. Gary for Virginia-American, Edward L. Flippen for the City, John F. Dudley for the Hopewell Committee, and Marta B. Curtis and William H. Chambliss for the Commission Staff.

Proof of service was marked as Exhibit A and made a part of the record. Briefs were filed by the parties and the Commission Staff on March 20, 1998. A copy of the transcript is filed with this Report.

Public Witnesses

A total of sixteen public witnesses offered remarks regarding the Company's application. Several members of the Prince William County Board of Supervisors objected to the Company's frequent and regular efforts to increase its rates. Numerous witnesses expressed outrage at what they considered to be exorbitant rates charged by the Company compared to water rates in

neighboring communities. Melvin H. Meyer complained of the Company's numerous ("never-ending") rate filings. (Tr. 46). Angela Lemmon pointed out that this case represents the Company's fourth application for a rate increase in the past six years. (Tr. 55). In addition, James R. Jones, a developer, strongly objected to the Company's increased tap fees. Mr. Jones considered it particularly unfair that the Company can arbitrarily raise its tap fees from $333 to $1,100 prior to Commission approval. (Tr. 57, 58).

POSITION OF THE PARTIES

Initially, the Company requested an increase in revenues of $1,838,979, representing an annual increase in total operating revenues of 7.30%. After resolving a number of issues with Commission Staff and Protestants, the Company reduced its requested revenue increase to $938,009. The Company objects to Staff's two tax proposals which would benefit the Company's ratepayers through a parent company interest expense deduction and a consolidated tax adjustment. The Company and Hopewell have reached a post-hearing agreement on the City's proposed wastewater expense adjustment. However, the Company and Hopewell continue to disagree on the Company's affiliated charges for the test period. Finally, the Company argues that the average prime interest rate for each calendar quarter used to calculate the interest on refunds traditionally required by the Commission is substantially too high. Instead of the traditional prime rate, the Company requests that its refund interest rate be set at approximately 6%.

The Hopewell Committee joins the Company and Commission Staff in the agreed resolution of certain issues. However, the Committee takes issue with the allocation of actual maximum day demand for Fort Lee, a non-jurisdictional customer. The Committee argues that the Company's allocation results in an unreasonable allocation to jurisdictional customers in the Hopewell District. The Committee joins Staff in asserting that tax savings associated with parent company debt should be reflected as previously ordered by the Commission. However, the Committee takes issue with Staff's allocation of the new filters and clearwell. Based on the argument that industrial customers do not need any of this filtration system, the Committee states that industrial customers are being generous by agreeing to accept one-third of the cost allocation. The Committee urges adoption of the Company's proposal to allocate any increase in the Hopewell District on a 60.94% domestic and 39.06% industrial class basis. In conclusion, the Committee recommends that the Company be required to present, in its next rate case, all pro forma adjustments on a total District basis.

Hopewell generally supports the Staff's adjustments, with the exception of adjustments regarding the Company's waste disposal and affiliate expenses. Hopewell witness Trimble proposed an adjustment to reduce the Company's waste disposal expense by $45,364. After consulting with the Company, Hopewell and the Company propose deferred accounting for these revenues. The proposed deferred accounting would be in lieu of Mr. Trimble's proposed adjustment. (Hopewell Brief at 2). Further, Hopewell recommends that the Commission eliminate entirely the Company's affiliate expense, arguing that the Company failed to prove its reasonableness. In conclusion, Hopewell takes no position on Staff's consolidated tax savings adjustment.

The Commission Staff, based on its revised statements and schedules, supports an increase in annual revenues of $627,901, which will allow the Company to earn a 10.75% return on equity. By Districts, Staff recommends increases of $120,249 for Alexandria; $257,557 for Hopewell; and $250,095 for Prince William. Staff maintains that its adjustment recognizing federal income tax savings associated with the parent company's debt should be adopted. Staff further urges adoption of its adjustment recognizing a return on consolidated tax savings which recognizes the time-value of money ratepayers have provided the parent company. Staff requests that prior Commission decisions regarding the Dinwiddie Avenue tank, the use of Company mains assigned to Prince George County, and the allocation of costs of the Company's granular activated carbon contactors to the industrial rate class be affirmed.

While the Company, Staff and the Hopewell Committee disagree in several respects on the appropriate allocation of expenses between Virginia-American's jurisdictional and non-jurisdictional customers, agreement has been reached on the issues of tank painting, payroll and payroll tax adjustments, purchased water, the capitalization of certain items, and return on equity.

DISCUSSION

Tax Issues

The Company opposes both of Staff's tax adjustments for several reasons. First, the Company argues that these tax adjustments penalize Virginia-American solely because the Company's owner is a holding company. The Company also contends that the two adjustments violate the long-standing principle that a utility's cost of service should be based on its jurisdictional costs and revenues. The Company points out that Staff's adjustment regarding consolidated tax savings relies on the financial operations of dozens of other regulated and non-regulated companies owned by American Water Works throughout the United States. The Company maintains that ratemaking should be based on the actual cost of service to jurisdictional customers. More importantly, the Company asserts that adoption of these adjustments will preclude the Company from having a reasonable opportunity to earn the 10.75% return on equity agreed upon in this proceeding.

a. Staff Adjustment to Federal Income Tax Expense for Parent Company Debt

Virginia-American is a wholly owned subsidiary of American Water Works ("AWW"). As Virginia-American's parent, AWW provides capital for Virginia-American by means of debt secured and equity issued on the open capital market. Also, as sole owner, AWW draws dividends from Virginia-American which are used, or can be used, to pay the interest on the debt secured by AWW for investment in Virginia-American.[1] AWW claims this interest expense as a deduction on its federal income tax return.

[1]AWW acknowledges in its 1996 Annual Report, that it "pays all of its interest expenses . . . from the dividends received from investments in its subsidiary companies." (Company Application, Schedule 9, Page 31).

Staff argues that, since Virginia-American ratepayers fund AWW's interest payments through rates, it is only equitable for the ratepayers to share in the resulting tax benefit. Therefore, Staff proposes to eliminate from Virginia-American's cost of service $83,361[2] in federal income tax expense as a result of the interest deduction claimed by Virginia-American's parent AWW.[3]

The Company makes three points in opposition to the Staff adjustment:

1. The adjustment would penalize Virginia-American solely because it is owned by a corporation rather than a collection of individuals.

2. Dividends earned on the parent company's investment in Virginia-American belong to the parent company to use as it deems appropriate. Yet, Virginia-American's revenues are to be reduced because of the presumed use of the dividends by the parent to pay interest on its own debt for which neither Virginia-American nor its customers are responsible or obligated.

3. Staff's adjustment violates the "stand-alone" concept for capital structure previously employed by the Commission in prior Virginia-American cases.

The Company also faults the manner in which Staff calculates its adjustment. Specifically, the Company states that Staff's premise that the parent company's equity contributions in Virginia-American are supported by parent company debt to the same extent as it supports the equity in each of its many subsidiaries is incorrect. The Company first points out that Staff witness Carr acknowledges Virginia-American's equity at test year end consisted of 36% retained earnings ($10.2 million out of the $27.6 million of total equity). (Tr. 137). The Company points out that retained earnings are not funded by debt issued by the parent company; they are derived directly from Virginia-American's earnings in Virginia. Second, the percentage of retained earnings in each AWW subsidiary is different, therefore, Staff's use of a common factor for all of AWW's subsidiaries cannot be accurate.

Furthermore, the Company maintains that, since AWW has not issued debt to support equity infusions for Virginia-American since 1992, Staff's assumptions cannot be accurate. The Company also points out that Staff's adjustment does not take into account any issuance costs associated with debt incurred on behalf of Virginia-American. If, the Company concludes, these tax benefits were to flow down to Virginia-American without consideration of these corresponding expenses, the adjustment would be one-sided and obviously unfair. (Brief at 8).

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[2]Staff witness Carr began his calculation by dividing Virginia-American's shareholder equity ($27.6 million) by AWW's total equity investment in all of its subsidiaries ($1.261 billion) to determine that 2.19% of AWW's debt underlies Virginia-American's equity. Virginia-American's customers are then granted 2.19% of the calculated tax benefit from the interest deduction of AWW.

[3]The Company states that this adjustment would reduce the Company's revenue requirement by $132,249. (Brief at 3).

Staff maintains that the Company's proposal to include these modifications is contrary to sound ratemaking principles which recognize the equity method of accounting and further recognize that the parent's investment in its subsidiaries is supported by a mix of the parent's debt and equity. (Tr. 122, 123, 135). Staff witness Carr testified that it is improper to pick out a piece of AWW's investment in its subsidiaries and attribute particular financing to that piece. (Tr. 135, 137, 138).

Staff further argues that the Company's position also reflects inconsistent ratemaking treatment. First, in determining its revenue requirement, the Company applied its overall weighted cost of capital to all investments in rate base regardless of how the individual investments were financed. (Tr. 260, 261). Staff claims that now the Company proposes a different ratemaking treatment for the determination of Virginia-American's allocation of AWW's tax savings. Specifically, the Company suggests that the financing of Virginia-American's retained earnings, since acquisition, be recognized differently from other portions of AWW's investment. (Tr. 260; Ex. No. JES-2 at Exhibit 1; Ex. No. JES-30, at 3, 4).

Staff witness Carr maintains that there is no difference between an equity infusion from AWW and retained earnings on Virginia-American's books. He states that because AWW determines Virginia-American's dividend payout, retained earnings exist only because AWW has set a payout ratio below 100%. According to Mr. Carr, setting a payout ratio of less than 100% is no different than making an equity investment in the subsidiary. (See Tr. 122, 123; Ex. No. PWC-14, at 10, 11).

Although the Company opposes this adjustment, it recommends that the adjustment, if approved, be modified to include administrative expenses and general tax expense and reflect a different allocation methodology than the one proposed by Staff. Specifically, the Company suggests that its retained earnings since its acquisition by AWW not be considered in calculating the percentage of AWW's equity investment in Virginia-American. (Ex. No. JES-2, at 9; Ex. No. JES-30, at 2, 3, 4).

Company witness Salser further argues that the expenses the parent incurs in issuing its capital should be allocated to the utility for rate case purposes if the Commission continues to require recognition of the tax savings pertaining to the parent's debt. (Ex. No. JES-30, at 2, 3). In other words, Mr. Salser suggests that the parent's cost to raise capital should offset the tax savings to be shared with the utility's customers in Virginia.

Staff witness Carr responds to this point by explaining that, "Staff is not allocating any of the tax savings relating to [any] retained costs to Virginia-American ratepayers. It would certainly be improper to do so without allocating additional expenses. This adjustment simply allocates the tax benefit of a cost that the ratepayer is already paying through the return on equity." (Ex. No. PWC-14, at 10).

Further, Staff argues that the Company's proposal to include operating and administrative and general tax expense in Staff's adjustment is not supported by the evidence. Moreover, Staff contends that these costs have nothing to do with the tax benefits attributable to parent company debt. (Id.). Such costs are investment related costs incurred by AWW in the course of running its business and, as such, are properly funded by AWW stockholders. These costs also duplicate costs

already being paid by ratepayers pursuant to allocations approved in various affiliate agreements. (Id.).

In conclusion, Staff contends that its parent debt adjustment should be adopted as proposed because it recognizes the benefits of tax savings funded by ratepayers and is consistent with the Commission's decision in the Company's last rate case.

The Company, in summation, contends that the evidence in this proceeding shows (a) that a substantial portion of Virginia-American's equity has not been contributed by the parent company but rather consists of retained earnings not supported by or traced to the debt of the parent company and (b) that no debt has been issued by the parent company in many years in support of equity infusions into Virginia-American. Moreover, states the Company, Staff's adjustment does not "share" the tax benefits of the parent company debt arithmetically allocated to Virginia; but instead donates to Virginia-American all of the calculated tax benefits without even consideration of the costs required to be spent by the parent company to issue and maintain its outstanding debt. In conclusion, the Company argues that, since no costs associated with the debt have been paid by customers in Virginia, there is no reason to give the Virginia customers the tax benefits associated with that debt. (Brief at 4, 5).

The Commission approved this adjustment in the Company's previous rate case, PUE950003, and held that:

> tax benefits accruing to AWW are clearly supported by payments it receives from Virginia-American. The tax benefits in question are due solely to the debt of the parent that was invested in its operating subsidiaries and the Service Company.

Final Order at 7 (February 19, 1997).

I find no reason to depart from the Commission's prior decision on this issue. The Company's request that expense incurred by AWW in issuing capital be included in the adjustment should also be denied because the Company does not quantify these costs, if in fact they have been incurred. Staff's adjustment should be approved because it recognizes the benefits of tax savings funded by ratepayers and is consistent with the Commission's decision in the Company's prior rate case.

Company witness Salser's modifications should also be rejected. The first modification that a portion of operating expenses currently retained by AWW should be allocated to the Company's cost of service is without merit. Any costs allocable to Virginia-American are currently being allocated through various affiliate agreements. Any remaining costs are properly retained by AWW. Mr. Salser's second proposal that retained earnings be removed from Staff's calculations is also without merit. AWW has complete control over Virginia-American's dividend payout and retained earnings. Retained earnings exist only because AWW has decided to set a payout ratio below 100%. Setting a payout ratio of less than 100% is no different than making an equity investment in Virginia-American.

b. Recognition of a Return on Consolidated Tax Savings

Staff's proposed consolidated tax savings adjustment reduces the Company's cost of service by $93,512. This adjustment is based on additional savings to the parent company resulting from the Company's filing of a consolidated tax return with AWW. Staff's calculation of the consolidated tax savings adjustment reflects the tax liability for AWW and each subsidiary calculated on a stand-alone basis for each year between 1975 and 1996, the period for which reliable information is available. (Ex. No. PWC-14, at 12). AWW's annual tax benefit is then allocated each year, on a pro rata basis, to each subsidiary that generated tax liabilities for that year.[4] (Id. at 13). The purpose of this adjustment is to recognize a return on the cash benefit funded by ratepayers that AWW receives by filing a consolidated return with subsidiaries having taxable income. (Id. at 11).

Staff's adjustment reflects the positive tax liabilities of Virginia-American and other positive tax liability subsidiaries, which have resulted in AWW realizing tax benefits of over $56,000,000 between 1975 and 1996. Staff maintains that such benefits could not have been realized without a consolidated tax filing, because AWW, as a loss affiliate, would incur net operating loss deductions which could be only carried forward or backward to offset any of its stand-alone taxable income. Staff contends that its adjustment recognizes the time value of money benefit that ratepayers have provided to the parent company. (Id.).

Staff further maintains that its methodology for calculating consolidated tax savings is fair to Virginia-American ratepayers and does not prejudice the Company. Specifically, it is fair to ratepayers to recognize the cumulative benefit of savings they have funded for the years 1975 through 1996. Staff maintains that this methodology will continue to treat the Company fairly in the future whether the cumulative savings increase or decrease due to the parent company having taxable income. In the latter event, Virginia-American ratepayers would be allocated a lower return amount reflecting the decreased cumulative tax benefit. (Id. at 16).

The Company raises numerous objections to this adjustment. First, the Company argues that tax losses are incurred because of interest and expense tax deductions of the parent company and neither the interest nor the expenses are included in Virginia-American's cost of service. (Tr. 151). The Company maintains that the benefit to the parent company of filing a consolidated tax return is a function of the federal tax laws and is fundamental to the business and financial planning of virtually all major corporations with subsidiaries. According to the Company, Staff's proposal would nullify the value of filing a consolidated tax return as allowed by the federal government and would hijack that value and bestow it on customers in Virginia. (Brief at 9).

The Company strenuously objects to the fact that Staff goes back twenty years to evaluate the operations of over fifty of AWW's subsidiaries to derive this adjustment. (Ex. No. PWC-14, App. A, at 13; Tr. 152, 154). Specifically, the Company points out that Staff determined the tax liabilities for as many as fifty AWW subsidiaries in twenty-one states for each year since 1975. The purpose of these calculations is to determine the difference between the positive tax liabilities in

[4]The cumulative tax benefit of such allocations is determined for Virginia-American for the years 1975 through 1996 and the benefit is then multiplied by the Company's after-tax cost of capital to calculate the return ratepayers should receive on such benefit. (Ex. No. PWC-14, at 13).

each of these years for each of these subsidiaries as compared to the negative tax losses of the parent company due to interest payments as well as other operating costs such as maintaining and raising debt. (Tr. 150, 151). The Company points out that these diverse subsidiaries, some regulated and some not, are wholly outside the ratemaking process in Virginia.

The Company also points to this Commission's long-standing principle of stand-alone ratemaking. In *Application of General Telephone Company of the Southeast*, Case No. 19052, 1972 S.C.C. Ann. Rep. 107, 113, the Commission rejected the inclusion of a consolidated tax savings adjustment and instead, utilized stand-alone ratemaking principles in treating the Virginia utility as a separate jurisdictional entity.[5]

I find that this adjustment should be rejected. Staff's calculations in arriving at this adjustment reach back twenty years and incorporate numerous subsidiary companies outside of Virginia. In *Central Telephone Co. of Virginia v. State Corporation Commission of Virginia*, 219 Va. 863, 880-881 (1979), the Supreme Court of Virginia rejected a similar adjustment based on past events. There the Court held that "the Commission acted erroneously. . . to reflect alleged excess profits realized over a ten-year period by Service Company from its dealings with Central." The Court agreed with Commissioner Bradshaw's dissent stating that: "[A]pplicants should be able to rely on precedent and past regulatory policy and practices in preparing their applications. . .Fairness is a two-way street – to the consumer and the companies we regulate." *Application of Central Telephone Company of Virginia, et al*., Opinion and Order, Case No. 19773, 1978 S.C.C. Ann. Rep. 97, 109.

This opinion by the Court citing Commissioner Bradshaw's dissent is applicable to Staff's proposed consolidated tax adjustment in this proceeding. Certainly, a company should not be permitted to retroactively reconstruct over a period of twenty years, a basis for additional revenue from present customers. Yet, Staff reaches back 20 years and evaluates the operations of over 50 of AWW's subsidiaries (many unregulated) as a basis for this adjustment.

Affiliate Charges

The Company's booked affiliated expenses were $606,083 for the 1996 test year. These expenses cover services provided to Virginia-American by the American Water Works Service Co., Inc. ("Service Company"), also a wholly owned subsidiary of AWW.

Hopewell contends that the Company's failure to support the reasonableness of its affiliate charges should preclude its recovery of those expenses. Hopewell states that Virginia-American offered no evidence pertaining to the reasonableness of its affiliate charges, only the copies of affiliate agreements and monthly summaries of charges submitted during the test period. Therefore, Hopewell argues, the Company's affiliate charges cannot be accepted as reasonable because of the failure to present evidence on affiliate costs compared to market prices. Moreover, Hopewell argues that the Company also failed to present evidence that could be examined to verify the costs to the Service Company of providing service to Virginia-American. Hopewell cites *Commonwealth*

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[5]*See also Application of Virginia Electric and Power Company*, Case No. 19027, 1972 S.C.C. Ann. Rep. 56, 71; *Application of Virginia Electric and Power Company*, Case No. 19342, 1974 S.C.C. Ann. Rep. 206, 222.

Gas Services, Inc. v. Reynolds Metals Company, 236 Va. 362 (1988), where the Court stated "the Commission's approval of a service agreement pursuant to Code § 56-77 is not equivalent to a finding that the affiliate costs have been approved satisfactorily under Virginia Code Sections 56-78 and 56-79. Approval of a service agreement simply is a determination that the structure of the arrangement is in the public interest." (Id. at 367-368).

The Commission recently addressed this issue in *Application of GTE South Incorporated*, Case No. PUC950019, 1997 S.C.C. Ann. Rep.___ (August 7, 1997) ("GTE"), stating:

> Where it is most economical for the utility to purchase the product or service from the market, it should do so. Where it can save money by purchasing from an affiliate at the affiliate's cost, including a reasonable return for the affiliate on the sale, it should do that. Where the Company proposes that the Commission set rates based on charges from an affiliate, the charges must be based on the affiliate's cost, including a reasonable return, so long as this cost does not exceed the market price. The market test applied by this Commission and the Court is to test whether the affiliate's costs are reasonable.

Slip op. at 12.

The Commission specifically cites *Central Telephone Company of Virginia v. State Corporation Commission of Virginia*, 219 Va. 863, 881 (1979), where the Court stated:

> We do not question the duty of the Commission to determine what expenditures by a telephone company for equipment are reasonable, and in so doing to determine if an affiliate supplier's profit margin is excessive or that the prices charged are higher than those charged by a competing supply company.

The Commission specifically states that this passage describes exactly the determination that the Commission has made in the GTE case. (Slip op. at 13).

Hopewell charges that Virginia-American's reliance on the investigation of its affiliate charges in its last case, Case No. PUE950003, is misplaced. Instead, Hopewell contends that the Company has the burden of proving the reasonableness of its expenses in each case. Hopewell argues that there is no legal basis for the Company to rely in this case on Commission approval of its affiliate expenses in a previous case when the relevant transactions in this case differ from the transactions in the previous case. (Brief at 7).

The Commission' Rate Case Rules for Schedule 24, Affiliate Transactions state:

> Instructions: Provide a narrative description of the services received and/or provided for each type of affiliated transaction in which the applicant is involved. Provide a summary of all charges during the test period by affiliate, by month, and by type of transaction. Also, describe the basis of the allocations for all such charges.

Section 56-78 of the Code of Virginia states that payment or compensation to an affiliate may be disapproved unless satisfactory proof is submitted to the Commission of the cost to the affiliated interest rendering the service. Section 56-79 further states:

> No proof shall be satisfactory. . .unless it includes the original (or verified copies) of the relevant cost records and other relevant accounts of the affiliated interest, or such abstract thereof or summary taken therefrom, as the Commission may deem adequate. . . .

The statute then goes on to say that the Commission may, where reasonable, approve or disapprove such contracts or arrangements without the submission of such cost records or accounts.

Specifically, Hopewell charges that Virginia-American failed to "describe the basis for the allocation for all such charges." Therefore, Hopewell states that Virginia-American's Schedule 24 is incomplete, deficient, and in violation of the Commission's Rate Case Rules. (Brief at 8-9).

The Company responds that, given the nature of the services in question and Virginia-American's purchase of the services at cost, the affiliate charges are reasonable and the Commission's market test for establishing prudent affiliate charges is satisfied. The Company explains that Virginia-American purchases services from the Service Company in accordance with the terms and conditions established in their service contract, which was approved previously by the Commission. Pursuant to the contract, Virginia-American is billed by the Service Company at an amount equal to the costs expended by the Service Company in rendering service. No profit is included in these costs. (Tr. 109). The Company argues that, because the Service Company's charges do not include the built-in return or profit specifically permitted in the GTE South decision, they clearly fall well within the scope of affiliate charges deemed reasonable by the Commission.

I find that the Company's affiliate expenses in this case should be approved. In support of its proposed affiliate adjustment, the Company has provided substantial information concerning all invoices and charges between Virginia-American and its subsidiaries. Company witness Salser provided detailed information regarding the Company's affiliate expenses. (Tr. 257, 258). The Company has provided adequate information in this case to find that the affiliate charges are reasonable. Moreover, these services are provided at cost to Virginia-American with no profit margin applied by the Service Company.

In contrast to GTE, in which services were rendered by affiliates with large markets external to the GTE system and in which market price comparisons were readily available, the services

provided to Virginia-American involve primarily internal functions for which there is no readily ascertainable market. The Service Company provides accounting, administration, communication, corporate secretarial, engineering, legal, financial, human resources, information systems, operations, rate and revenue, risk management, and water quality service exclusively to AWW affiliates. These services have been scrutinized in previous cases and found to be reasonable.

In particular, the issue of affiliate charges was litigated extensively in the Company's last rate case, Case No. PUE950003. In that case, Staff retained the Washington Utility Group to conduct an extensive study regarding affiliate expenses and the Company engaged the services of Baryenbruch & Company to perform an analysis of the services and charges rendered by the Service Company to Virginia-American. To require the Company to go to these lengths in each case would be costly and unnecessary.

Points of Agreement

At the hearing, Staff witness Carr explained the accounting issues that were settled between Staff and the parties. First, as to tank painting, Mr. Carr explains, that effective November 3, 1997, (the effective date of rates established in this case) the Company will write off the balance of the deferral currently on the Company's books and the Company will accrue $72,000 to its tank painting reserve annually until the year in which it begins painting tanks. At that point, the accrual will be based on a rolling historic five-year average. The only modification from Staff's original adjustment is the amount of the accrual during the period before Company begins painting its tanks.

The parties have agreed to accept Staff's payroll and payroll tax adjustments, with certain modifications proposed by Company witness Fuller in his rebuttal testimony. The personal and payroll modifications taken into account are only those occurring prior to September 1, 1997. In his rebuttal testimony, Mr. Fuller explains that, during both the pro forma year and the rate year ending November 2, 1998, there will have been 261 working days, which translates to 2,088 hours instead of the 2,080 hours used by Staff. The jurisdictional amount of this adjustment by District results in an increase of $2,157 to Alexandria; $4,011 to Hopewell; and $1,119 to Prince William.

Mr. Fuller further explained that the Company, in the Alexandria and Prince William Districts, had two employees whose service time with the Company accorded them a $1/hour increase in accordance with the union contract. These two changes would result in $3,231 in jurisdictional operation and maintenance ("O&M") payroll, broken down between Alexandria ($3,174) and Prince William ($57). In Hopewell, two employees' step increases were not recognized. These increases would increase jurisdictional O&M payroll in Hopewell by $2,275.

The other adjustments offered by the Company and accepted by Staff and the parties are minor. First, Staff did not factor the effects of the resignation of a Northern Virginia employee. Staff correctly excluded the employee that resigned but did not include the resulting promotion of three remaining employees. The effect of these changes are an additional $369.00 allocated to the Alexandria District and $1,304.00 to the Prince William District. Second, Staff again correctly reflected the retirement of an employee in the Hopewell District, but did not provide for his replacement who was hired in November of 1997 at the hourly rate of $14.46. This results in an increase of $26,005.00 for the Hopewell District.

Finally, Staff inadvertently allocated one new employee to the Hopewell District that should have been spread between the Alexandria and Prince William Districts. These changes necessitate increases in payroll taxes (FICA only) as follows: Alexandria - $1,924; Hopewell -$616; and Prince William- $454.

Staff and Protestants also agreed to accept the Company proposals as set forth in Company witness Sorbello's rebuttal testimony regarding purchased water expense and the Company's proposals to capitalize certain items as set forth in Company witness Edgemon's rebuttal testimony. (Tr. 120, 121). Company witness Sorbello proposes that a methodology consistent with that used by Staff to calculate purchased water expense for the Alexandria District should be used for the Prince William District as well. This results in a downward adjustment of $108,399 for purchased water expense in the Prince William District. (Ex. No. JTS-27, at 2, 3).

Company witness Edgemon disagreed with Staff's capitalization of five items on the books of the Alexandria District:

(1) The Northern Virginia Planning District Commission involves an expense of $14,944, which is an ongoing expenditure for the management of the Occoquan watershed.

(2) The Northern Virginia Planning District Commission also involves an expense of $10,353 which represents a multi-year commitment for the upgrade of the computer model of the Occoquan watershed.

(3) Another item entitled "Dresser Manufacturing" involves $1,205 for a 20-inch diameter repair clamp utilized in the routine repair and maintenance of 20-inch water mains.

(4) Jones Roofing Company was paid $1,137 to repair a roof drain in the Alexandria operations center. This repair to the building's roof will not substantially extend the life of the building.

(5) Keenan Mechanical Services was paid $1,715 for the repair of the air conditioner for the Alexandria office building. The parts involved do not represent a unit of property but are instead repair items.

Staff agreed with Mr. Edgemon that these items should be expensed. I find that the resolution of all of the items agreed upon as set forth in this section is reasonable and should be adopted.

Wastewater Adjustment

Hopewell takes exception to Staff's proposed adjustments regarding the Company's waste disposal expense. Hopewell witness Trimble proposed an adjustment to reduce the Company's waste disposal expense by $45,364. (Tr. 222). Mr. Trimble's adjustment reflects Virginia-American's share of revenues received as a refund from the Hopewell Regional Waste Treatment Facility. Specifically, Mr. Trimble used the Hopewell Regional Wastewater Treatment Facility's 1997-98 Summary of Forecast Revenues which indicates a pro forma expense level that is $17,331

lower (on a jurisdictional basis) than the amount proposed by the Company. Mr. Trimble states that his adjustment is based on more current information than was available to the Company when it filed its application. (Ex. No. DWT-22, at 8).

Company witness Edgemon explained that the actual refund amount, if any, owed to Virginia-American is uncertain as the financial results of the Hopewell Regional Waste Treatment Facility for the 1998 fiscal year have not yet been determined. (Tr. 247). A letter from the Hopewell Regional Wastewater Treatment Facility to the Company dated January 19,1997, confirmed that the level of revenues from outside sources is not currently known and that expenses or other operating and maintenance reserves may increase to offset the additional revenues. (Tr. 246, 249; Ex. No. STE-29). Thus, the Company contends that it is undetermined at this time if it will receive a refund. The Company further points out that, pursuant to § 56-235.2 of the Code of Virginia, any adjustments or expenses that are speculative or cannot be predicted with reasonable certainty are prohibited.

The Company and Hopewell have discussed this adjustment further since the record closed and have agreed that the most appropriate ratemaking procedure would be to true-up the Company's costs involving the Hopewell Regional Wastewater Treatment Facility each year. To implement this process, the Company would record to Account No. 186.22 – Sewer Authority Expenses, in 1998 and each year thereafter until the Company's rates are changed, the difference between the 1998 fiscal year budgeted cost of $643,007 (per Staff report) and the audited actual cost charged by the Hopewell Regional Wastewater Treatment Facility to Virginia-American – Hopewell District. This cost would then be multiplied by the jurisdictional factor, which is currently 92.75% to arrive at the final adjustment. The Company would reflect the balance in Account No. 186.22 in the Company's next rate case application for amortization over a two-year period.

The Company and Hopewell as noted above, have agreed on a deferral mechanism for this cost of service item. However, the Commission generally provides for deferral treatment only in instances where the cost is voluminous and volatile. I find that this expense item does not meet those requirements and therefore should not be afforded deferred accounting treatment. In this case Staff's expense level of $643,007 is based on the most current information available, which is consistent with treatment approved by the Commission in the past. There is no need to depart from that treatment in this case, therefore Staff's adjustment should be adopted.

Cost of Capital

Staff, Protestants and the Company have agreed to accept a cost of equity range of 10.25% - 11.25% with the midpoint of the range, 10.75%, to be used in determining the Company's revenue requirement. Staff's proposal for use of an actual end of test period December 31, 1996 capital structure, which includes 49.590% long-term debt, 4.020% preferred stock, 43.680% common equity, and 2.710% investment tax credits, was also accepted by the parties.

Prior to the agreement with Company and the Protestants, Staff witness Ballsrud suggested a cost of equity estimate for Virginia-American of 10.00% to 11.00%, with an overall cost of capital of 9.016% to 9.466%. With a 10.50% cost of equity midpoint, Staff's overall cost of capital was 9.240%. Company witness Phillips initially recommended a return on common equity of 11.75% as

necessary to preserve Virginia-American's financial integrity (Ex. No. CFP-6, at 26). Dr. James R. Haltiner, testifying on behalf of Hopewell and the Committee, did not present studies on the Company's cost of capital. Dr. Haltiner instead critiqued Dr. Phillips' studies and resolved that his cost of capital proposals were too high. (Ex. No. JRH-21).

I find the agreed upon return on equity range with a midpoint of 10.75 and the resulting overall weighted cost of capital of 9.353% to be reasonable in this case.

Jurisdictional Allocation

The Company, Staff and the Hopewell Committee disagree in several respects on the appropriate allocation of expenses between Virginia-American's jurisdictional and non-jurisdictional customers. Issues raised include: (1) the appropriate methodology for estimating individual customer class demand; (2) whether any expenses associated with the Dinwiddie Avenue Storage Tank should be allocated to Fort Lee, a non-jurisdictional customer; (3) what, if any, portion of the Company's domestic transmission and distribution mains should be allocated to the Prince George County resale customers; and (4) the appropriate allocation of the jurisdictional costs of the Company's new filters, carbon contactors and clearwell between the industrial and domestic customers in Hopewell.

Individual Class Demands

Hopewell Committee witness Watkins contends that the Company's jurisdictional cost-of-service study for the Hopewell District overstates its jurisdictional revenue requirement because it underestimates non-jurisdictional load, thereby overestimating the relative jurisdictional cost responsibility.[6] Specifically, Mr. Watkins disagrees with the Company's allocation of 0.880 million gallons a day ("MGD") as Fort Lee's maximum day demand. According to Mr. Watkins, this assumption significantly underestimates the actual maximum day demand for Fort Lee, resulting in an unreasonable allocation to jurisdictional customers in the Hopewell District. Mr. Watkins contends that a reasonable estimate of Fort Lee's maximum day demand is 1.5 MGD and states that the Commission should accept this allocation for four reasons:

1. The Company's contract with Fort Lee expressly reflects a maximum day demand of 2 MGD. Thus, the Company has committed to providing this level of service, and to having the facilities and capacity available to fulfill its 2 MGD obligation.

2. The Company and Staff, which accepted the Company's 0.880 MGD allocation, provide no reasonable justification as to why 1.5 MGD

[6]The Hopewell District has only one non-jurisdictional industrial customer, the Hopewell Waste Water Treatment Facility. The domestic system, however, serves several non-jurisdictional customers including Fort Lee; a federal correctional institution; a large state regional jail; other federal, state and local governmental offices and schools; and Prince George County, which is a sales-for-resale customer. In addition, the Company provides public fire protection service to the City of Hopewell and to portions of Prince George County.

does not represent the actual maximum day demand experienced by Fort Lee.

3. The Company's 0.880 MGD allocation is in direct contradiction to actual usage reported by Fort Lee personnel. Mr. Watkins states that Fort Lee engineering and utilities personnel confirmed the actual purchase of 3 MGD for one or two days each summer. (Ex. No. GAW-20, at 15; Tr. 204). Since Fort Lee receives water from the Company and the City of Petersburg and pumps equally from each source, Mr. Watkins claims that his allocation of 1.5 MGD as a maximum day demand is thus validated.

4. Mr. Watkins further explains that the Company determined maximum day ratios for each class by comparing its estimated maximum day demands over average day demands; consequently, the closer the ratio is to "1," the higher the load factor for that class. The Company calculated a load factor for the Industrial System of 1.3; comparatively, using its estimated 0.880 MGD maximum day, the Company calculated a load factor for Fort Lee of 1.4. (Ex. No. GAW-20, at 8). Although the load factors for the Industrial System and Fort Lee would appear to be similar, Mr. Watkins contends that this is not the case. For example, the Industrial System customers use water for process purposes, running approximately 24 hours per day, at an almost constant load. On the other hand, Mr. Watkins points out that water consumption at Fort Lee, which includes swimming pools, homes, a golf course, and watered lawns, is very volatile with large use surges during periods of hot and dry weather. Therefore, argues Mr. Watkins, the load factor for Fort Lee is not even closely equivalent to that of the Industrial System and the maximum day assumption of 0.880 MGD for Fort Lee produces an unreasonable result.

I find that an allocation of 0.880 MGD for Fort Lee is reasonable. Mr. Watkins' estimate of Fort Lee's maximum day demand is entirely inconsistent with the basis used by him to estimate the maximum day demand for other customer classes. Furthermore, his maximum day demand factor for Fort Lee is based on unsupported daily demand estimates purported to have been made by Fort Lee personnel. Mr. Watkins' maximum day usage for the other non-jurisdictional customers is estimated from average day usage during their maximum month, an entirely different methodology. Lastly, Mr. Watkins deducts the sum of the non-jurisdictional demands from the domestic system's test year maximum day level and the jurisdictional domestic system maximum day demand "falls out." This is yet another entirely different methodology for estimating the maximum day demand for a customer class.

Moreover, as evidenced by the Company's Exhibit No. TGM-32, which tests Mr. Watkins' peak summer daily demand, an estimate for Fort Lee of 1.5 MGD for two consecutive days would reflect an extraordinarily low usage rate for the remaining days in that month. Staff reviewed the Company's usage data and methodology for deriving allocation factors and found them to be reasonable. I find that an allocation of 0.880 MGD for Fort Lee is reasonable and should be

adopted in allocating system cost for the Hopewell District. Finally, as noted below, Fort Lee has its own water storage system which serves to eliminate spikes in demand as portrayed by Mr. Watkins.

Dinwiddie Avenue Tank Allocation

As approved in the Company's last rate case, Staff witness Stevens allocated a portion of the costs of the Dinwiddie Avenue storage tank to Fort Lee, a non-jurisdictional customer. Based on information from a prior case, Staff contends that the Dinwiddie Avenue tank was built adjacent to Fort Lee in order to dampen surges in the Company's distribution system caused by the on-off cycling of Fort Lee's booster pumps. Staff contends that, without the presence of the storage tank, Fort Lee's operations could be impacted or damage to Company assets could result. Staff, therefore, allocates a portion of the Dinwiddie Avenue tank operation and maintenance expense to Fort Lee.

The Company disagrees with this adjustment. It asserts that, in making this adjustment, Staff and the Committee overestimate Fort Lee's reliance on the tank and ignore the significant benefits enjoyed by the Company's domestic customers in Hopewell from the use of Fort Lee's transmission line. The Company points out that Fort Lee does not depend on the Company's storage facilities in Hopewell to meet any of its water needs. Fort Lee owns and maintains a distribution and storage system which includes 2.2 million gallons of storage capacity. The Company points out that this storage capacity existed prior to the construction of the Dinwiddie Avenue tank and is sufficient for Fort Lee's needs, including fire demands. (Ex. No. STE-1, at 13; Ex. No. TGM-31, at 10).

The Company further points out that jurisdictional customers enjoy a significant benefit from interconnections to the Fort Lee transmission main, with no resulting charge from Fort Lee. (Ex. No. STE-1, at 13). As explained by Company witness Edgemon, jurisdictional customers would experience reduced flows and pressures prior to the interconnection of the Company's mains with the Fort Lee main. Therefore, the Company's jurisdictional customers are enjoying a high level of service because of the interconnection with the Fort Lee main. (Ex. No. STE-28, at 6).

In the Company's previous case, PUE950003, Staff's allocation of 20.88% of the costs and rate base associated with the Dinwiddie Avenue tank to Fort Lee was approved as reasonable. I find no compelling reason to depart from that decision in this case. Therefore, Staff's allocation, as approved in the previous case, should be confirmed in this case as well.

Transmission and Distribution Mains

In a similar adjustment, Staff allocated a portion of distribution main operation and maintenance expense to the Prince George County Service Authority ("Prince George"). Prince George buys water from Virginia-American, but has no dedicated main through which it receives this water. The water reaches the Prince George meter after flowing through numerous Company distribution mains. Staff argues that the resulting demand on the distribution system is properly assigned to Prince George and not to the Company's ratepayers.

The Company, on the other hand, argues that Prince George should not be assigned a full percentage of the costs associated with the Company's mains, but should be assigned only a portion of the costs of the distribution mains sufficient to cover that part of the Virginia-American system serving Prince George because Prince George provides its own distribution mains. Company witness McKitrick provided a detailed analysis of the Company's investment, by which he calculates a specific allocation for Prince George. Based on Mr. McKitrick's calculation, only $136,268 should be allocated to Prince George, and the remainder of the $236,187 net plant investment should be allocated to the domestic system. (Ex. No. TGM-33). Mr. McKitrick assigns between 50% to 90% of the eight mains listed in his exhibit to Prince George. However, at the hearing, Mr. McKitrick acknowledged that there might be additional hydraulic flows on additional pipes. (Tr. 279).

In this instance, the Company inappropriately bases its allocation on proximity to the system plant. I find that Staff's cost allocations as adopted by the Commission in the Company's prior rate case should be approved in the present case.[7] Under Staff's allocation methodology, a residential customer who lives next door to the system plant pays the same rate as the residential customer living at the far reaches of the system. This example portrays the generally accepted premise that distribution costs are most appropriately allocated on the basis of maximum demand regardless of proximity to the system plant.

Allocation of New Filters, Clearwell and Carbon Contactors

There is significant disagreement between Staff, the Hopewell Committee, and the Company regarding the appropriate allocation of the depreciation expenses and rate base associated with the Company's new filters and 2.5MG clearwell. Although Staff and the Committee basically agree on allocation of the cost of the carbon contactors, the Company assigns more of this cost to the industrial customers. Historically, the new filters and carbon contactors have been considered common facilities that could be used interchangeably by the domestic and industrial service classes. Based on the Commission's historic treatment of these accounts, coupled with the increased reliability and improved water quality that necessarily will flow through to the industrial customers, Staff allocated the costs associated with these items based on maximum day demand. Specifically, Staff assigned $4,362,873 for the new filters and $789,007 for the clearwell, or approximately 85% of the total costs of these facilities to the Hopewell industrial customers. In addition, Staff allocated two-thirds of the carbon contactors to the domestic system and one-third to the industrial customers. (Ex. No. JAS-16, at 13, 14). Staff's position in regard to the allocation of the new filters, clearwell and carbon contactors is consistent with the Commission's decision in the Company's two prior cases.

In contrast, the Hopewell Committee argues that the industrial customers neither want nor need the new filtration capacity and proposes allocation of only one-third of the total cost of these facilities, or $1,840,543 of the new filters, $332,854 for the clearwell, and $927,620 for the contactors to the industrial jurisdictional customers. (Ex. No. GAW-20, at 19; Sch. 2, p. 3).

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[7] *See Application of Virginia-American Water Company*, Case No. PUE950003, 1997 S.C.C. Ann. Rep. __ (February 19, 1997); *See also* Report of Howard P. Anderson, Jr. at 27 (December 13, 1996).

The Company allocated its investment in new filters, carbon contactors and clearwell between its jurisdictional customers in Hopewell using a demand allocation factor based on the maximum design capacity of the new filters. This methodology assigns primary responsibility for these items to the domestic service class. As is shown in the following table, the Company's allocation is approximately midway between that of Staff and the Committee.

Allocation to Industrial Customers	**New Filters**	**Clearwell**	**Contactors**
Staff	$4,362,873	$789,007	$1,008,022
Hopewell Committee	$1,840,543	$332,854	$ 927,620
Company	$2,883,033	$521,384	$1,579,988

In the Company's previous rate case, PUE950003, one-third of the cost of the carbon contactors was allocated to the industrial class, based on a filter capacity rating at that time of 9 MGD. As previously stated, Staff witness Stevens allocates 14.9% of the jurisdictional cost of the new filters and clearwell to the domestic class and all of the remainder, 85.10%, to the industrial class. (Ex. No. JAS-16, at 14). In contrast, Committee witness Watkins allocates two-thirds of the cost of new filters and clearwell to the domestic customers and one-third to the industrial customers. Mr. Watkins basically uses the same allocation as Staff for the carbon contactors.

Committee witness Watkins also notes that the Virginia Health Department recently upgraded the licensed capacity of the new filters to 12 MGD and renews the Committee's position that the industrial customers do not want or need the new facilities because they receive service from a separate filtration system, (the old wood tub filters, and their own separate clearwell) which are fully allocated to the industrial class.

Staff acknowledges that the capacity rating of the new filters presently approved by the Virginia Department of Health has increased from 9 MGD to 12 MGD. However, as a practical matter, Staff believes that this additional capacity is not required by either the industrial or domestic classes at this time nor does it change the manner in which the costs and rate base associated with the carbon contactors are incurred. (Ex. No. JAS-16, at 13). Therefore, Staff bases its allocation on 9 MGD rather than the currently rated 12 MGD.

Staff argues that the industrial customers should share in the cost of the new filters and the clearwell. Water from the new filters can be diverted to the industrial system, if the need arises, and therefore the new filters and the clearwell provide some measure of reliability to the industrial customers. Committee witness Watkins recognizes that the industrial customers do receive some measure of reliability from the ability to divert water from the domestic to the industrial system, and for this reason, assigned one-third of the cost of the new filters and clearwell to the industrial class and two-thirds to the domestic customers. However, Mr. Watkins maintains that "it defies logic" that the industrial customers should pay 85% of the cost of the new filters and clearwell when the industrial customers only receive back-up or "reliability" service from the new facilities. He points out that the domestic customers have a design maximum day demand in excess of 6 MGD and are only served through the new filters. Mr. Watkins considers his allocation of one-third of the cost of

the new facilities to the industrial customers to be "very generous" considering that increased reliability is the only reasonable basis to assign such costs to the industrial class. (Tr. 207).

The Commission, in the Company's prior rate case, determined that the clearwell and filters should be considered common facilities and allocated based on the system's maximum day demand.[8] Although the maximum day consumption rating has risen to 12 MGD, Staff continues to use a maximum day consumption rating of 9 million gallons in its allocation of cost associated with the carbon contactors because, in Staff's opinion, the additional capacity is not presently needed.

I find that Staff's allocation methodology is fair and reasonable. The manner in which the costs associated with the carbon contactors are incurred has not been changed by the addition of filter capacity not currently needed to provide service, therefore the allocations should be based on a maximum day rating of 9 million gallons. The majority of the cost for the carbon contactors is assigned to the domestic customer class since they are the primary beneficiaries. Continued use of a maximum day consumption rating of 9 million gallons provides for allocation consistent with prior cases and does not unduly burden either the domestic or industrial classes.

Service Connection Fees

The Company has agreed to accept Staff's recommendation to revise its tariff language regarding contributions in aid of construction to allow the collection of these costs, plus applicable taxes, as they are incurred by the Company in the future. (Brief at 30).

Staff points out that, since the Company is not certain at this time whether the service connection fees fall within the classification of contributions in aid of construction and as such are non-taxable, it is improper to include the potential cost associated with federal income taxes directly in its connection charges. As an alternative, Staff recommends that the costs associated with federal income taxes be removed from the actual service connection charges and that the Company modify its tariff language to allow it to recover any actual costs associated with federal income taxes if any should occur. Specifically, Staff recommends the following service connection charges:

Service Connection Charges

Alexandria	$789.00
Hopewell	$760.00
Prince William	$734.00

I find that Staff's proposed service connection charges are reasonable and should be adopted. Staff's charges are based on the Company's proposed charges less its gross-up for federal income taxes at the rate of 35 percent.

[8]This determination followed the decision reached in Case No. PUE900017.

REVENUE REQUIREMENT

Staff recommends that Virginia-American receive a $627,901 increase in revenues (Ex. No. PWC-14, Statement II – Revised; Tr.119). By operating District, Staff recommends an increase of $120,249 for the Alexandria District; an increase of $250,095 for the Prince William District; and an increase of $257,557 for the Hopewell District. Staff contends that its recommended revenue increase will allow the Company to earn a 10.75% return on common equity, as agreed to by Staff and the parties. Staff further recommends a rate base of $22,425,745 for the Alexandria District; $14,380,121 for the Prince William District; and $22,094,747 for the Hopewell District. A return on rate base of 9.35% for all three Districts is Staff's final recommendation.

The Company, on the other hand, requests an overall increase in rates of $938,009, apportioned as follows:

Alexandria	$222,487
Hopewell	$409,588
Prince William	$305,934

The Company maintains that this increase will ensure the continued high quality water service at reasonable rates to all of its customers.

I find, based on the adjustments found reasonable herein, that the Company should be afforded an overall increase in rates of $776,251, and that the following apportionment by District should be adopted:

Alexandria	$171,912
Hopewell	$329,596
Prince William	$274,743

MISCELLANEOUS

The Committee points out that the Company, in this case, calculates certain pro forma adjustments only on a jurisdictional basis. (Ex. No. GAW-20, at 5). In the future, the Committee requests that the Company should be directed to first present all pro forma adjustments on a total District basis and then allocate the adjusted amounts to jurisdictional and non-jurisdictional business. In support, the Committee contends that to accept the pro forma adjustments calculated by the Company on a jurisdictional basis, a party to the rate case is forced to either accept the Company's jurisdictional cost allocations or perform complex and costly calculations. Thus, to facilitate proper analysis and comments in the Company's next rate proceeding, the Committee requests that the Company be directed to present pro forma adjustments on a total District basis. (Brief at 16, 17).

I find that the Committee's request for future pro forma adjustments to be presented on a total District basis with adjusted amounts allocated to jurisdictional and non-jurisdictional business to be reasonable and should be adopted.

INTEREST ON REFUNDS

The Company argues that the average prime interest rate for each calendar quarter used to calculate interest on refunds traditionally required by the Commission is substantially too high for use in this proceeding. The Company explains that, during the period from November 1997, when the new rates went into effect, until March of 1998, prime rates have averaged approximately 8.5% while the Company's average short-term borrowings have averaged approximately 6.0%. Since the additional revenues produced by the interim rates effectively replace only short-term borrowings, the Company maintains that the short-term rate is more appropriate to use for refunds than the prime rate. For that reason, the Company requests that a refund interest rate of no more than approximately 6.0% be used in this proceeding.

I find that interest on the Company's refunds should be calculated as set forth below in Finding (18). This calculation follows the customary procedure used by the Commission.

FINDINGS AND RECOMMENDATIONS

Upon consideration of the evidence in this case, I find that:

(1) The twelve months ending December 31, 1996, is an appropriate test period for this case;

(2) The Company's test year operating revenues, after all adjustments, were $25,236,174;

(3) The Company's test year operating revenue deductions, after all adjustments, were $20,208,911;

(4) The Company's test year net operating income and adjusted net operating income, after all adjustments, were $5,027,263 and $5,019,936, respectively;

(5) The Staff's proposed accounting recommendations and adjustments, except as modified herein, are just and reasonable and should be adopted;

(6) The Company should provide journal entries documenting its compliance with Staff's booking recommendations within sixty days of the issuance of a final order in this case;

(7) The points of agreement on accounting issues reached between Staff and the Company are reasonable and should be adopted;

(8) The Company's current rates produced a return on adjusted end of test period rate base of 8.52%, and a return on equity of 8.85%;

(9) The Company's current cost of equity is between 10.25% and 11.25%, and the midpoint of the range, 10.75%, should be used to calculate the Company's overall cost of capital and revenue deficiency;

(10) The Company's overall cost of capital, based on the December 31, 1996 capital structure of Virginia-American and a 10.750% cost of equity, is 9.353%;

(11) The Company's end of test period rate base, after all adjustments, is $58,900,613;

(12) The Company requires additional gross annual revenues of $776,251 to earn a reasonable rate of return on rate base;

(13) The $776,251 rate increase should be allocated as follows: Alexandria - $171,912; Hopewell - $329,596; Prince William - $274,743;

(14) The Company's rate design and terms and conditions of service should be modified in accordance with the recommendations contained in this Report;

(15) The Company should file permanent rates designed to produce the additional revenues found reasonable herein using the revenue apportionment methodology recommended in this Report;

(16) The Company, in the future, should be required to present all pro forma adjustments on a total District basis and then allocate the adjusted amounts to jurisdictional and non-jurisdictional business;

(17) The Company should be required to promptly refund, with interest, all revenues collected under its interim rates, effective November 3, 1997, in excess of the amount found just and reasonable herein; and

(18) Interest upon the refunds should be computed from the date payment of each monthly bill was due during the period the interim rates were in effect and subject to refund until the date the refunds are made, at an average prime rate for each calendar quarter. The applicable average prime rate shall be the arithmetic mean, to the nearest one-hundredth of one percent, of the prime rate values published in the Federal Reserve Bulletin, or in the Federal Reserve's "Selected Interest Rates" (Statistical Release G.13), for the three months of the preceding calendar quarter.

I therefore ***RECOMMEND*** that the Commission enter an order that:

(1) ***ADOPTS*** the findings contained in this Report;

(2) ***GRANTS*** the Company an increase in gross annual revenues of $776,251;

(3) ***DIRECTS*** the prompt refund of amounts collected under interim rates in excess of the rate increase found reasonable herein, and

(4) ***DISMISSES*** this case from the Commission's docket of active cases and passes the papers herein to the file for ended causes.

COMMENTS

The parties are advised that any comments (Section 12.1-31 of the Code of Virginia and Commission Rule 5:16(e)) to this Report must be filed with the Clerk of the Commission in writing, in an original and fifteen (15) copies, within fifteen (15) days from the date hereof. The mailing address to which any such filing must be sent is Document Control Center, P. O. Box 2118, Richmond, Virginia 23218. Any party filing such comments shall attach a certificate to the foot of such document certifying that copies have been mailed or delivered to all other counsel of record and to any party not represented by counsel.

Respectfully submitted,

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Howard P. Anderson, Jr.
Hearing Examiner