BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF ARTESIAN WATER COMPANY, INC. FOR AN INCREASE IN WATER RATES (FILED FEBRUARY 5, 2004)	)	PSC DOCKET NO. 04-42
IN THE MATTER OF THE APPLICATION OF ARTESIAN WATER COMPANY, INC., FOR EXPEDITED RATE CHANGE FOR PURCHASED WATER COSTS (FILED AUGUST 16, 2005)	)	PSC DOCKET NO. 05-293

FINDINGS, OPINION AND ORDER NO. 6911

BEFORE COMMISSIONERS:

ARNETTA McRAE, Chair
JOSHUA M. TWILLEY, Vice Chair
JAYMES B. LESTER, Commissioner
JOANN T. CONAWAY, Commissioner
DALLAS WINSLOW, Commissioner
JEFFREY J. CLARK, Commissioner[1]

APPEARANCES:

On behalf of Applicant, Artesian Water Company, Inc.:

MICHAEL HOUGHTON, ESQ.
R. JUDSON SCAGGS, JR., ESQ.
JERRY C. HARRIS, JR., ESQ.
MORRIS, NICHOLS, ARSHT & TUNNELL LLP

On behalf of the Division of the Public Advocate:

G. ARTHUR PADMORE, ESQ.

On behalf of the Delaware Public Service Commission Staff:

JAMES McC. GEDDES, ESQ., Rate Counsel
REGINA A. IORII, ESQ., Rate Counsel
ASHBY & GEDDES

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[1]Vice Chair Twilley participated in the Commission's deliberations and decisions in this docket prior to the remand of issues pursuant to PSC Order No. 6681 (July 19, 2005). Subsequent to PSC Order No. 6681, Commissioner Clark replaced Vice Chair Twilley on the Commission.

On behalf of Intervenor General Motors Corporation:

LOUIS R. MONACELL, ESQ.
CHRISTIAN & BARTON, LLP

On behalf of Intervenor Christiana Care Health Services, Inc.:

GLENN C. KENTON, ESQ.
RICHARDS, LAYTON & FINGER

BACKGROUND

1. On February 5, 2004, Artesian Water Company, Inc. ("Artesian" or "the Company") filed with the Delaware Public Service Commission (the "Commission") an application to increase its water service rates and to change its tariffed rules and regulations. The proposed rates were designed to produce additional annual revenues of $8,766,132 (a 24.22% increase). With its application, the Company submitted the pre-filed testimony of Richard S. Minch, Controller of Artesian Resources Corp. ("Resources") and its subsidiaries, including the Company; Bruce P. Kraeuter, Artesian's Vice President of Planning and Engineering; Henry G. Mülle, President of H.G. Mülle & Associates, LLC; John F. Guastella, President of Guastella Associates, Inc.; and John M. Guastella, Director of Rates and Valuation for Guastella Associates, Inc.

2. On March 16, 2004, the Commission issued Order No. 6378 suspending the Company's application pending the completion of evidentiary hearings concerning the justness and reasonableness of the proposed rates. The Commission designated Robert P. Haynes as Hearing Examiner, directed him to conduct the evidentiary hearings, authorized him to grant or deny petitions to intervene, delegated to him the authority to determine the appropriate form and manner of public

notice for the evidentiary hearings and public comment sessions, and instructed him to report back to the Commission with his proposed findings and recommendations. Upon Hearing Examiner Haynes' departure from the Commission, Senior Hearing Examiner William F. O'Brien was assigned to preside over the evidentiary hearings and to report his findings and recommendations to the Commission.

3. On March 16, 2004, the Division of the Public Advocate ("DPA") intervened pursuant to 29 *Del. C.* §8829(c). On April 27, 2004, General Motors ("GM") and Christiana Care ("CC") were granted leave to intervene in the proceedings.

4. On March 26, 2004, the Company submitted the supplemental pre-filed testimony of Messrs. Minch, Kraeuter, and John F. Guastella, in which the Company reduced its requested rate increase to approximately $8,725,000 (a 23.8% increase over current rates).

5. On April 6, 2004, by Order No. 6390, the Commission granted Artesian's request, pursuant to 26 *Del. C.* §306(c), to place a portion of its requested rate increase (approximately 6.9%) into effect on an interim basis, under bond, and subject to refund pending the Commission's final decision.

6. On June 7, 8, 9 and 10, 2004, duly-noticed public comment sessions were held in Middletown, Wilmington, Bethany Beach, and Dover, Delaware. Five customers spoke at those sessions, and five customers submitted written comments to the Commission.

7. On August 9, 2004, Staff submitted the pre-filed testimony of Robert J. Henkes, principal of Henkes Consulting, Inc.; Brian

Kalcic, principal of Excel Consulting, Inc.; and Charles W. King, President of Snavely King Majoros O'Connor & Lee, Inc. On the same date, the DPA submitted the testimony of Andrea C. Crane, a principal of The Columbia Group, Inc., and Howard J. Woods, Jr. of Howard J. Woods, Jr. & Associates, L.L.C. GM submitted the pre-filed testimony of Michael Gorman and Ernest Harwig, consultants with Brubaker & Associates, Inc.

8. On August 24, 2004, the Company submitted a petition to increase the rates allowed under bond by 8.1%, as permitted by 26 *Del. C.* §306(b). On August 31, 2004, in Order No. 6468, the Commission granted that petition.

9. On September 13, 2004, the Company submitted pre-filed rebuttal testimony from Messrs. Minch, Mülle, and John F. Guastella.

10. On October 4-5, 2004, the Hearing Examiner conducted duly-noticed evidentiary hearings at which the parties submitted a stipulation that resolved all of the cost of service and rate design issues. (Ex. 50). The parties also presented the testimony of certain of their witnesses, who were then subject to cross-examination. Staff elected not to put Mr. King on the stand and did not proffer his pre-filed testimony into the record. As a result of Staff electing not to proffer Mr. King's testimony, Staff witness Henkes was required to revise his schedules. The Company sought to strike Mr. Henkes' testimony in total, which motion was denied by the Hearing Examiner. Mr. Henkes testified to (and was subject to cross-examination on) the revisions that Staff's decision not to offer Mr. King as a witness required to his testimony, and the Hearing

Examiner granted Staff additional time to submit those revised schedules into the record. On October 7, 2004, after receipt of Mr. Henkes' revised schedules, the record, then consisting of 59 exhibits and 529 pages of transcript, was closed.

11. Pursuant to the briefing schedule established by the Hearing Examiner at the conclusion of the evidentiary hearings, the Company submitted its Opening Brief on November 18, 2004. Staff, the DPA, GM, and CC filed their answering briefs on December 20, 2004. The Company filed its reply brief on January 10, 2005.

12. On February 23, 2005, the Hearing Examiner issued his proposed findings and recommendations (hereafter "HER"). Artesian, Staff, DPA, and GM filed timely exceptions to the Hearing Examiner's proposed findings and recommendations.

13. On April 5, 2005, the Commission met at a regularly-scheduled meeting to consider the record, the HER, the parties' exceptions, and to hear oral argument and to conduct public deliberations regarding Artesian's request for a rate adjustment.

14. On June 29, 2005, before the Commission issued a written order reflecting its April 5, 2005 vote, Artesian filed a Petition for Post-Hearing Relief concerning the alternative minimum tax ("AMT") issue, citing a June 28, 2005 amendment to 26 *Del. C.* §102(3), which specifies that the determination of a utility's rate base includes an adjustment against accumulated deferred income tax ("ADIT") liability for its payment of AMT.

15. At its July 5, 2005 meeting, the Commission heard Artesian's Petition for Post-Hearing Relief regarding the statutory amendment, and the objections thereto made by Staff, the DPA, and GM, and decided

to remand the AMT issue to the Hearing Examiner for further proceedings. PSC Order No. 6681 (July 19, 2005).

16. Also at the July 5, 2005 meeting, Artesian requested that the Commission's final Order reflect a "true-up" of its overall rate base in order to include the actual amount of plant-in-service at the end of the test period, or June 30, 2004. Staff, DPA, and GM objected, maintaining that because Artesian failed to move the final "true-up" figure into the hearing record, the Commission could not include the "true-up" as part of the approved rate base. The Commission voted to include the plant-in-service "true-up" issue in the remand that it had already ordered. PSC Order No. 6681 (July 19, 2005).

17. On August 15, 2005, Artesian filed a Petition to Place Increased Rates into Effect (the "Purchased Water Petition") to increase its rates to include increased purchased water expenses in the amount of $131,529, which result from rate increases that the Chester Water Authority and the City of Wilmington placed into effect on July 1, 2005. On September 20, 2005, by Order No. 6728, the Commission consolidated Artesian's August 15 petition regarding purchased water costs (PSC Docket No. 05-293) with the Docket No. 04-42 remand and permitted Artesian to raise its rates by the proposed amount on a temporary basis, subject to refund.

18. On October 31, 2005, Staff submitted the pre-filed testimony of Connie S. McDowell, the Chief of Technical Services for the Commission, and Lane Kollen, a Vice President and Principal with Kennedy and Associates. The DPA submitted additional testimony from Ms. Crane. On January 9, 2006, the Company submitted pre-filed rebuttal testimony from William F. Santora, a Certified Public

Accountant with the firm of Santora C.P.A. Group, and David B. Spacht, the Company's Vice President.

19. On February 2, 2006, after a period of discovery and submission of pre-filed testimony, a duly noticed remand hearing was conducted. The parties introduced the pre-filed testimonies of the witnesses on remand and the parties were subject to cross-examination. No members of the public attended the hearing or offered written comments. At the conclusion of the evidentiary hearing, the record, consisting of 67 exhibits and the transcript, was closed. Pursuant to the procedural schedule approved by the Hearing Examiner, the parties filed post-hearing briefs on February 24 and March 8, 2006.

20. On March 23, 2006, the Hearing Examiner issued his proposed findings and recommendations on the remanded and consolidated issues (hereafter "R-HER"). Artesian and Staff filed timely exceptions to the R-HER. In lieu of formal exceptions, the DPA filed a letter, dated April 3, 2006, requesting, among other things, that for the next Artesian rate case, the Commission direct Staff to investigate whether or not it should continue the current PSC policy of allowing Artesian to base its rates on the statutory tax rate rather than on actual taxes paid.

Comment [JCH1]: I don't believe DPA filed any exceptions.

21. On April 11, 2006, the Commission met at a regularly-scheduled meeting to consider the record, the R-HER, the parties' exceptions, to hear oral argument, and to conduct public deliberations regarding the remanded and consolidated issues. This is the Commission's final Findings, Opinion and Order on the initial issues raised in the rate case, as well as the remanded and consolidated issues.

RATE BASE

A. Churchmans Road Property.

22. Artesian included in its rate base $5,022,238 of expenses associated with its purchase of its headquarters facility at 664 Churchmans Road in Newark, Delaware (the "Property") from White Clay Realty Company ("White Clay"). As this issue is heavily dependent on the facts, we set them forth in detail herein as found by the Hearing Examiner.

Date	Event
1971	State condemns Artesian's headquarters property located in Newport, DE in connection with the widening of Route 141.
November 1971	White Clay is formed as a limited partnership to construct and own Artesian's new headquarters facility at 664 Churchmans Road. Ellis D. Taylor and Norman H. Taylor, Sr. are general partners and John R. Eisenbrey, Sr. is the substitute general partner. Each gentleman held officer positions with Artesian at one time or another.
March 1, 1972	The Commission approves Artesian's sale of 664 Churchmans Road property (10.52 acres) to White Clay for $132,000 for the purpose of leasing it back to Artesian (PSC Order No. 1104 dated 12/30/71). The Commission found that the sale price was fair, based on an independent appraisal that valued the property at $106,000, and that the construction plan was fair to Artesian and its customers despite the common ownership and control between the parties. White Clay then built the facility for approximately $2 million.
June 1972	The Commission approves the terms of the proposed lease between Artesian and White Clay, noting that the proposed lease and financial relationship between the parties was subject to "close scrutiny." (PSC Order No. 1149 dated June 21, 1972).
January 1973	White Clay and Artesian enter into a lease for the property. Ellis D. Taylor signs the lease on behalf of both White Clay and Artesian. The lease (1) contains a de-escalator clause whereby rent declines after the mortgage is paid off in 25 years; (2) provides a purchase option at fair market value; and (3) provides that tenant improvements become property of White Clay. In the event that Artesian determined to repurchase the property, it was required to follow a three-appraiser method for determining fair market value and to secure Commission approval for the repurchase.

2001	Artesian management studies space needs for headquarters and decides that expansion is necessary.
2002	Based on changes in ownership over time, Dian C. Taylor (current President, CEO and Chair of the Board of Directors of Artesian) owns 12.25% of White Clay). Two others affiliated with Artesian own 23% of White Clay. Thus, persons affiliated with Artesian own 35.5% of White Clay.
March 2002	Artesian commissions an outside firm to appraise its headquarters property; appraiser determines fair market value to be $3.8 million.
August 2002	Artesian sends a renewal notice for the lease to White Clay.A White Clay limited partner challenges the timeliness of the notice and asserts that the lease will terminate on 12/31/02. The timing requirement of the renewal notice is clouded by the failure to record the inception date of the lease term.
September 2002	Artesian forms a special committee of outside Board of Directors unaffiliated with White Clay to consider acquiring the headquarters and to review the challenge to the timeliness of the renewal notice. The committee retains counsel, obtains an updated appraisal of the property, obtains surveys of other available properties, and engages a second appraiser. The committee meets 20 times over 14 months.
November 2002	The special committee determines that the best course of action is to repurchase the property and authorizes outside counsel to negotiate with White Clay. According to Artesian, the building needed a new roof and HVAC system, which together would cost approximately $1 million. The Company decided to try to purchase the building before making those improvements, which, under the lease, would have become the property of White Clay and for which Artesian would have had to pay again in the event it *did* repurchase the property. Artesian makes an initial offer of $3.0 million. Because of the deaths of all of its general partners, White Clay is unable to respond as an entity to the offer. A limited partner unaffiliated with Artesian demands $6 million for the property but admits that he is seeking speculative value. Helena C. Taylor, who, as executrix of the estate of Ellis Taylor, owns 24.5% of White Clay, obtains an appraisal of the property reflecting a value of $4.8 million.
December 2002	After reviewing other options, the special committee decides to exercise Artesian’s power of eminent domain and Artesian institutes condemnation proceedings to force a purchase of the property for fair market value. One of the owners files a motion to dismiss the proceeding, challenging the constitutionality of the taking.
February 2003	The Superior Court declares that White Clay had been dissolved upon the death of the last general partner in 2001. Individual owners therefore are unable to speak

	for the other owners.
Late 2003	Prior to the Superior Court's ruling on the motion to dismiss, the parties agree to a purchase price of $4.5 million, which is approved by the Court. The price reflects an additional 34,580 square feet of land on which office space could be built, which was recognized in Helena Taylor's appraisal, but not in Artesian's.

(HER at 13-17).

23. The Company contended that this chronology demonstrated that it was entitled to the protection of the business judgment rule and that the amounts associated with the purchase of the Churchmans Road property should be included in rate base.

24. Both Staff and the DPA objected to the Company's proposal to include the $5,022,238 (which includes not only the purchase price of the property but also legal fees and other ancillary costs associated with the purchase) in the rate base. Staff and the DPA contended that the transaction should be subject to the entire fairness test rather than the business judgment rule because representatives of Artesian stood on both sides of the transaction and profited from the transaction. Even if the transaction was not subject to the stricter entire fairness standard, Staff argued that the Company had failed to meet the requirements of the business judgment rule because of its "inexplicable" failure to timely renew the lease. Therefore, both Staff and the DPA urged the Commission to deny the Company rate base treatment of the costs associated with the purchase of the Churchmans Road property.

25. Staff proposed that the amount to be allowed for ratemaking purposes should be the revenue requirement associated with the continuation of the lease pursuant to its terms. The DPA proposed that the transaction be priced at the lower of cost or book value, and since there was no information available regarding the book value of

the property, the DPA recommended rate recovery of the lease payment that would be due if the Company had continued to lease the facility.

26. Alternatively, Staff and the DPA also argued that if the Commission was inclined to include the costs in rate base, the net book value of the improvements for which the ratepayers had already paid (and would be paying for again with the inclusion of the purchase price in rate base) -- approximately $407,000 -- should be excluded from rate base.

27. **The Hearing Examiner's Recommendation.** The Hearing Examiner recommended that the costs associated with the repurchase of the Churchmans Road property should be included in rate base. (HER at 15). He concluded that Artesian had "substantially followed the terms of the lease (including the purchase option)," and that the lease had been "fully scrutinized and approved by the Commission, with full knowledge of the common ownership between Artesian and White Clay…," and that the sale of the property satisfied both the entire fairness and business judgment standards of review. (Id.).

28. The Hearing Examiner acknowledged that the Commission's approval of the lease back in 1972 had been conditioned on Artesian obtaining the Commission's approval for a repurchase, "in all likelihood for the purpose of verifying that the purchase price was at fair market value, in light of the conflict of interest created by the common ownership." He found that "[a]t the very least, Artesian should have notified the Commission of its intentions and, if at all possible, should have sought approval from the Commission prior to completing the transaction." (HER at 18). However, he concluded that Artesian's failure to notify the Commission and obtain its approval for the repurchase was "mitigated somewhat" by the Superior

Court's approval of the purchase price as "just compensation," which in Delaware is synonymous with fair market value. Hence, the purpose of requiring Commission approval in the first place – verification of fair market value – was accomplished, albeit not in the order contemplated by the Commission. (Id.).

29. The Hearing Examiner rejected Staff's contention that ratepayers would have been better off if Artesian had continued under the below-market lease. (Id.). He observed that no party disputed Artesian's need for additional space; that the building needed some $1 million of repairs; and that if the Company had waited until the end of the lease to repurchase the property, it would have had to pay twice for those repairs. (HER at 19). Thus, the Hearing Examiner was unable to conclude that ratepayers would have been better off continuing under the lease. He further found that the allegation that the lease renewal notice was untimely was made by one White Clay limited partner who later admitted to seeking speculative value for the property and likely was exploring all legal measures by which he could encourage a sale. That limited partner never proved that the notice was untimely and Artesian never conceded that it had not timely renewed the lease. Furthermore, the Hearing Examiner noted that there was no set date in the lease by which the renewal notice had to be provided. (HER at 19).

30. The Hearing Examiner also rejected Staff's contention that the entire fairness standard, rather than the business judgment rule, applied to the transaction, finding that even if that standard did apply, the Company had satisfied it. The Hearing Examiner determined that the purchase was fair because it was made for fair market value under a Commission-approved lease that provided for repurchase of the

property at fair market value. (Id.). He further found that the fact that ratepayers were paying twice for improvements made to the property was merely a consequence of the Commission-approved lease, and that the ratepayers would not have been better off if the Company had purchased another property since they would have been paying for past improvements to that property. (HER at 19-20).

31. Similarly, the Hearing Examiner rejected the DPA's contention that under PSC Order No. 5469 in Docket No. 99-582 and NARUC guidelines, the sale by a non-regulated affiliate to a regulated utility should be priced at the lower of cost or market price. Even if the transaction could be considered affiliated, the Hearing Examiner concluded that Artesian was not bound by Order No. 5469 (which applied only to Delmarva Power) or the NARUC guidelines. The Hearing Examiner found that it would be unfair to impose asymmetrical pricing upon a utility without notice or guidance from the Commission that it would become effective as to that utility. Moreover, if the purpose of asymmetrical pricing for affiliated transactions is to ensure that utilities do not overpay for goods or services purchased from affiliates, the Hearing Examiner found that that purpose was served here by the Commission's requirement that Artesian pay fair market value for the property and Artesian's compliance with that requirement. (HER at 20).

32. **Exceptions.** Both Staff and the DPA excepted to the Hearing Examiner's recommendation. Staff reiterated the arguments it had made to the Hearing Examiner regarding the unfairness of ratepayers paying twice for improvements to the property, the Company's failure to timely renew the lease, and the fact that the transaction was between affiliated entities from its inception. The DPA also made the same

arguments it had made to the Hearing Examiner regarding affiliated transactions. Staff and DPA again urged the Commission to exclude the costs associated with the repurchase of the property from rate base. Alternatively, if the Commission did not exclude the entire amount from rate base, Staff requested the Commission to exclude the net book value of the improvements to the property for which ratepayers had already paid ($407,000) so that ratepayers would not be paying twice for the same thing. (Staff Exceptions at 16-22). For its alternative position, the DPA also sought to exclude the $407,370 of already-paid-for improvements, as well as the amount of $1,968,000 (the difference between the price of the land when it was originally transferred to White Clay by Artesian and the price at which Artesian proposes to repurchase the property from White Clay. (DPA Exceptions at 2-10).

33. **Discussion.** Although the arguments espoused by Staff and the DPA on this issue have a superficial appeal, we concur with the Hearing Examiner and conclude that the Company should be permitted to include the entire $5,022,238 associated with the repurchase of the Churchmans Road property in rate base. First, although we acknowledge that the transaction at its inception was an affiliated transaction, the Commission did in fact approve the lease with all of the provisions that are now being challenged. Second, although the Company did not comply with the terms of the Order granting approval of the lease when it failed to advise the Commission of its repurchase of the property and seek Commission approval of that repurchase prior to its occurrence, we conclude that the purpose behind that requirement has been satisfied by the Superior Court's finding of fair market value.

34. Third, we believe that Staff and the DPA did not meet their burden of demonstrating why the business judgment rule should not protect the Company in its actions in effecting the repurchase. The record evidence shows that the Company needed additional space and, if it had not repurchased the Churchmans Road headquarters, would have to have secured space somewhere else. If it had bought some other property, it likely would have been paying for improvements made in the past by some prior tenant or owner. And there is no conclusive evidence that the Company did in fact remit its renewal notice late; rather, that was the position of one White Clay owner who admittedly had his own agenda for pursuing that position.

35. We understand that at the time the property was sold to White Clay and the lease was entered into, Ellis Taylor stood on both sides of the transaction. The Commission was aware of that potential conflict of interest at the time and inserted provisions in its Order approving the lease that were designed to make sure that the Commission would be in a position to review any repurchase of the property that occurred. By the time of the repurchase, however, only 35% of White Clay was owned by anyone with any connection to Artesian, and those persons were not involved in the decision to repurchase the property, the negotiations to repurchase the property, or any other activity involving the property. Given that Artesian was not subject to any standards governing affiliated transactions at the time of the repurchase, we find that it would not be appropriate to impose such standards upon it retroactively, as the DPA's position would have us do.

36. For these reasons, as well as the other reasons set forth by the Hearing Examiner, we adopt the Hearing Examiner's findings and

recommendations on this issue. (3-2, Vice Chair Twilley and Commissioner Conaway voting nay).

B. Alternative Minimum Tax/Accumulated Deferred Income Taxes.

37. A deferred tax balance is recorded as a liability on the balance sheet and therefore serves to reduce the total amount of rate base. In this case Artesian, for the first time, proposed to reduce its regular accumulated deferred income tax ("ADIT") balance of $15,320,734 by its prepaid deferred taxes associated with its AMT of $2,097,424, such that the total rate base deduction for ADIT would be $13,233,210 instead of $15,320,734.

38. Staff and DPA objected to the Company's proposal. The DPA contended that the Commission uses a utility's statutory income tax expense, rather than AMT payments, to set rates and rate base, and therefore it would be inappropriate to include a deferred income tax reserve based on AMT payments as an adjustment to rate base. If such an adjustment was included, then, according to the DPA, it was likely that the Company's income tax expense (which for ratemaking purposes is calculated on a stand-alone basis) would have to be substantially reduced. Consequently, if this adjustment was adopted, DPA argued, then the Commission should also make an adjustment to calculate the Company's income tax liability based on actual taxes paid on a consolidated basis.

39. Staff similarly argued that although tax credits from AMT carry forwards or AMT related tax refunds were recorded on the Company's books, they have never been part of the income tax formula used for ratemaking purposes. Rather, for ratemaking purposes, the pro forma income taxes are based on the application of federal and state income tax rates to the Company's PSC-adopted test period pre-

tax operating income, reduced by the Company's PSC-adopted pro forma interest. Since AMT tax considerations are not used for ratemaking purposes in determining the Company's regulated pro forma test period income taxes, it would be inappropriate to give rate base recognition to AMT-related ADIT balances in rate base.

40. **The Hearing Examiner's Recommendation.** The Hearing Examiner originally accepted DPA's and Staff's positions. He found that the "mismatch" that they had identified:

> hurts ratepayers in that rate base recognition of prepaid AMT as a reduction to deferred taxes serves to increase rate base, while *not* recognizing the prepaid AMT as a reduction to the income tax expense serves to increase operating expenses. The AMT paid is not recognized as a reduction to the income tax expense because income taxes are calculated for regulatory purposes on a stand-alone basis rather than on an actual-taxes-paid basis. Actual taxes are not paid on a stand-alone basis but on a consolidated basis with Artesian's parent.

(HER at 23). Therefore, while finding that the proposed adjustment "may be appropriate in concept," the Hearing Examiner concluded that in practice it would be unfair to ratepayers so long as the Commission continued to calculate income taxes on a stand-alone basis rather than on an actual, consolidated basis. (*Id.* at 24).

41. **Exceptions.** The Company excepted to the Hearing Examiner's findings and recommendations. The Company argued that the Commission should reject the Hearing Examiner's recommendation because: (1) it "disregards: established Commission precedent and a Delaware statute regarding the treatment of deferred taxes;" (2) threatens the Company's use of accelerated depreciation for federal tax return purposes…, which would result in an increase in rate base and an increase in rates for customers;" (3) "disregards the fact that a portion of the accelerated depreciation allowed for in standard tax

calculations is disallowed by the AMT calculation;" (4) "ignores the fact that AMT paid… reduced Artesian's ADIT liability;" and (5) "is at odds with decisions of other governing bodies that have directly addressed" the issue. (Company Exceptions at 24).

42. **Discussion.** At the April 5, 2005 Commission Hearing, we voted to deny Artesian's request to adjust its rate base by its accumulated AMT asset ADIT, which Artesian had calculated as $2,097,424. On June 29, 2005, before the Commission issued a written Order reflecting its vote, Artesian filed a Petition for Post-Hearing Relief, citing the Delaware General Assembly's enactment of Senate Bill 175. Senate Bill 175 amended 26 *Del. C.* § 102(3) by replacing the previous paragraph (d) with the following language:

> d. Any accumulated deferred and unamortized income tax liabilities and investment credits, adjusted to reflect any accumulated deferred income tax assets including, but not limited to, those arising from the payment of alternative minimum tax, related to plant included in paragraph a. above, plus.

In clarifying Section 102, the General Assembly explained:

> [t]he existing definition of rate base predates the imposition of the Alternative Minimum Tax ("AMT") on corporations. The payment of AMT results in an adjustment to accumulated deferred income taxes. This legislation clarifies that this adjustment to accumulated deferred income taxes is recognized in determining the utility's rate base.

Senate Bill No. 175 (synopsis).

43. At our July 5, 2005 Commission Hearing, we considered Artesian's Petition for Post-Hearing Relief regarding the statutory amendment, and the objections thereto made by Staff, the DPA, and GM, and decided to remand the AMT issue to the Hearing Examiner for further proceedings. PSC Order No. 6681 (July 19, 2005).

The AMT Issue on Remand

44. Under 26 *Del. C.* § 102(3), "rate base" means:

> a. The original cost of all used and useful utility plant…; less…
>
> d. Any accumulated deferred and unamortized income tax liabilities and investment credits, **adjusted to reflect any accumulated deferred income tax assets including, but not limited to, those arising from the payment of alternative minimum tax**, related to plant included in paragraph a. above, plus….

(The bold-faced language reflects the changes to Section 102(3) made by Senate Bill 175). As seen under Section 102(3)d, rate base is reduced by ADIT liability, which itself is adjusted to reflect ADIT assets (such as AMT), "related to" plant.

45. Artesian collects income taxes from ratepayers as if it pays taxes on a stand-alone basis, at the statutory 34 percent federal income tax rate. Because Artesian's plant is depreciated for tax purposes faster than for ratemaking purposes, Artesian incurs tax liability it collects in its rates. Artesian records the tax it has collected, but not yet incurred, as a deferred tax liability, or ADIT, which it then subtracts from rate base until ratemaking depreciation catches up to tax depreciation for a particular asset. In this way, the ratepayers who use and pay for an asset over the depreciation life of the asset are the ones who benefit from the tax advantage derived from accelerated tax depreciation. In addition, by offsetting rate base by the deferred tax balance, the utility does not earn a return on funds not supplied by shareholders. (R-HER ¶ 18).

46. Artesian asserted that all of its AMT asset ADIT was related to utility plant and therefore all of the AMT asset ADIT should be included in rate base.

47. After initially objecting to the AMT adjustment to rate base, Staff agreed with Artesian that the plant-related AMT asset ADIT should be included in rate base. Staff witness Kollen, however, made several downward adjustments to Artesian's $2,097,424 AMT claim. Artesian accepted two of the adjustments, excluding from its claim: (i) the AMT incurred by Artesian's affiliates; and (ii) the AMT Artesian already recognized in its 2001 amended tax return. Together, the two adjustments reduced Artesian's AMT rate base claim by $605,574, to $1,491,850.

48. Staff also made two adjustments that Artesian did not accept. First, Staff excluded approximately 70 percent of the AMT asset ADIT from the claim, arguing that only 30 percent of the AMT balance is related to plant. (R-HER ¶ 20). Only plant-related deferred taxes, or ADIT, are subtracted from rate base and, therefore, only plant related AMT is eligible as an offset to ADIT liability. According to Staff, the AMT asset ADIT is caused by the diminished value of *all* deductions under the AMT calculation, rather than just plant-related tax depreciation. In general, the regular tax calculation is income less deductions times the 34 percent tax rate. The AMT calculation is income less deductions plus certain preferences (which, Artesian contended, consists solely of plant-related tax depreciation) times the 20 percent AMT tax rate. Staff argues that under the 20 percent AMT rate, all deductions are worth less to the taxpayer than under the 34 percent rate and all deductions therefore contribute to AMT liability. (*Id.*)

49. The second adjustment made by Staff witness Kollen, which was not accepted by the Company, involves levelization of the AMT asset ADIT. Based on his opinion that the AMT carry-forward will

likely be reduced to zero within the next five years, Mr. Kollen recommended levelizing the return on the unamortized AMT asset ADIT over the next five years, which reduced Artesian's revenue requirement for AMT asset ADIT from $46,557 (which reflects Staff's above 70/30 allocation) to $25,146. (R-HER ¶ 26).

50. The DPA made several legal and policy arguments against inclusion of the AMT as an offset to ADIT liability. First, the DPA argued that the AMT legislation was not passed until after the close of the test period and after Commission deliberations and, therefore, should not be applied in this case. (R-HER ¶ 28). Second, the DPA argued that the statutory amendment calls for an ADIT adjustment for AMT "paid" and, because Artesian has not actually "paid" any AMT, no adjustment is warranted. (*Id.*). Third, the DPA raised the broader issue of whether to allow Artesian to continue to collect income tax from ratepayers using the statutory corporate tax rate, rather than its actual taxes paid. (*Id.*).

51. **The Hearing Examiner's Recommendation on Remand.** The Hearing Examiner agreed with Artesian that, under the plain meaning of "related to," its entire AMT asset ADIT amount is "related to" plant and is, therefore, appropriate as an offset to ADIT liability. (R-HER ¶ 22). The Hearing Examiner found that it is difficult to argue that the AMT claimed by Artesian, which is only the *difference* between regular tax liability and tax liability under the AMT calculation, is not related to plant, when plant-related tax depreciation is the only AMT preference added back to income and, therefore, the only trigger for Artesian's AMT liability. (*Id.*). Furthermore, even if the appropriate standard were "caused by," then Artesian's claim would still stand because AMT is "caused by" tax depreciation, under the

"but for" standard of causation. It is undisputed, after all, that "but for" the tax depreciation preference, no AMT would be incurred.[2] (*Id.*).

52. In rejecting Staff's position, the Hearing Examiner found that attributing any AMT liability to the "diminished value" of the regular deductions under the AMT calculation made no sense. (R-HER ¶ 24). The Hearing Examiner stated that because AMT liability consists only of the difference between regular tax liability and tax liability under the AMT formula, it would be inappropriate to attribute AMT to all components of the entire tax liability. (*Id.* ¶ 25). Additionally, the Hearing Examiner reasoned that attributing any portion of the difference in the tax calculations (*i.e.*, the AMT) to the lower 20 percent AMT tax rate (which is the genesis for the diminished value of the deductions) does not make sense because the 20 percent tax rate actually lowers the AMT amount. The Hearing Examiner stated, "[f]rom a broader perspective, even if the 'diminished value' analysis made sense, to carve out any portion of AMT liability as unrelated to plant, based on the AMT tax rate's effect on the value of regular deductions, unduly restricts the meaning of 'related to' and adds unwarranted complexity to the ratemaking calculus." (*Id.*). Lastly, the Hearing Examiner explained, "[i]t is more reasonable, and frankly inescapable, to relate Artesian's AMT liability, in total, to the sole preference item that triggered every dollar of its AMT liability; *i.e.*, plant-related tax depreciation." (*Id.*).

[2]Citing *Culver v. Bennett*, 588 A.2d 1094, 1097 (Del. 1991), Artesian noted that the "but for" test is commonly used in Delaware to establish causation.

53. The Hearing Examiner recommended that the Commission accept Staff's proposal to levelize the Company's AMT asset ADIT. The Hearing Examiner opined, "[th]e AMT asset ADIT may be a rate base item, but it differs fundamentally from the tangible plant-in-service assets that should be included in rate base as they stand at the end of the test period, without reaching into the future for anticipated changes." (R-HER ¶ 27). The Hearing Examiner found the AMT asset ADIT to be an accounting offset to deferred taxes that is dependent entirely on the existence of the ongoing AMT carry-forward, which, according to Mr. Kollen, will be eliminated, with nearly 100 percent certainty, within five years. (*Id.*). In support of his conclusion, the Hearing Examiner cited Company witness Mr. Santora's testimony that the tax depreciation preference, which is the cause of the AMT asset ADIT, is a temporary preference and will reverse itself in future years and that the Company's AMT liability has declined from $3.6 million in 2000 to $1.6 million in 2004. (*Id.*).

54. The Hearing Examiner rejected all of DPA's AMT arguments but acknowledged that DPA had raised the broader issue of whether Artesian should be allowed to continue to collect income tax from ratepayers using the statutory corporate tax rate, rather than its actual taxes paid. (R-HER ¶¶28-30). Because the policy behind allowance of the statutory tax rate (and the effect of abandoning the policy now) was not a fully-litigated issue in this case, the Hearing Examiner found it would be inappropriate for the Commission to change course on this matter in this proceeding. (*Id.*). The Hearing Examiner recommended that the Commission, in Artesian's next rate case, direct Staff to revisit the policy behind allowing Artesian to base its rates on the

statutory tax rate, rather than on actual taxes paid, and to investigate whether the Commission should abandon this policy.

55. **Exceptions.** Both Artesian and Staff excepted to the Hearing Examiner's recommendations.

56. The Company excepted to both the Hearing Examiner's recommendation to levelize its AMT asset ADIT over five years and the Hearing Examiner's recommendation that the Commission direct Staff to revisit the "policy behind allowing Artesian to base its rates on the statutory tax rate, rather than on actual taxes paid, and to investigate whether the Commission should abandon this policy."

57. The Company argued that the Hearing Examiner's recommendation to levelize the AMT asset ADIT should be rejected on three grounds. First, citing *Public Service Commission v. Diamond State Telephone Co.*, 468 A.2d 1285 (Del. 1983), the Company argued that levelization of rate base is wholly inappropriate because it will deny the Company a fair return on its approved rate base. Second, the Company argued that the Hearing Examiner's recommendation of levelization should be rejected because the timing of the elimination of the Company's AMT asset ADIT carry-forward is not "known and measurable." Third, the Company argued that levelization of only select rate base items, (*i.e.*, AMT asset ADIT), is inequitable -- whereas levelization of all rate base items could have an unintended and adverse impact on ratepayers (*i.e.*, the inclusion of projected plant-in-service in current rate base).

58. The Company argued that the Commission should reject the Hearing Examiner's recommendation to direct Staff to revisit the policy of allowing the Company to base its rates on the statutory tax rate, rather than on actual taxes paid because the recommended

direction is unnecessary, procedurally too narrow for addressing a policy issue, and potentially prejudicial.

59. Staff excepted to the Hearing Examiner's recommendation to include all of the Company's AMT asset ADIT in rate base on the grounds that: (i) the Hearing Examiner erred in accepting the Company's contention that the entire AMT liability was "related to" or "caused by" plant-related depreciation; and (ii) Staff's proposed quantification of the AMT asset ADIT caused by plant-related deductions was unchanged and should be accepted.

60. **Discussion.** For the reasons set forth by the Hearing Examiner, we agree with and adopt the Hearing Examiner's recommendation to allow Artesian to offset its ADIT tax liability by its AMT asset ADIT in the amount of $1,491,850. (Unanimous).

61. We do not accept the Hearing Examiner's recommendation that Artesian's return on the unamortized AMT asset ADIT be levelized over the next five years because we are not convinced that this is a "known and measurable" change since it is unclear when the tax asset will be reduced. In addition, we note that the likelihood of future Artesian rate cases will allow us to monitor this rate base adjustment to insure that future rates properly reflect its affect on Artesian's rate base. (3-2, Commissioners Lester and Winslow voting nay).

62. We also reject at this time the Hearing Examiner's recommendation to direct Staff to revisit, in Artesian's next rate case, the policy behind allowing Artesian to base its rates on the statutory tax rate, rather than on actual taxes paid, and to investigate whether the Commission should abandon this policy. (Unanimous). However, we would like to become more educated on the potential affects of adopting a different methodology for calculating

taxes for ratemaking purposes other than the statutory tax rate approach. Accordingly, we instruct Staff to set up a workshop to discuss this issue outside the context of a contested rate case.

OPERATING REVENUES

A. Method for Estimating Water Sales Revenues.

63. The Company must determine its operating revenues under current rates in order to calculate its revenue deficiency. In this case, the Company employed a computer model that used the historic five-year average for each customer to normalize variations in consumption caused by weather. For customers for whom less than five years of data were available, the Company used the average consumption for the period for which data were available. According to the Company, this method is preferable because the consumption of many of its new customers does not vary with weather changes (for example, those with little irrigation use) and it more accurately accounts for each customer's usage pattern because it better accounts for demographic and geographic characteristics.

64. The DPA recommended using an aggregate average for all residential customers rather than the average based on individual residential customer usage. The DPA contended that in a growing system such as Artesian's, when large numbers of customers are added during the five-year period, the Company's method ignores the expected usage for those customers in the early years (which could be substantially different from usage in later years, based on weather anomalies). According to the DPA, if per customer usage has decreased (or increased) during the five-year period because of cool wet weather (or hot dry weather), then the per customer usage will be skewed downward (or upward).

65. **The Hearing Examiner's Recommendation.** The Hearing Examiner recommended that the Commission adopt the Company's estimation

methodology. He found that there was no evidence that the DPA’s recommended estimation methodology was more accurate overall, and thus there was no reason to change the method that had been accepted in past cases. Furthermore, he observed that even if the skewing identified by the DPA occurred, it did not necessarily follow that the skewing would always favor the Company. (HER at 25).

66. **Exceptions.** The DPA excepted to the Hearing Examiner’s findings and recommendations. The DPA contended that the Company’s methodology skewed the five-year average, especially where the system was growing (like the Company’s). According to the DPA, the Company’s methodology understates prospective average consumption when customers are added in years of low usage, but overstates consumption when customers are added during years of particularly high usage. (DPA Exceptions at 11-13). The DPA argued that when a multi-year average is developed on an aggregate basis, the effects of weather anomalies are included in the average (unless they are so abnormal that they are removed). When a multi-year average is developed on the basis of individual customer usage, however, these anomalies can “seriously skew the overall average, particularly if there are a large number of new customers … .” (DPA Exceptions at 14). The DPA disputed the Hearing Examiner’s statement that the DPA had not shown its methodology to be more accurate, referring to the examples it had provided in Ms. Crane’s testimony and in its brief regarding the calculation of the averages. Finally, the DPA argued that the Company’s methodology was impossible for anyone attempting to replicate the Company’s calculation to calculate a separate average for each of the approximately 60,000 residential customers and then sum up those 60,000 averages; therefore, Staff and the DPA would be

unable to verify the accuracy of the Company’s claim in future cases. (DPA Exceptions at 14-15).

67. **Discussion.** The methodology for estimating revenues is always a sticky issue. Certainly, there are various methodologies that can be used to estimate revenues, and depending on which is used, the calculation may be skewed in favor of overestimating or underestimating consumption. Indeed, those very arguments were made in prior rate cases involving this Company and its proposed methodologies for estimating revenues. However, we accepted the five-year individual customer average in the prior rate case, and we are not convinced at this point that the DPA’s proposed methodology is any more accurate at predicting the usage of Artesian’s residential customers. Therefore, for the reasons expressed by the Hearing Examiner, we adopt his findings and recommendations

B. Contract Revenues.

68. These are the revenues that the company obtains from providing certain services under contract to other water systems. The Company calculated its pro forma contract revenues by taking its actual test year contract revenues ($158,853) and adding $24,300 to this amount to reflect the addition of two customers during the test period. Then the Company “normalized” what it called “non-recurring” contract revenues’ activities over two years, which resulted in a reduction in contract revenues. Thus, the Company’s proposed pro forma contract revenues were $142,252. (The “non-recurring” portion of contract revenues, according to the Company, are those derived from one-time or start-up activities).

69. Staff and the DPA both challenged the Company’s adjusted level of contract revenues. Staff contended that even assuming that

the Company was correct that some $41,000 of the contract revenues were non-recurring, this did not mean that the $41,000 amount itself was non-recurring. Staff witness Henkes observed that in 2001, the Company's contract revenues were $26,896, but by 2003 they had increased to $144,985. According to Staff, this marked increase "clearly suggest[ed] that contract operations' activities considered to be non-recurring on one year are simply replaced by other, new contract operations' activities in subsequent years with continuing growth in overall contract operations revenues." (Ex. 48 (Henkes) at 29). Staff noted that there are many items in the test year that are non-recurring, but they have not been removed for ratemaking purposes. Rather, Staff focused on the overall level of the total expense, and assumed that individual non-recurring expense items within the overall expense account would be replaced by similar types of expenses. Staff urged the Commission to take the same approach with respect to the Company's contract operations. Thus, Staff recommended a pro forma contract revenue level of $183,153 (the test year level plus the additional customers added during the test period).

70. The DPA also noted the rapid increase from 2001 to 2003 in the Company's contract revenues. Furthermore, the DPA observed that the Company had understated the base contract amount for its contract with Delaware City. For these reasons, the DPA recommended that the actual test year level of contract revenues be used for ratemaking purposes.

71. **The Hearing Examiner's Recommendation.** The Hearing Examiner concluded that Staff and DPA had the better of this argument. He found that the Company had not demonstrated that the test year level, as adjusted for the customers added during the test period, was

abnormal and therefore required normalization. In the Hearing Examiner’s view, simply because certain revenues are non-recurring for a particular contract did not mean that they would not recur in future years with the addition of new contract customers. He observed that since 2001, contract revenues had increased every year, which he found supported Staff and the DPA’s arguments that downward adjustments should not be permitted. Thus, the Hearing Examiner recommended that Staff’s position on contract revenues, which would result in a pro forma contract revenue level of $183,153, be approved. (HER at 26-27).

72. **Exceptions.** The Company excepted to the Hearing Examiner’s recommendation. The Company argued that it had in fact shown that the test year contract revenue level was “abnormal” (“not representative of reliable annual revenues”) because the Company could not reasonably expect them to recur. (Company Exceptions at 30). The Company contended that there was no record evidence to support Staff’s and DPA’s argument that the non-recurring revenues would be replaced by revenues from “new, unidentified, and hypothetical customers.” Next, it argued that merely because contract revenues had increased during the past three years, this was not a sufficient basis on which to assume that in the future all non-recurring revenues would be replaced by revenues from new customers. It observed that its contract revenues did not have a “reliable history of steady and consistent growth,” but, rather, had been volatile. Thus, the history of the contract revenues did not support any reliable trend and could not support an assumption that all non-recurring revenues would be replaced. (Company Exceptions at 30-31). Finally, the Company noted that it had not assumed that none of the non-recurring revenue would

be replaced; it had used a two-year average of non-recurring revenues. (Company Exceptions at 31).

73. **Discussion.** The record reflects that since 2001, the revenues that the Company has derived from contract operations has increased from $26,896 in 2001 to $158,853 in the test year, and then two additional customers were added in the test period. While we understand the Company’s argument, we are not persuaded by it. We therefore adopt the Hearing Examiner’s Findings and Recommendations on this issue. (5-0).

C. <u>Purchase Discounts.</u>

74. The Company included its actual test year purchased water discount revenues of $53,423. The primary source of this revenue is a 2% discount from the Chester Water Authority; the rest comes from various other purchase discounts.

75. Staff sought to increase purchase discount revenue by $3,159, using a seven-year average of such discount revenues.

76. **The Hearing Examiner’s Recommendation.** The Hearing Examiner accepted the Company’s proposal to use its actual test year purchase discount revenues. He found that Staff’s selection of a seven-year average appeared somewhat “arbitrary, as it is simply an extension of the entire term used in the last case to include the intervening years.” (HER at 27). Furthermore, using the 5-year average (the same term used for water sales revenues) would result in an amount only $1,598 less that the Company’s actual purchased discount revenues for the test year. Thus, the Hearing Examiner concluded that the test year data did not require normalization. (HER at 27-28).

77. **Exceptions.** Staff excepted to the Hearing Examiner's recommendation, arguing that the principle here was what mattered, not the small number of dollars at stake. Moreover, Staff contested the Hearing Examiner's characterization of its position as arbitrary, explaining that it had only taken the methodology used in the prior rate case for calculating such revenues and extended it to include the intervening two years. (Staff Exceptions at 24).

78. **Discussion.** We agree with the Hearing Examiner's Findings and Recommendations on this issue for the reasons set forth in those Findings and Recommendations. We do not find it appropriate in this instance to adopt a seven-year normalization of these revenues. (5-0).

OPERATING EXPENSES

A. Charitable Donations.

79. The Company sought to include $31,000 of charitable donations in operating expenses to be recovered in rates. Staff recommended a complete disallowance of charitable donations, and the DPA recommended a 50/50 sharing of such expenses between shareholders and ratepayers.

80. **The Hearing Examiner's Recommendation.** The Hearing Examiner recommended that the Commission adopt Staff's position and disallow charitable donations in their entirety. The Hearing Examiner recognized that the Delaware Supreme Court had held in *Application of Diamond State Tel. Co.* 149 A.2d 324, 331 (Del. 1959), a case that is 46 years old, that "modest charitable donations" "made to preserve community good will" are recoverable as operating expenses, but observed that much had changed in the regulatory environment since

that opinion was issued, and since the Company's last rate case (in which the Commission did permit the Company to include $31,000 for rate recovery). Since the last rate case, the Company had: (a) expanded into areas of the state that it has never served before, which affects rates for all ratepayers; (b) experienced increased security costs and insurance premiums as a result of 9/11; (c) experienced increased directors' and officers' insurance costs and auditing costs as a result of the Sarbanes-Oxley Act; and (d) experienced increased costs associated with stricter standards for water quality. (HER at 29, citing Ex. 48 (Henkes) at 32-33). Additionally, the Hearing Examiner observed that the Company has acknowledged that the average time between rate cases had decreased to two years, which suggested that even more rate increases would be forthcoming for Artesian ratepayers. Thus, the Hearing Examiner suggested, these factors warranted the Commission taking another look at whether ratepayers "should be charged for this type of discretionary spending." (HER at 29).

81. With respect to the *Diamond State case*, the Hearing Examiner pointed out that the Supreme Court had also stated that the Commission may disallow charitable donations "if they are not related to the fostering of the goodwill of the Company." (HER at 29). The Hearing Examiner found that it was likely that in today's environment, in light of ever-increasing utility rates, "charitable donations no longer foster goodwill, at least among the ratepayers." (Id.). He further noted that courts have changed their positions in the past, and that the great majority of the states, either by statute, case law or regulation, did not permit utilities to include charitable donations in operating expenses. (HER at 29-30).

82. The Hearing Examiner also agreed with the DPA that it was inappropriate to require ratepayers to pay for the charitable donations to entities selected by Artesian management. Finally, he concluded that charitable donations are not a necessary cost of utility service and that the Company had failed to show what, if any, benefit ratepayers derived from the goodwill engendered by the donations. (HER at 30).

83. **Exceptions.** The Company excepted to the Hearing Examiner's recommendation. First, it argued that the Hearing Examiner had ignored Delaware Supreme Court precedent and the Commission's prior decisions permitting charitable donations to be recovered in rates. The Company cited the *Diamond State* case, pursuant to which it has "been clear for decades" that modest contributions to important local charities, made to preserve community goodwill, will be allowed. (Company Exceptions at 25). The Company contended that the Hearing Examiner had acknowledged that the Commission cannot change its previous regulatory practice without a rational explanation for doing so, and that the Hearing Examiner had failed to articulate such a rational explanation. The Company asserted that the reasons cited by the Hearing Examiner -- increased security costs, stricter water quality standards – did not justify the Hearing Examiner's departure from the prior practice, since the Company's last rate case was filed and decided after 9/11 and included additional security and chemical expenses. (Company Exceptions at 25-26). The Company further contended that the Commission, in the last rate case, had anticipated the increased costs associated with Sarbanes-Oxley when it allowed the Company's increased audit expenses. (Company Exceptions at 26).

84. The Company also took issue with the Hearing Examiner's observation that the Company has expanded into new service areas, arguing that the increased number of customers created a greater base over which to spread the costs of the charitable contributions. It calculated that the level of expense sought would result in only 44 cents being allocated to each Artesian customer, and would constitute only 0.07% of water sales revenue in this rate filing. (Company Exceptions at 26).

85. Artesian next contended that the public comments did not support the Hearing Examiner's conclusion that its charitable contributions were not fostering goodwill with the community. The Company claimed that none of the customers mentioned the Company's charitable contributions in their comments, none criticized the Company's community activities, and none accused the Company of being a poor corporate citizen. (Company Exceptions at 27).

86. Finally, the Company asserted that any change in Delaware law regarding the inclusion of charitable contributions as an operating expense should come from the Delaware Supreme Court, and that if Staff and the DPA thought this was such an important issue, they could have appealed the Commission's most recent decision allowing the expenses. (Company Exceptions at 27).

87. In conclusion, the Company described itself as "tak[ing] seriously the importance of good corporate citizenship," and urged the Commission to reject the Hearing Examiner's recommendation. (Company Exceptions at 27-28).

88. **Discussion.** We recognize that the *Diamond State* case provides that a modest level of charitable contributions can be included in rates. We agree that that case states that the Commission

may disallow such expenses if they are “unreasonably large” or if they are “not related to the fostering of the good will of the Company in the locality in which it operates.” *Diamond State*, 149 A.2d at 331. However, we are also cognizant that the *Diamond State* case was issued in the late 1950s, at a time when there were fewer operating expenses to be borne by ratepayers. Now, ratepayers are being asked to shoulder the burdens of paying for additional security costs after 9/11; they are being asked to shoulder the burden of additional auditing costs with the passage of Sarbanes-Oxley; they are being asked to shoulder the costs of paying for expansion into areas where there are few customers but the cost of the infrastructure is large; in short, they are being asked to shoulder the burden of costs that were never contemplated by the Delaware Supreme Court at the time that it issued the *Diamond State* decision.

89. We had concerns about this issue in the Company’s last rate case, but at that time we felt we were constrained by the *Diamond State* case. Upon further reflection, we do not believe that that case imposes upon us the constraints that we perceived in the last rate case. Times have changed, and with it the Public Utilities Act has changed as well. At the time that *Diamond State* was decided, Delaware was a fair value rate base state; as a result of the overhaul of the Public Utilities Act in 1974, Delaware became an original cost rate base state. Since *Diamond State* was decided, the Legislature has amended the Public Utilities Act to provide, among other things, that property that is not 100% used and useful in providing service to utility customers may nonetheless be included in a utility’s rate base without revenue imputation, and that a water utility is entitled to

assess a distribution service improvement charge against its ratepayers.

90. We believe that these changes, which have placed a greater financial burden on ratepayers than was present at the time that *Diamond State* was decided, warrant a departure from the policy advanced in that decision. In this regard, we note that the vast majority of utility commissions do not permit the utilities subject to their jurisdiction to recover charitable contributions from ratepayers.

91. It does not appear to us that the Company has established that the charitable contributions that it makes foster goodwill in the community. We can assume that the recipients of the contributions are happy to get them, but we cannot assume that ratepayers would be happy to make those contributions. We are not persuaded by the Company's contention that none of the few customers that attended the public hearings or wrote to the Commission are unconcerned about the Company's charitable contributions simply because they did not specifically mention them. Several of those customers did mention the ever-increasing cost of utility service, even if they do not know the particular components of the utility's expenses.

92. In our view, charitable donation costs are not necessary for the provision of safe and adequate utility service. In light of the more burdensome expenses that ratepayers must shoulder (i.e., water quality study expenses, Sarbanes-Oxley compliance), we believe that where the expense is not necessary for the provision of safe and adequate utility service, if the utility wants to be a good corporate citizen, its shareholders can and should bear the financial responsibility for that decision. Therefore, for the reasons set

forth herein and by the Hearing Examiner, we adopt the Hearing Examiner’s Findings and Recommendation, and conclude that charitable contributions will not be included as operating expenses in this rate proceeding.

B. Swimming Pool Expenses.

93. The Company sought to include $24,526 for operating expenses associated with its swimming pool.

94. Staff and the DPA recommended disallowance of all swimming-pool-related expenses because the pool is not a normal and customary employee benefit and because there is no evidence that it improves employee morale.

95. **The Hearing Examiner’s Recommendation.** The Hearing Examiner recommended that the swimming pool expenses be disallowed for many of the same reasons that he recommended disallowing the Company’s charitable contributions. First, he found that the expense was no longer “modest” in light of the fact that lifeguard expenses had doubled since the last rate case. (HER at 31). Second, he found that the pool was not necessary to improve employee morale, as could be the case if employees were asked to forego salary increases in order to keep rates in check. (HER at 31). In this regard, he observed that the Company provided a host of other benefits that served to boost employee morale, all of which ratepayers paid for in rates. Third, the pool was not an expense that was necessary for the provision of safe and adequate water utility service; indeed, he noted that the practice of allowing rate recovery for a swimming pool appeared to be unique to Delaware. (HER at 31).

96. **Exceptions.** No party excepted to the Hearing Examiner’s recommendation.

97. **Discussion.** For the reasons stated herein and by the Hearing Examiner, we approve the Hearing Examiner's Findings and Recommendations on this issue. (Unanimous).

C. <u>Payroll Expenses.</u>

1. New Positions.

98. The Company sought to include the payroll expenses associated with 201 full-time employees in rates. This included 10 positions that were not filled as of the end of the test year. In its rebuttal testimony, Company witness, Mr. Minch, testified that the Company had filled seven of those positions by the end of the test period.

99. The DPA recommended that the remaining three positions not be included in rates because they are normal vacancies that the Company will experience on a regular basis. The DPA recommended reducing the Company's requested payroll expense by the three employees, using the average cost per employee to calculate the adjustment.

100. **The Hearing Examiner's Recommendation.** The Hearing Examiner recommended adopting the DPA's position. He acknowledged the Company's contention that the Commission had allowed rate recognition of all positions without any disallowance to account for the potential of vacancies, but noted that the Commission only allowed recovery for positions that had been filled as of the end of the test period. (HER at 32). The Hearing Examiner found that "[s]imply stating their intention to fill the positions does not rise to the level of known and measurable, especially in light of the fact that the Company had yet to fill the positions a full nine months after stating (in its

application) its intention to fill the positions." (HER at 33). Moreover, even if those positions were filled, there probably would be other vacancies by then. Additionally, he observed that the Company's expenses also included temporary labor expenses, which the Company asserts is necessary when there are vacancies. In his view, to include both the three positions and the temporary labor expense would constitute double recovery. (HER at 33).

101. **Exceptions.** No party excepted to the Hearing Examiner's findings and recommendation.

102. **Discussions.** Accordingly, the Commission adopts as its own the Hearing Examiner's summary of the evidence and his recommended findings and conclusions on this issue, as set forth by paragraphs 72-74 of the HER. (Unanimous).

2. Grass Cutting.

103. The Company sought to include $62,335 in payroll expenses for grass cutters. $34,178 of that expense was for two persons currently on the payroll, and the remaining $28,224 was for two positions that the Company intended to fill.

104. Staff challenged the Company's claim, noting that its proposed expense was more than three times the actual test year expenses and the Company had failed to justify the amount of the increase. Thus, Staff recommended that the Commission allow a normalized three-year average of expenses of $11,585.

105. The Company clamed that since it had more properties, it had more grass to cut. It also argued that under the business judgment rule, the Company's expenses should be allowed unless they were the product of waste, bad faith, or an abuse of discretion.

106. **The Hearing Examiner's Recommendation.** The Hearing Examiner rejected both Staff's and the Company's recommendations, and instead found that the Commission should permit the Company to include $34,178 in its rates representing the amount of its test year grass cutting expense. The Hearing Examiner disagreed with the Company's argument regarding the application of the business judgment rule. The Hearing Examiner stated that the business judgment rule would protect the Company decision to hire grass cutters rather than use outside vendors, but it did not address the reasonableness in amount and accuracy of an accounting entry. Rather, that was covered by 26 *Del. C.* §307(b), which specifically provides that the Company has the burden of justifying every accounting entry of record questioned by the Commission. Moreover, because the Company's proposed expense level was not an actual expense level but included expenses projected to be incurred after the test period, the Company's burden was even heavier: it had to prove that the expenses were known and measurable. Here, the Hearing Examiner concluded that the Company had not shown either that the expense was "reasonably certain" or that the amount was "sufficiently ascertainable." (HER at 35-36).

107. The Hearing Examiner did not agree with Staff's use of a three-year average of grass cutting expenses either, because there was no indication that those expenses would decrease, especially in light of the fact that Artesian has more properties to cut. Furthermore, Staff had not provided any rationale (such as weather normalizing) for using a normalized level of expense instead of the actual expenses.

108. **Exceptions**. Staff excepted to the Hearing Examiner's recommendation. Staff contended that the Company had failed to meet

its burden of proving that the amount it sought to include in rates was supported by record evidence. Staff also argued that the Company had included $40,685 in test period expenses associated with ground maintenance by outside vendors -- thus, the Company was actually asking the Commission to include over $100,000 of expenses associated with ground maintenance.

109. **Discussion.** The Commission agrees with the Hearing Examiner's analysis. Therefore, for the reasons expressed by the Hearing Examiner, we adopt his findings and recommendations as contained in paragraphs 75-81 of the HER on this issue. (Unanimous).

3. Courier/Custodian Position.

110. In its pro forma test period payroll expenses, the Company included $38,701 of salary for a courier/custodian who is out of work on long-term disability. The Company does not know if or when this employee will return to work. The Company's pro forma payroll expenses also included the salary expense for a second courier/custodian to replace the person who is out on disability leave. The Company included the replacement person's salary as well as the original employee's salary because it believes that it is legally required to maintain the original employee's position should he be able to return to work. Furthermore, the Company contended that the original employee was employed at Artesian for more than 20 years and that the Company wishes to reward him by keeping his job open.

111. Staff challenged the inclusion of two salaries for the same position in the payroll expense. The Company contended that the business judgment rule protects its decision to hire another employee and keep the original position open.

112. **The Hearing Examiner's Recommendation.** The Hearing Examiner rejected the Company's argument. He opined that, while the business judgment rule might protect the Company's decision to carry a second courier/custodian when the original employee returned to work after a replacement had been hired, that was not the case here. The Company sought to include an empty position in case the original employee were to return to work at some future date, which was uncertain. The Hearing Examiner observed that the Company was not certain of the original employee's return since it hired a replacement rather than use temporary help during his absence. Thus, the Hearing Examiner concluded that the double position was not "known and measurable" and could not be included in payroll expense. (HER at 37-38).

113. **Exceptions.** No party excepted to the Hearing Examiner's findings and recommendation.

114. **Discussion.** Accordingly the Commission adopts as its own the Hearing Examiner's summary of the evidence and his recommended findings and conclusions on this issue, as set forth by paragraphs 82-84 of the HER. (Unanimous).

4. Pension Expense.

115. The Company sought to include pension expenses totaling 6.9% of direct payroll. In light of the fluctuations in the pension to payroll ratio from year to year, the DPA recommended using the average ratio over the past 5 years, or 6.36%.

116. **The Hearing Examiner's Recommendation.** The Hearing Examiner found that the Company's proposed 6.9% ratio was more accurate than the DPA's position. The Hearing Examiner noted that it would be better to start with the actual ratio and make any appropriate changes

to that ratio for normalization or known and measurable changes, but in this case found that the Company's proposed ratio was adequately supported. (HER at 39-40).

117. **Exceptions.** No party excepted to the Hearing Examiner's findings and recommendation.

118. **Discussion.** Accordingly, the Commission adopts as its own the Hearing Examiner's summary of the evidence and his recommended findings and conclusions on this issue, as set forth by paragraphs 85-89 of the HER. (Unanimous).

D. Allocations to Affiliates.

119. The Company currently is in the process of assembling a Cost Allocation Manual ("CAM") as a result of the increased activity in some of its subsidiaries. In this case, however, the Company used a direct cost allocation methodology to capture costs attributable to its subsidiaries, resulting in an allocation of $88,501.

120. Staff recommended that instead of using the Company's direct cost allocation methodology, which allocated only payroll and payroll-related expenses to the subsidiaries, the Commission allocate 3% of all of the Company's expenses to its affiliates. Staff argued that four of Artesian's officers are also officers of its parent company and its affiliates, but only 2% of the entire allocation went to the parent company. Staff argued that there should have been some allocation for common expenses such as auditing and tax, property and liability insurance, directors' fees and expenses, bank fees, and stock transfer fees. Staff argued that Artesian has not met its burden with regard to these cost issues. Staff's proposed allocation would reduce the Company's operating expenses by $58,611.

121. The DPA did not make any adjustment to the expenses allocated to affiliates. However, the DPA recommended that the Commission direct Artesian to file its CAM within six months of the Order in this case, and that the CAM include the following (at a minimum):

- a description of each corporate entity, including a description of the organizational structure and a description of the services provided;
- for each operating expense account, a description of how costs will be allocated or charged among various affiliates;
- for each capital cost that is used to provide service to multiple entities, a description of how those costs will be allocated or charged among the various entities;
- a process for periodically reporting on costs allocated or charged to other entities; and
- a process for periodically reviewing cost allocations to determine if adjustments are required.

Furthermore, the DPA recommended that the Company file the CAM with Staff and the DPA and commit to working with Staff and the DPA to resolve issues regarding the CAM prior to the next rate case.

122. **The Hearing Examiner's Recommendation.** The Hearing Examiner found that both Staff's and the Company's allocations were flawed, but that the Company's was more acceptable than Staff's. First, he found that the Company's allocation to the parent company appeared reasonable because it was a holding company and had no business of its own. Second, although Artesian had not allocated any non-payroll-related expenses, there had been no quantification of the affiliates' sharing of such expenses and therefore no way to know whether it would

make a significant difference to the overall allocation. Third, Staff's proposed 3% was not based on any quantification of actual sharing in the record and therefore lacked factual support -- although the Hearing Examiner acknowledged that that was because the Company was unable to provide an appropriate accounting at the time Staff requested the information. (HER at 41). The Hearing Examiner also recommended that the Commission accept the DPA's recommendation with respect to the CAM. (HER at 43).

123. **Exceptions.** Staff excepted to the Hearing Examiner's recommendations based on its original position.

124. **Discussion.** We adopt the findings and recommendations of the Hearing Examiner on this issue as contained in paragraphs 90-96 of the HER. Specifically, we direct the Company to: (i) complete and file its CAM within 6 months of the date this Order is entered; and (ii) work with Staff and the DPA to attempt to resolve issues regarding the CAM in a timely manner. (Unanimous).

E. Rate Case Expense.

125. The Company's original rate case expense included an estimate of $10,000 for a depreciation study to be conducted by Company witness Mr. Guastella. No formal study was necessary, however, because the parties agreed to use essentially the same rates that were accepted in the prior rate case. Staff sought to reduce rate case expense by the $10,000 that was not necessary for the depreciation study. The Company objected, arguing that its consultant's overestimate in this area was likely balanced by an underestimate in another area, and that the overall expense was reasonable. Company witness Mr. Minch testified that the total proposed fee for Guastella and Associates had been confirmed with them

as “an appropriate expectation for all services rendered,” and that other components of the case, such as cost of service, had required more effort and cost than originally contemplated.

126. **The Hearing Examiner’s Recommendation.** The Hearing Examiner recommended allowing the expense because there was nothing in the record to contradict Mr. Minch’s sworn testimony regarding the accuracy of the overall estimate and it was “understandable” that unanticipated work in other areas absorbed the $10,000 allocated for the depreciation study. (HER at 44).

127. **Exceptions.** Staff excepted to the Hearing Examiner’s recommendation, contending that he had placed the burden of proof on the wrong party. Staff contended that it was the Company’s burden of proving that the money allocated for the depreciation study was in fact used elsewhere, and that it was not enough to say that it was probably used elsewhere because we had two unexpected intervenors on cost of service.

128. Discussion. The Commission agrees with the Hearing Examiner’s analysis. Therefore, for the reasons expressed by the Hearing Examiner, we adopt his findings and recommendations as contained in paragraphs 97-101 of the HER on this issue. (Unanimous).

F. Consulting Fees.

129. The Company sought to include in rates its actual test year consulting expense of $155,556. Staff recommended that a five-year average of the Company’s consulting expense be used, which resulted in a reduction in consulting expense of $71,174. Staff contended that consulting fees generally vary from year to year and that the actual test year expenses were abnormally high. The Company argued that in

light of the passage of Sarbanes-Oxley, a five-year average was not a good predictor of the Company's consulting expenses on a going-forward basis; Staff countered that Sarbanes-Oxley was in effect in 2002 and the Company's actual expense for 2003 and the 12-months ended April 30, 2004 was substantially lower than the actual costs for 2002.

130. On rebuttal, Company witness Mr. Minch testified that the Company had recently entered into a contract for consulting services that would result in approximately $200,000 in costs for 2004 in order to comply with Sarbanes-Oxley. He testified that Sarbanes-Oxley requires extensive documentation and testing of internal controls that will result in significant increases in consulting costs.

131. **The Hearing Examiner's Recommendation.** The Hearing Examiner recommended that the Commission adopt the Company's proposed consulting expenses. He noted that the existence of the contract made the incurrence of the consulting costs "known and measurable," and that the test year expense was a more accurate estimate of expense for the rate effective period. (HER at 48-49).

132. **Exceptions.** Staff excepted to the Hearing Examiner's recommendation. Staff contended that the Company's actual consulting expenses from 1999 through 2003 and the 12-months ended April 30, 2004 showed abnormally high consulting fees in 2002, with substantial reductions in such fees in 2003 and the 12-months ended April 30, 2004 -- after the passage of Sarbanes-Oxley and at a time when Sarbanes-Oxley was in effect. Furthermore, Staff pointed out that the Company had not attached a copy of the consulting contract it had just entered into to its rebuttal testimony. Since the Company's consulting fees had varied widely from year to year and since normalization is designed to smooth the fluctuations in such expenses from year to

year, Staff urged the Commission to adopt its position and normalize the consulting expenses.

133. **Discussion.** The Commission agrees with the Hearing Examiner’s analysis. Therefore, for the reasons expressed by the Hearing Examiner, we adopt his findings and recommendations as contained in paragraphs 111-113 of the HER on this issue. (Unanimous).

G. <u>Miscellaneous Expenses.</u>

134. The Company contended it should be allowed to recover $56,392 in “miscellaneous expenses” because these expenses represent employee-related costs incurred in the due course of providing water service. These expenses included items such as monthly dinners for the Committee of 100, the Delaware Contractors’ Association Golf and Clay shoot outings, and the Delaware Contractors Association’s Annual Crab Feast. The Company also contended that this figure included $11,331 in working meals and training costs.

135. Staff argued that the Company provided no evidence of how these expenses fostered the provision of safe, adequate, and economic water service. Additionally, Staff witness, Mr. Henkes, testified that the $11,331 in Christiana Country Club expenses and American Express charges were disallowed because these expenses were not specifically identified.

136. **The Hearing Examiner’s Recommendation.** The Hearing Examiner agreed with Staff’s position and recommended that $56,392 of Artesian’s expenses be disallowed. The Hearing Examiner also noted that Artesian had not supplied Staff with an adequate amount of data to support its characterization of the Christiana Country Club and American Express charges.

137. **Exceptions.** The Company excepted to the Hearing Examiner’s recommendation, claiming that Mr. Minch’s testimony that $24,030 of expenses were for working lunches and training was unrebutted. The Company claimed that supplementary information supporting the Christiana Country Club and American Express charges was made available to Staff, but Staff chose not to review it.

138. **Discussion.** We adopt the Hearing Examiner's findings and recommendations on this issue as contained in paragraphs 119-121 of the HER. (4-1; Commissioner Winslow voting nay).

COST OF SERVICE AND RATE DESIGN

139. The parties entered into an agreement entitled "Stipulation of Parties and Order of the Hearing Examiner Regarding Cost of Service and Rate Design" (the "Stipulation"). In addition to providing that all pre-filed testimony of the cost of service and rate design witnesses would be admitted into the record without cross-examination, the Stipulation set forth the following terms:

- The final rates will reflect a reallocation of miscellaneous revenues in accordance with the method proposed by Staff witness Kalcic at page 4 of his pre-filed testimony;

- For the Artesian rate case, there will be no requirement for the installation of special metering equipment to gather the load profile for customers subject to Artesian's Wholesale Industrial Rate;

- For the Artesian rate case, Artesian may rely on estimated maximum day and maximum hour profiles as a single customer class derived from monthly billing data for all customers subject to Artesian's Wholesale Industrial Rate;

- GM and Christiana Care shall receive service under Artesian's Wholesale Industrial Rate;

- Rate case expenses shall be allocated based on the "O&M-EXCL POWER, CHEM & PURCH WATER" factor, as described in Schedules 7 and 9 of Exhibit 2 of the Guastella Supplemental Testimony, which equates to operation and maintenance expenses reduced by the expenses for power, chemicals and purchased water;

- Purchased water expenses and electric power expenses shall be allocated entirely based on the Base allocation factor, as described in Schedules 7 and 9 of Exhibit 2 of the Guastella Supplemental Testimony, and to each customer class on the basis of their average consumption;

- There shall be no rate decreases in any rate element for any class of customer based on any reduced revenue requirement allowance or revised cost of service and rate design analyses conducted in the Artesian rate case;

- Artesian’s method of billing quarterly and monthly customers will remain unchanged; and

- The stipulation applies solely to the Artesian rate case and is not binding on any party in any future rate case, and shall not affect or prejudice the ability of any party to adopt any position or make any argument in any future rate cases, including but not limited to any position or argument that may appear inconsistent with the positions contained in the Stipulation.

(HER at 52-53).

140. The Hearing Examiner found that each party, which represented a wide variety of interests, agreed to the Stipulation. The Hearing Examiner further agreed, based on his review of the evidence, that CC’s user characteristics qualified it for the “Wholesale Industrial” Rate, as opposed to the “All Other” classification under which it had been served. Thus, the Hearing Examiner found that the Stipulation was reasonable and in the public interest pursuant to 26 *Del. C.* §512. (HER at 53-54).

141. No party excepted to the Hearing Examiner’s recommendation. Accordingly, the Commission adopts as its own the Hearing Examiner’s summary of the evidence and his recommended findings and conclusions on this issue, as set forth in paragraphs 122-123 of the HER. (Unanimous).

142. At the deliberations, GM requested a point of clarification regarding the compliance rates to be filed by the Company. We hereby make it clear that the compliance rates to be filed by the Company should be done pursuant to the Stipulation. (Unanimous).

CAPITAL STRUCTURE

A. Inclusion of Short-Term Debt.

143. Artesian proposed a capital structure as of September 30, 2003 consisting of 60.24% long-term debt and 39.76% common equity. GM supported the Company's proposed capital structure because it believed that capital structure was adequate to maintain Artesian's financial integrity and access to capital. CC did not question the propriety of Artesian's capital structure. The DPA proposed an alternative capital structure for Artesian comprised of 55.09% long-term debt, 8.54% short-term debt, and 36.37% common equity. Staff did not express a position on the issue until it filed its answering brief supporting DPA's position.

144. The Company contended that including short-term debt in its capital structure ignores the long-term nature of ratemaking and the fact that the Company's assets that are financed by short-term debt (infrastructure and plant improvements) are long-term assets. The Company argued that it is preferable to match long-term assets with long-term liabilities and, since Artesian's short-term debt is used for construction projects which are long-term assets, it is appropriate to match these with the long-term debt which ultimately finances the assets.

145. Staff and the DPA argued that it would be unfair to ignore short-term debt for ratemaking purposes because the Company consistently and regularly carries short-term debt on its books. Staff and DPA also argued that short-term debt should be included in a utility's capital structure when, like here, it is used as a bridge to permanent financing. Thus, the DPA, with Staff concurring,

recommended that the Commission include the average balance of short-term debt outstanding during the past three years, or $13.1 million.

146. **The Hearing Examiner's Recommendation.** The Hearing Examiner agreed with Artesian and recommended that the Commission not include short-term debt in Artesian's capital structure in order to "maintain an appropriate matching between the capitalization supported by the ratepayers and the capitalization used for setting rates." (HER at 58). The Hearing Examiner found that removing short-term debt *did* result in "the actual capitalization used by the Company *for the rate base that the ratepayers are supporting.*" (*Id.* (emphasis in original)).

147. **Exceptions.** Staff was the only party to except to the Hearing Examiner's recommendation. Staff argued that in Docket No. 02-109, the Commission had specifically stated that short-term debt should not be included in rates when there was evidence that it was being replaced with long-term financing, and there was no record evidence that the Company was planning to do that here. Staff also reiterated its positions that: (a) short-term debt should be included in the capital structure when it is used as a bridge to permanent financing; and (b) Artesian consistently and regularly carries short-term debt on its books.

148. **Discussion.** The Commission agrees with the Hearing Examiner's analysis. Therefore, for the reasons expressed by the Hearing Examiner, we adopt his findings and recommendations as contained in paragraphs 124-135 of the HER on this issue. (Unanimous).

<u>RATE OF RETURN</u>

A. **Cost of Long-Term Debt.**

149. The Company claimed that its cost of long-term debt is 6.67%, although in briefing it admitted various mistakes in its calculation. However, it urged the Commission to approve the methodology that it used, and direct the parties to determine the effective rate from the undisputed components of the cost of long-term debt. That methodology is as follows:

- Divide the actual interest paid on the stated principal issued by the net principal outstanding (after deducting issuance expenses).
- Where a sinking fund associated with retirement of principal over the life of the bond exists, make adjustment to increase the effective cost of the bond (the "average net proceeds ratio").

The Company also objected to including a rebate paid by CoBank on certain debt issuances, arguing that it has no contractual or legal right to the rebate and therefore it should not be used to reduce the long-term interest rate calculated for the Company.

150. Staff argued that in addition to miscalculating the effective interest rate for its Series P debt, Artesian had also miscalculated the effective interest rate for its Series M, N, O and SRF debt. Staff contended that the Company had calculated the proposed effective rate for the most recent debt issuances by dividing the stated interest rate by the net proceeds ratio -- but had used some other method not described in the record for the older issuances. As for the CoBank rebate, Staff argued that the Company had received a rebate every year for the past 7 years and therefore it was known and measurable. Furthermore, if the Commission were to project that the rebate would not be issued in the future, then the Commission should also project other changes that would serve to reduce long-term

interest rates. Specifically, Staff observed that the Commission determined that the Company's long-term cost of debt in Docket No. 02-109 was 7.27%, while the actual cost has been 6.73%. Staff witness Henkes calculated the effective rates using the stated interest rate divided by the net proceeds ratio for all of the issuances and the CoBank rebate, and derived a cost of long-term debt of 6.34%.

151. The DPA also challenged the Company's calculation of the cost of long-term debt. The DPA calculated a cost of long-term debt of 6.48%, derived from taking the Company's originally-proposed 7.18% rate and adjusting it to: (a) correct the misstated Series P debt; (b) remove the sinking fund adjustment because approximately 90% of the Company's debt has no sinking fund requirement; and (c) including the CoBank rebate.

152. **The Hearing Examiner's Recommendation.** The Hearing Examiner recommended that the Commission accept Staff's recommended cost of long-term debt. First, he agreed with Staff and the DPA that the CoBank rebate should be included in the calculation of long-term debt. He found that the Company had received the rebate in the test year (and for the six years prior), and that it was the Company's burden to establish that it would not receive a rebate in the rate effective period. Second, he agreed with Staff that because the Company failed to correct the debt rate for its older issuances in the same manner as it did the Series P debt, and did not explain how it had calculated the interest rate for the older issuances, its long-term debt proposal could not be accepted. He further found that because the DPA had relied on Artesian's original (inaccurate) debt rate as its starting point, its recommendation could not be accepted either. (HER at 62).

153. **Exceptions.** No party excepted to the Hearing Examiner's recommendation.

154. **Discussion.** Accordingly, the Commission adopts as its own the Hearing Examiner's summary of the evidence and his recommended findings and conclusions on this issue, as set forth by paragraphs 138-144 of the HER. (Unanimous).

Cost of Equity.

155. The Company claims a cost of equity of 11.06% (reduced from its original request of 12.70%) based on four different methods to estimate the cost of equity for the Company: Discounted Cash Flow ("DCF"); Capital Asset Pricing Model ("CAPM"); Risk Premium Analysis ("RP"); and the Fama-French Three-Factor model ("FFM"). To derive his recommended cost of equity, the Company's witness, Mr. Mülle, examined a proxy group composed of nine water companies located throughout the United States: American States Water Co., Aqua America, Inc., Artesian Resources Corp.,[3] California Water Service Group, Connecticut Water Service, Inc., Middlesex Water Company, SJW Corp., Southwest Water Company, and The York Water Company. In his CAPM calculation, Mr. Mülle included a "small-company" adjustment to account for the additional risk for investors created by Artesian's relative small size. Averaging the results of these four methods, the Company determined that the market cost of equity was 11.12%. Mr. Mülle then adjusted the market cost of equity upward to convert the market-required equity return rates to regulatory-required book-value equivalent return rates. Mr. Mülle used three different methods to effectuate the conversion. First, Mr. Mülle made an adjustment to the

[3]Artesian Resources Corp. is the Company's parent.

. . . (footnote continued to next page.)

DCF-derived cost of equity to maintain the target market-to-book value ratio. Second, Mr. Mülle applied a method, devised by Modigliani and Miller, designed to recognize the return value between one set of market-levered cost rates, and another differently-levered set, or condition, such as that seen in the lesser book values employed in regulation. Finally, he applied the Brigham Leverage Curve methodology.

156. The DPA used the DCF and CAPM methodologies to calculate its recommended cost of equity for the Company. The DPA's witness, Ms. Crane, used the same companies in her proxy group as those used by Mr. Mülle, except that Ms. Crane's group did not include Artesian Resources Corp. Ms. Crane testified that because the Commission has generally relied primarily upon the DCF, she weighted her results 75% for the DCF and 25% for the CAPM. This weighting resulted in a recommended cost of equity of 8.90%. She also recognized that in the past the Commission had considered a small company premium for some utilities, and so testified that if the Commission determined that such a premium was justified for Artesian, a 25 basis point premium was appropriate. With that adjustment, Ms. Crane's recommended cost of equity for the Company was 9.14%. The DPA disagreed with the "market-to-book" adjustments suggested by Company's witness Mr. Mülle.

157. GM's witness, Mr. Gorman, also calculated the Company's cost of equity using the DCF and CAPM methodologies. He used the same comparison group of water companies as Mr. Mülle. Based on the results of his DCF and CAPM analyses, Mr. Gorman estimated the appropriate return on equity for the Company to be 9.8%. Like

Ms. Crane, Mr. Gorman also took issue with Mr. Mülle’s upward adjustments to the calculated return on equity. With respect to Mr. Mülle’s CAPM analysis, Mr. Gorman disagreed that a small size adjustment was necessary because this adjustment did not reflect the Company’s risk. Mr. Gorman also rejected Mr. Mülle’s DCF analysis as unreasonable because he believed it included an adjustment for generic flotation costs for companies, rather than on Company-specific flotation costs.

158. Although Staff submitted pre-filed testimony of Charles W. King on cost of capital issues, Staff elected not to proffer that testimony at the evidentiary hearing. The Company acknowledged at the hearing that it could not force Staff to put Mr. King on the stand, but argued that due to the prejudicial effect of Staff’s actions, Mr. King’s pre-filed testimony should be part of the record. At the hearing, the Hearing Examiner rejected the Company’s request to include Mr. King’s pre-filed testimony in the record. In the post-hearing briefing, Staff recommended that the Commission leave Artesian’s currently authorized 10.50% return on equity in place.

159. **The Hearing Examiner’s Recommendation.** After reviewing the results of the parties’ various analyses, the Hearing Examiner recommended that the Commission allow the Company a return on equity of 10.11%, which he stated represented the unadjusted DCF-derived cost of equity for Mr. Mülle’s proxy group. The Hearing Examiner observed that the Commission has always used the DCF as the primary equity cost method, and the Commission had not changed that stance in any written Order. He further noted that the 10.11% result was reasonable because it fell between the DPA’s and GM’s DCF results and between the two highest and two lowest recommendations. The Hearing Examiner

recommended that the Commission reject both the “small company” and “market-to-book” adjustments made by the Company. The Hearing Examiner did not recommend any adjustment be made for flotation costs because he did not believe the Company’s 10.11% result he was recommending was overstated since it was lower than GM’s 10.19% DCF result.

160. **Exceptions.** Both GM and the Company excepted to the Hearing Examiner’s Findings and Recommendations. GM excepted to the Hearing Examiner’s failure to reject the flotation cost adjustment that the Company made. GM argued that the unadjusted DCF cost of equity that the Hearing Examiner should have used was 9.82%.

161. The Company asserted that the record did not support the Hearing Examiner’s 10.11% equity cost recommendation. Recognizing the Commission’s primary reliance on the DCF model for determining the cost of equity, the Company contended that the use of the DCF in this case supported a return on equity of 11.06%. The Company contended that factors other than the straight application of the DCF model should figure into the determination of a fair return on equity for the Company: (a) Artesian’s small size; (b) the return on equity that has been awarded to companies with which it competes for capital, such as Aqua Pennsylvania; (c) the rising interest rate environment that has developed since this proceeding began a year ago; (d) Staff’s conduct in relation to its case on return on equity; and (e) the Hearing Examiner’s errors in identifying the Company’s DCF recommendation upon which he based his own recommendation.

162. **Discussion.** Although the parties have presented the Commission with a wide range of possible returns on equity, we believe the Hearing Examiner did a very good job of distilling the issues;

considering the various theories, methods, analyses, calculations, and adjustments; and ultimately recommending a return on equity of 10.11% for the Company. Based on the Hearing Examiner's thoughtful recommendation, and Artesian's overall performance, we believe the appropriate rate of return on equity for the Company should be 10.25%. Our decision should not be construed as reflecting negatively on Artesian's performance. It is simply a reflection that Artesian's requested 11.06% cannot be sustained in light of current market conditions and the conditions that are expected during the rate effective period. (Unanimous).

ORIGINAL ISSUES NOT ADDRESSED BY HEARING EXAMINER

163. The Hearing Examiner neglected to address two issues -- the amount of power expense to be included in operating expenses and the Parsons' study expenses. The Company accepted Staff's proposed treatment of both, and so there is no dispute. We find that with respect to power expense, the amount to be included in operating expenses is $1,191,502. We further find that the appropriate ratemaking treatment for the Parsons' study expense is normalization over three years. (Unanimous).

164. There were also several other issues that were either not contested during the evidentiary hearings or which were abandoned on exceptions. Those are as follows:

- Including the acquisition costs of the Shady Park system in rate base;
- The appropriate amount of chemical expenses to be included in operating expenses ($385,572);
- Reduction of operating expenses by $9,457 for expenses associated with lobbying; and

- Reduction of operating expenses by $11,919 for expenses associated with advertising, marketing and public relations.

165. The Hearing Examiner recommended approval of the positions as set forth above. Since there is no longer any dispute about those issues, we adopt the Findings and Recommendations of the Hearing Examiner for the reasons set forth therein. (Unanimous).

166. To the extent that the Findings and Recommendations of the Hearing Examiner (dated February 23, 2005) addressed issues that we have not specifically addressed herein, we adopt the Hearing Examiner's findings and recommendations on those issues. (Unanimous).

ADDITIONAL REMAND ISSUES

The "True-Up" Issue

167. At the July 5, 2005 Commission Hearing, Artesian requested that the Commission's final Order reflect a "true-up" of its overall rate base in order to include the actual amount of plant-in-service at the end of the test period, or June 30, 2004. Staff, the DPA, and GM objected, maintaining that because Artesian failed to move the final "true-up" figure into the hearing record, the Commission could not include the "true-up" as part of the approved rate base. The Commission voted to include the plant-in-service "true-up" issue in the remand that it had already ordered. PSC Order No. 6681 (July 19, 2005).

168. Artesian witness, Mr. Spacht, testified that Artesian provided the actual figures for the end of the test period in response to data request PSC-A94, dated September 8, 2004. (Ex. 60 at 2). Noting that Company witness Mr. Minch stated in his rebuttal testimony

(dated September 13, 2004) that the parties had agreed to "true up" the rate base, Mr. Spacht argued that there was no need to provide the figures again. Mr. Spacht attached a copy of the discovery response that included the actual, "trued-up" figures to his written testimony on remand. Mr. Spacht also asserted that to use the actual information, rather than the projected data, would be fair to both the Company and its customers. (*Id.* at 3).

169. Connie S. McDowell, PSC Chief of Technical Services, testified that she verified the accuracy of Artesian's claimed rate base as of June 30, 2004 (*i.e.*, the end of the test period), which included Artesian's "true-up" regarding construction costs. (Ex. 66 at 3). Ms. McDowell recommended that the Commission accept Artesian's claimed rate base, including the plant-in-service "true-up." (*Id.* at 5).

170. The DPA recommended that the Commission reject Artesian's updated plant-in-service figures because they were not placed into the record of the proceeding at the hearing. (Ex. 65 at 8-9). The DPA argued that, as a matter of public policy, utilities should not be permitted to update their rate case claims after the close of the record, except under extraordinary circumstances.

171. **The Hearing Examiner's Recommendation**. The Hearing Examiner found that the Company's end-of-test-period figures should be used to set rate base because: (i) the parties agree that rate base should reflect the actual test period figures (consistent with the Commission's Minimum Filing Requirements, § IV(F)(1)); (ii) the parties agree that the figures provided by the Company are accurate; and (iii) the record was reopened and the updated, actual figures were placed into the record. (R-HER ¶ 36).

172. **Exceptions.** No party excepted to the Hearing Examiner's findings and recommendation.

173. **Discussion.** Accordingly, the Commission adopts as its own the Hearing Examiner's summary of the evidence and his recommended findings and conclusions on this issue, as set forth by paragraphs 32-36 of the R-HER. (Unanimous).

The Purchased Water Petition.

174. On August 15, 2005, Artesian filed its Purchased Water Petition to increase its rates to include its increased purchased water expenses, in the amount of $131,529, which result from rate hikes that the Chester Water Authority and the City of Wilmington placed into effect on July 1, 2005.

175. Ms. McDowell testified that she verified Artesian's claims regarding its increased purchased water expenses. (Ex. 66 at 4-5). Based on July 1, 2005 rate increases from the City of Wilmington and the Chester Water Authority, Artesian's purchased water expense increased $131,529. Ms. McDowell recommended that the Commission approve Artesian's request for a rate increase based on this increase in purchased water expenses.

176. The DPA witness, Ms. Crane, recommended that, as a matter of public policy, the Commission reject Artesian's request to increase its purchased water expense to reflect increases effective July 1, 2005. (Ex. 65 at 11). DPA argued that the increases fall well outside the test period from the rate case and that there is no statutory authority to increase operating costs outside of a base rate case filing. The DPA, however, argues that even if Artesian's application constitutes a "single issue rate case" (which is permitted by statute), it should not be allowed during an ongoing full rate

case. (R-HER ¶ 40). In addition, the base rate included in the Company's rate case filing included no base meter charges while its purchased water adjustment application requests $3,643 for cost increases relating to base charges.

177. Artesian's witness, Mr. Spacht, acknowledged that the Company inadvertently omitted the base meter charge in its rate case, as noted by Ms. Crane. (Ex. 60 at 15.) Mr. Spacht explained that, because of this omission, Artesian seeks now to recover only the *increase* in the base charge, not the charge itself. According to Mr. Spacht, this additional expense is currently being incurred by the Company and he urged its approval.

178. **The Hearing Examiner's Recommendation.** The Hearing Examiner recommended that the Commission allow the requested rate increase to recover Artesian's increase in purchased water expenses, in the amount of $131,529. The Hearing Examiner found that the Commission has the undisputed authority, under 26 *Del. C*. § 304(b), to consider limited issue rate proceedings. The Hearing Examiner explained, "[o]ne reason that the Commission would hesitate to allow a limited issue proceeding is the potential that the petitioning utility seeks to recover a cost that has risen but ignores other costs that have fallen, which could lead to over-earning." (R-HER ¶ 41). The Hearing Examiner stated, "[i]n this case, however, such a concern is minimal because all of Artesian's costs have recently been investigated and litigated [and] [i]n addition, because the increase in purchased water costs is discrete, easily verifiable, and has no corresponding impact on revenues, it is the type of cost that is suitable for recovery via this mechanism." (*Id.*).

179. **Exceptions.** No party excepted to the Hearing Examiner's findings and recommendation.

180.`**Discussion.** The Commission adopts as its own the Hearing Examiner's summary of the evidence and his recommended findings and conclusions on this issue, as set forth by paragraphs 37-41 of the R-HER. (Unanimous).

181. To the extent that the Findings and Recommendations of the Hearing Examiner on Remand from the Commission (dated March 23, 2006) addressed issues that we have not specifically addressed herein, we adopt the Hearing Examiner's findings and recommendations on those issues. (Unanimous).

ORDER

AND NOW, this 9th day of May, 2006, **IT IS HEREBY ORDERED:**

1. That Artesian Water Company, Inc. may include in rate base the costs associated with its purchase of the Churchmans Road property (Increases rate base by $5,022,038).

2. That Artesian Water Company, Inc. may include in rate base the costs associated with the acquisition of the Shady Park water system (Increases rate base by $140,000).

3. That Artesian Water Company, Inc. may offset its Accumulated Deferred Income Tax ("ADIT") balance by its Alternative Minimum Tax ("AMT") asset in the amount of $1,491,850 that shall not be levelized.

4. That Artesian Water Company, Inc.'s methodology for calculating water sales revenues is approved.

5. That Artesian Water Company, Inc.'s adjustment to test period contract revenues to remove $16,222 for "normalization of non-recurring revenues" is rejected. (Increases contract revenues by $16,222).

6. That Artesian Water Company, Inc.’s test year purchase water discount revenue level of $53,423 is approved. (No change to purchase water discount revenues).

7. That the $31,000 of charitable donation expenses included in Artesian Water Company, Inc.’s operating expenses be removed for ratemaking purposes. (Decreases operating expenses by $31,000).

8. That the $24,526 in operating expenses associated with Artesian Water Company, Inc.’s employee swimming pool be removed for ratemaking purposes. (Decreases operating expenses by $24,256).

9. That Artesian Water Company, Inc. be permitted to include in operating expenses the payroll expenses associated with seven new employees that were hired as of the end of the test period.

10. That Artesian Water Company, Inc. be permitted to include the test year payroll expense for grass cutters in operating expenses.

11. That Artesian Water Company, Inc. be permitted to include the payroll expense associated with only one Courier/Custodian position in operating expenses.

12. That Artesian Water Company, Inc.'s proposed pension to payroll expense ratio of 6.9% is approved.

13. That Artesian Water Company, Inc.'s allocation of expenses to its affiliates for this case is approved, but that Artesian is directed to file a Cost Allocation Manual within six (6) months of the date of this Order, and that the Cost Allocation Manual address, at a minimum, the following:

    - A description of each corporate entity, including a description of the organizational structure and a description of the services provided;
    - For each operating expense account, a description of how costs will be allocated or charged among various affiliates;
    - For each capital cost that is used to provide service to multiple entities, a description of how those costs will be allocated or charged among various entities;
    - A process for periodically reporting on costs allocated or charged to other entities; and
    - A process for periodically reviewing cost allocations to determine if adjustments are required.

Additionally, the Company is directed to file the Cost Allocation Manual with Staff and the DPA and to work with Staff and the DPA to resolve issues regarding the Cost Allocation Manual in a timely manner.

14. That Artesian Water Company, Inc.'s $60,000 of rate case expenses for Guastella & Associates is approved.

15. That the amount of chemical expenses to be included in operating expenses for ratemaking purposes is $385,572.

16. That Artesian Water Company, Inc.'s operating expenses be reduced by $9,457 for lobbying expenses.

17. That Artesian Water Company, Inc.'s test year expense of $155,556 for consulting expenses is approved for inclusion in operating expenses.

18. That Artesian Water Company, Inc.'s operating expenses be reduced by $11,919 for advertising, marketing and public relations expenses.

19. That Artesian Water Company, Inc.'s operating expenses be reduced by $56,392 of miscellaneous expenses.

20. That the amount of power expenses to be included in operating expenses for ratemaking purposes is $1,191,502.

21. That the Parsons' Study expenses shall be normalized over three years, which results in $17,702 to be included in operating expenses for ratemaking purposes.

22. That the Stipulation of Parties and Order of the Hearing Examiner Regarding Cost of Service and Rate Design, attached hereto as Exhibit "A", is approved. Furthermore, the rates that are placed into effect as a result of this Order shall be calculated in accordance with that Stipulation.

23. That Artesian Water Company, Inc.'s capital structure for ratemaking purposes in this proceeding shall not include short-term debt, and shall consist of the following: 60.24% long-term debt and 39.76% common equity.

24. That Artesian Water Company, Inc.’s cost of long-term debt to be used for ratemaking purposes in this proceeding is 6.34%.

25. That the return on equity hereby approved for Artesian Water Company, Inc. in this proceeding is 10.25%.

26. That we adopt the Hearing Examiner’s Findings and Recommendations (attached hereto as Exhibit “B”) on all issues not explicitly addressed in this Final Findings, Opinion and Order.

27. That Artesian Water Company, Inc.’s actual, end-of-test period “true-up” figures be used to set rate base.

28. That Artesian Water Company, Inc.’s rates be increased by the aggregate annual amount of $131,529 to recover increases in its purchased water expenses resulting from July 2005 rate hikes imposed by the City of Wilmington and the Chester Water Authority as requested by Artesian Water Company, Inc.’s August 15, 2005, Petition to Place Increased Rates into Effect.

29. That the revenue requirement resulting from the determinations made in this Order is $4,914,952.

30. That Artesian Water Company, Inc. shall file compliance rates in accordance with the determinations made in this Order.

31. That the Commission retains the jurisdiction and authority to enter such further Orders in this matter as may be deemed necessary or proper.

BY ORDER OF THE COMMISSION:

/s/ Arnetta McRae
Chair

/s/ Joann T. Conaway
Commissioner

/s/ Dallas Winslow
Commissioner

/s/ Jaymes B. Lester
Commissioner

/s/ Jeffrey J. Clark
Commissioner

ATTEST:

/s/ Karen J. Nickerson
Secretary

E X H I B I T "A"

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION	)	
OF ARTESIAN WATER COMPANY, INC.	)	PSC Docket No. 04-42
FOR A REVISION OF RATES	)	

STIPULATION OF PARTIES AND ORDER OF THE HEARING EXAMINER REGARDING COST OF SERVICE AND RATE DESIGN

WHEREAS, on February 5, 2004, Artesian Water Company, Inc. ("Artesian" or "the Company") filed with the Delaware Public Service Commission ("the Commission") an application for a revision of its water service rates and for several changes to its tariffed rules and regulations (the "Artesian Rate Cast");

WHEREAS, in connection with the filing of the Artesian Rate Case, Artesian submitted the Direct Testimony of its cost of service and rate design witness, John F. Guastella of Guastella Associates Inc. (the "Guastella Direct Testimony");

WHEREAS, as documented by a letter ruling to the parties dated April 27, 2004, General Motors Corporation (and its subsidiary, Saturn Corporation) ("GM") and Christiana Care Health Care Services, Inc. ("Christiana Care") were permitted to intervene in the Artesian Rate Case;

WHEREAS, on March 26, 2004, Artesian filed the Supplemental Direct Testimony of John F. Guastella, Sr. and John M. Guastella Associates Inc. (collectively, "Guastella Supplemental Testimony") and on September 13, 2004, Artesian filed the Rebuttal Testimony of John F. Guastella Associates, Inc. (the "Guastella Rebuttal Testimony" and collectively with the Guastella Direct Testimony and the Guastella Supplemental Testimony, the "Guastella Testimony") addressing cost of service and rate design issues; and

WHEREAS, on August 9, 2004, the Public Service Commission Staff (the "PSC" Staff) submitted the Direct Testimony of Brian Kalcic (the "Kalcic Testimony"), GM submitted the Direct Testimony of Ernest Harwig (the "Harwig Direct Testimony") and Christiana Care submitted the Direct Testimony of John R. Palko (the "Palko Testimony"), each of which also addressed certain cost of service and rate design matters; and

WHEREAS, on September 10, 2004, GM submitted the Rebuttal Testimony of Ernest Harwig (the "Harwig Rebuttal Testimony" and collectively with the Harwig Direct Testimony, the "Harwig Testimony"); and

WHEREAS, the parties have agreed to execute this Stipulation of Parties and Order of the Hearing Examiner Regarding Cost of Service and Rate Design (this "Stipulation").

THE PARTIES HEREBY AGREE, SUBJECT TO APPROVAL OF THE HEARING EXAMINER, AS FOLLOWS:

1. The Guastella Testimony, the Kalcic Testimony, the Harwig Testimony and the Palko Testimony shall be admitted into evidence.

2. All parties waive their right to cross-examine Messrs. Guastella, Kalcic, Harwig and Palko and none of them will appear at the hearing.

3. All parties agree that when establishing final rates reflecting the Public Service Commission's allowed revenue requirement, the cost of service study will reallocate miscellaneous

revenues according to the method proposed by the PSC Staff, as described on page 4 of the Kalcic Testimony.

4. All parties agree that for the Artesian Rate Case there will be no requirement for the installation of special metering equipment to gather the load profile for customers subject to Artesian’s Wholesale Industrial Rate.

5. All parties agree that Artesian for the Artesian Rate Case may rely on estimated maximum day and maximum hour profiles as a single customer class derived from monthly billing data for all customers subject to Artesian’s Wholesale Industrial Rate.

6. All parties agree that GM and Christiana Care shall receive service under Artesian’s Wholesale Industrial Rate.

7. All parties agree that rate case expenses should be allocated based on the O & M – EXCL POWER, CHEM & PURCH WATER factor, as described in Schedules 7 and 9 of Exhibit 2 of the Guastella Supplemental Testimony, which equates to operation and maintenance expenses reduced by the expenses for power, chemicals and purchased water.

8. All parties agree that purchased water expenses and electric power expenses should be allocated entirely based on the Base allocation factor, as described in Schedules 7 and 9 of Exhibit 2 of the Guastella Supplemental Testimony, and to each customer class on the basis of their average consumption.

9. All parties agree that there should be no rate decreases in any rate element for any class of customer based on any reduced revenue requirement allowance or revised cost of service and rate design analyses conducted in the Artesian Rate Case.

10. All parties agree that Artesian’s method of billing quarterly and monthly customers will remain unchanged.

11. This Stipulation applies solely to the Artesian Rate Case. This Stipulation is not binding on any party in any future rate case, nor will it be considered precedent in any future proceeding, and shall not affect or prejudice the ability of any party to adopt any position or make any argument in any future rate cases, including but not limited to any position or argument that may appear inconsistent with the positions contained in this Stipulation.

MORRIS, NICHOLS, ARSHT & TUNNELL

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Attorneys for General Motors Corporation

SO ORDERED this 5th day if October, 2004.

/s/ William F. O’Brien
Hearing Examiner

E X H I B I T "B"

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF	**)**
ARTESIAN WATER COMPANY, INC. FOR AN	**) PSC DOCKET NO. 04-42**
INCREASE IN WATER RATES	**)**
(FILED FEBRUARY 5, 2004)	**)**

FINDINGS AND RECOMMENDATIONS OF THE HEARING EXAMINER

DATED: FEBRUARY 23, 2005 **WILLIAM F. O'BRIEN**

SENIOR HEARING EXAMINER

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BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF	**)**	
ARTESIAN WATER COMPANY, INC. FOR AN	**)**	**PSC DOCKET NO. 04-42**
INCREASE IN WATER RATES	**)**	
(FILED FEBRUARY 5, 2004)	**)**	

FINDINGS AND RECOMMENDATIONS OF THE HEARING EXAMINER

William F. O'Brien, duly appointed Hearing Examiner in this Docket pursuant to 26 *Del. C.* § 502 and 29 *Del. C.* ch. 101, by Commission Order No. 6378, dated March 16, 2004, (as reassigned by the Executive Director) reports to the Commission as follows:

I. <u>INTRODUCTION</u>

A. Appearances

On behalf of the Applicant, Artesian Water Company, Inc.:

Morris, Nichols, Arsht & Tunnell, by
Michael Houghton, Esquire,
R. Judson Scaggs, Jr., Esquire,
Jerry C. Harris, Jr., Esquire.

On behalf of the Public Service Commission Staff:

Ashby & Geddes, by
James McC. Geddes, Esquire,
Regina A. Iorii, Esquire.

On behalf of the Division of the Public Advocate:

G. Arthur Padmore, Public Advocate.

On behalf of General Motors Corporation and Saturn Corporation:

Christian Barton, LLP, by
Louis R. Monacell, Esquire.

On behalf of Christiana Care Health Services, Inc.:

Richards, Layton & Finger, by
Glenn C. Kenton, Esquire.

B. Procedural Background

1. On February 5, 2004, Artesian Water Company, Inc. ("Artesian" or "the Company") filed with the Delaware Public Service Commission ("Commission") an application for an increase in its water service rates and for several changes to its tariffed rules and regulations. The proposed rates, as originally filed, were designed to produce additional annual revenues to the Company of $8,766,132, or an increase of approximately 24.22 percent. With its application, the Company filed the direct testimony of four of its witnesses.

2. On March 16, 2004, the Commission issued Order No. 6378 suspending the Company's application pending the completion of evidentiary hearings concerning the justness and reasonableness of the proposed rates. On April 6, 2004, by Order No. 6390, the Commission granted Artesian's request, under 26 *Del. C.* § 306(c), to place a temporary rate increase of approximately 6.9 percent (a revenue increase of just less than $2,500,000) into effect, under bond and subject to refund, pending the Commission's final decision. On August 31, 2004, by Order No. 6468, because seven months had expired since the filing of the case, the Commission granted Artesian's request, under § 306(b), to place another temporary rate increase into effect, also under bond, which brought the total temporary increase to 15 percent.

3. On March 16, 2004, the Division of the Public Advocate ("DPA") intervened as a party in the proceeding. In addition, on April 27, 2004, the intervention petitions of General Motors Corporation and its subsidiary Saturn Corporation ("General Motors")

and of Christiana Care Health Services, Inc. ("Christiana Care") were granted.

4. On March 26, 2004, Artesian filed supplemental testimony of three witnesses updating its financial schedules with actual data through December 31, 2003, as required by Commission rules. Based on the new data, Artesian reduced its requested revenue increase by $41,550 to $8,724,582, reflecting an actual increase over current approved rates of approximately 23.8 percent.

5. On the evenings of June 7, 8, 9, and 10, 2004, duly noticed public comment sessions were conducted in Middletown, Wilmington, Bethany Beach and Dover, Delaware. A total of six members of the public attended. The Commission also received five letters or e-mail from customers concerning the proposed rate increase. Public comment is summarized below.

6. On August 9, 2004, after conducting discovery, Staff (three witnesses), DPA (two witnesses), General Motors (two witnesses) and Christiana Care (one witness) filed written direct testimony, in accordance with the procedural schedule. On September 13, 2004, after completing their own discovery, Artesian (three witnesses) and General Motors (one witness) filed rebuttal testimony.

7. On October 4-5, 2004, duly noticed[4] evidentiary hearings were conducted at which the witnesses presented their testimony and were subject to cross-examination. At the onset of the hearing, the parties presented a stipulation and agreement reached by all parties

[4] The affidavits of publication of notice from the *Delaware State News* and *The News Journal* are included in the record as Exhibit 1. Exhibits will be cited as "Ex.__ at __" or "Ex.__ (witness name) at __" and references to the hearing transcript will be cited as "Tr. at __."

. . . (footnote continued to next page.)

to resolve the cost of service and rate design issues (Ex. 50), meaning that the only disputed issues remaining in the case involve rate base and revenue requirements.

8. At the conclusion of the hearing, the evidentiary record, then consisting of 58 exhibits and 532 pages of transcript, was kept open pending receipt of certain revised schedules from Staff. On October 8, 2004, those schedules were received and admitted (Ex. 59), and the record was closed.

9. In accordance with the post-hearing schedule, as modified after the hearing, the Company filed its opening brief on November 18, 2004, Staff and the intervenors filed their answering briefs on December 20, 2004, and the Company filed its reply brief on January 13, 2004.[5] I have considered all of the record evidence, as well as the public comment and post hearing briefs and, based thereon, I submit for the Commission's consideration these findings and recommendations.

C. Jurisdiction

10. The Commission has jurisdiction over this matter pursuant to 26 Del. C. § 201(a).

D. Public Comment

11. Three members of the public appeared at the June 7, 2004 public comment session in Middletown, Delaware. Mr. Chuck Mulholland of Middletown noted that he is not a customer of Artesian's but asked what portion of the requested 24 percent increase could be attributed

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[5] The Company's opening brief and reply brief will be cited as "Artesian OB at __" and "Artesian RB at __." The answering briefs will be cited as "[name of party] AB at __."

to the water line that Artesian is constructing across the C&D Canal.[6] (Tr. at 17–22.) Beverly Schreiber of Bear stated that the proposed increase would be "devastating" because she has not had a raise in two years (as a State employee) and because other living expenses had increased. (Tr. at 24.) Richard McAloon, of Middletown, asked certain questions regarding the allocation of the rate increase between the fixed customer charge and the usage charge. (Tr. at 25-26.)

12. Two customers appeared at the June 8, 2004 public comment session in Wilmington. Mr. James Purdy of Wilmington asserted that, to the extent the rate increase reflects the cost of constructing the C&D Canal pipeline in order to serve customers to the south of the Canal, the customers to the south of the Canal should pay for the pipeline. (Tr. at 38.) Mr. Purdy also suggested that Artesian pay for the pipeline with profits, rather than paying "record dividends" to shareholders. He also asserted that Artesian cannot justify even a five percent increase and that customers on fixed incomes will not be able to afford an increase. Richard Merrill of Arundel stated that it was Artesian's poor planning that has led to so many increases in recent years, that 24 percent is way too high of an increase, and that he will have difficulty affording a rate increase because he is retired and living on a fixed income.

13. No customers appeared at the June 9, 2004 public hearing in Bethany Beach. However, Wynona Dawson, a representative from Bayview Park Association, indicated that her community, which is currently

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[6] By letter dated June 21, 2004, Artesian responded to Mr. Mulholland, indicating that $208,242 of the proposed revenue increase can be attributed to . . . (footnote continued to next page.)

served by private wells, was looking into requesting public water service from Artesian. No customers or members of the public appeared at the June 10, 2004 public comment session in Dover.

14. In addition to those who spoke at the public comment sessions, five customers submitted written comments by regular mail or e-mail. The written comments include an assertion that the cost of Artesian's headquarters and the C&D Canal connection should come from profits, an objection to the ratepayers paying for system expansion, a complaint that the rates are weighted too heavily on the fixed customer charge (which discourages water conservation and is unfair to customers who use very little water), and general objections to the size of the increase in light of the recent rate increases already approved by the Commission.

II. SUMMARY OF EVIDENCE AND DISCUSSION

15. Artesian based its application for a rate increase on a test year ending September 30, 2003, and a test period ending June 30, 2004. Consistent with the Commission's *Minimum Filing Requirements*, the Company filed its application based on test year data (with pro forma adjustments to account for anticipated changes during the test period) and then updated its filing every three months with actual data, until the end of the test period. In general, the need for additional revenue results from: (1) substantial capital expenditures made since the last rate case; (2) increases in certain operating expenses; and (3) the Company's request for an increase in its approved return on equity from 10.5 percent to 12.7 percent. (Application at 2, 5.)

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the C&D Canal connection, which is a 0.57 percent increase in rates, which . . . (footnote continued to next page.)

16. After a thorough investigation of Artesian's application and supporting documentation, Staff and the other parties accepted much of the data and testimony filed by the Company as well as the proposed changes to its tariffed rules and regulations. In the interest of effectively defining the issues for resolution by the Commission, therefore, this "Summary of Evidence and Discussion of Issues" section (after briefly outlining the content of the prefiled written testimony) will focus on those matters that remain in dispute at this stage of the proceeding.

A. Overall Summary of Testimony

17. With its original application, which reflected a 24.2 percent rate increase request, Artesian filed the direct testimony of four witnesses. Richard B. Minch, Controller of Artesian Resources Corp. (Artesian's parent corporation), addressed Artesian's accounting system, the components of the requested rate relief (*i.e.*, rate base, net operating income, and rate of return), and the proposed changes to Artesian's rules and regulations. (Ex. 9 (Minch).) Proposed rule changes include a $30 charge for a missed service appointment after the first missed appointment and a change in the late payment charge to prime rate plus 5 percent.

18. Bruce P. Kraeuter, Artesian's Vice President of Planning and Engineering, provided testimony on the design of Artesian's water system (including reliability considerations and supply and demand projections) and on utility plant additions expected during the test period. (Ex. 2 (Kraeuter).) Henry G. Mülle, President of H.G. Mülle & Associates, LLC, estimated Artesian's prospective cost of common equity and, based

converts to less than $0.60 per quarter for the average residential customer.

thereon, recommended a rate of return on equity of 12.7 percent. (Ex. 27 (Mülle).) John F. Guastella, President of Guastella Associates, Inc., proposed a rate design that reflects an across-the-board rate increase for all retail customer classes, without any rate increase to the wholesale class. (Ex. 51 (Guastella).)

19. The Company updated its application by filing supplemental direct testimony from Messrs. Minch (Ex. 10), Kraeuter (Ex. 3), and John F. Guastella (Ex. 52 (Guastella)), as well as from John M. Guastella, Director of Rates and Valuation for Guastella Associates, Inc., (Ex. 58 (Guastella.). Using updated information, Artesian reduced its rate increase proposal from 24.2 percent to 23.8 percent based on a rate base of $150,910,602, net income under present rates of $8,909,196, a rate of return of 9.38 percent and a total proposed revenue increase of $8,724,582. (Ex. 10 (Minch) at 1.) In addition, Messrs. John F. and John M. Guastella provided a cost allocation and rate design study to replace the proposed across-the-board allocation of the increase from the initial application. (Exs. 52, 58.)

20. Staff filed the direct testimony of three witnesses. Robert J. Henkes, principal of Henkes Consulting, Inc., presented Staff's recommendations regarding rate base operating income and revenue requirements for Artesian. (Ex. 48.) Mr. Henkes recommended $9,035,173 in reductions to Artesian's proposed rate base and $5,279,333 in reductions to Artesian's proposed revenue requirements (based on a 10.7 percent cost of equity, which was later modified.) Brian Kalcic, principal of Excel Consulting, Inc., proposed certain modifications to Artesian's rate design and recommended that Christiana Care be found eligible for Artesian's wholesale industrial rate (Ex. 54.).

21. Staff also filed the direct testimony of Charles W. King, President of Snavely King Majoros O'Connor & Lee, Inc., regarding cost of equity. At the hearing, however, citing recently developed concerns regarding the content of Mr. King's prefiled testimony, Staff elected neither to call Mr. King as a witness nor to introduce his prefiled testimony. (Tr. at 255-258; 338-352.)

22. DPA filed the direct written testimony of Andrea C. Crane, a principal of The Columbia Group, Inc., and Howard J. Woods, Jr. of Howard J. Woods, Jr. & Associates, L.L.C. Ms. Crane analyzed all facets of Artesian's revenue requirement, made numerous adjustments, and recommended a rate increase of $1,403,995, in contrast to Artesian's request for $8,724,581. (Ex. 35.) Mr. Woods reviewed and described Artesian's capital investment program and concluded that it is supported by an appropriate planning process. (Ex. 49.)

23. General Motors filed the direct testimony of Michael Gorman and Ernest Harwig, consultants with Brubaker & Associates, Inc. Mr. Gorman addressed Artesian's proposed rate of return and recommended a return on equity of 9.8 percent. (Ex. 37.) Mr. Harwig reviewed Artesian's cost of service study and, in particular, the classification of purchased water expense and electric power expense. (Ex. 55.) Mr. Harwig concluded that Artesian has over-allocated costs to General Motors by $13,239, or $0.139 per thousand gallons.

24. Christiana Care filed the direct testimony of John R. Palko, Vice President of AUS Consultants. (Ex. 57.) Mr. Palko reviewed Artesian's cost of service allocation and rate design and concluded that Christiana Care should be afforded the opportunity to receive service under a water rate comparable to that available to General Motors.

25. Artesian submitted prefiled rebuttal testimony from five witnesses. Mr. Minch responded to Staff's and DPA's direct testimony regarding long-term debt and rate base, particularly in relation to projected utility plant in service, the Shady Park system acquisition and deferred taxes. (Ex. 11.) Mr. Mülle responded to Staff's, DPA's, and General Motors' testimony regarding risk, capitalization, and return on common equity. (Ex. 28.) He also described certain changes in the market place since he filed his direct testimony but concluded that his proposed return on equity of 12.7 percent remained appropriate.

26. Mr. Kraeuter responded to Staff's and DPA's testimony regarding customer consumption, chemical expenses, and power costs. (Ex. 4.) In addition, Mr. Kraeuter provided the total, actual capital plant placed in service by the end of the test period, or $33,189,974, as an update to his earlier testimony. Mr. Guastella responded to General Motors', Christiana Care's and Staff's direct testimony regarding cost allocation and rate design. (Ex. 53.) Mr. Guastella agreed with Mr. Palko's recommendation to treat Christiana Care similar to General Motors for rate design purposes. Joseph A. DiNunzio, Senior Vice President of Artesian, described the purchase of Artesian's headquarters facility at 664 Churchmans Road, Newark, and concluded that, contrary to Ms. Crane's and Mr. Henkes' recommendations, the purchase should be fully included in rate base. (Ex. 40.)

27. General Motors submitted Mr. Harwig's rebuttal testimony, in which he disagreed with Mr. Palko regarding certain recommendations regarding eligibility for the Wholesale Industrial classification. (Ex. 56 at 2-3.) Mr. Harwig also disagreed with Mr. Kalcic's recommendation that the Commission direct Artesian to develop actual daily and hourly

peaking ratios (to be used as cost allocation factors) from readings obtained from special metering equipment. (*Id.* at 3-4.)

28. At the hearing, the parties presented their witnesses for cross-examination and proffered their prefiled written testimony. (Tr. at 63-529.) Because the parties settled the cost of service and rate design issues, they waived their right to cross-examine Messrs. J.F. Guastella, J.M. Guastella, Kalcic, Harwig and Palko, and simply introduced their pre-filed written testimony into the record. (Ex. 50.)

29. After the hearing, Staff submitted revised schedules for Mr. Henkes, which reflected two alternatives for his proposed total revenue requirement using the currently authorized return on equity of 10.5 percent (in contrast to the 10.7 percent cost of equity from Mr. King's pre-filed testimony that he used originally). (Ex. 59.) "Alternative No. 1" is based on DPA's proposed capital structure and results in a revenue requirement of $3,052,667. (*Id.* at Schedule RJH-1 (revised)). "Alternative No. 2" is based on General Motors' proposed capital structure and results in a revenue requirement of $4,083,817. (*Id.*)

B. Rate Base

30. The Company is entitled to earn a fair return on its rate base, which is defined generally as its investment in assets that are dedicated to providing water service. Artesian requests rate base recognition of $150,910,602, which is an increase of $38,299,745 over the rate base approved in Artesian's last rate case (PSC Docket No. 02-109). (Ex. 10 at 1, RSM Supp. Exhibit 1, Schedule 1.) The capital projects and cash working capital portions of Artesian's rate base request are undisputed. The disputed rate base issues consist of Artesian's purchase of its headquarters on Churchmans Road, the

purchase of the Shady Park Water System, and deferred taxes. (Artesian OB at 5-23.)

1. Churchmans Road Headquarters

31. Artesian's rate base request includes $5,022,238 for expenses associated with the purchase of its headquarters facility at 664 Churchmans Road in Newark, Delaware from White Clay Realty Company ("White Clay"). Prior to the purchase, and dating back to 1972, Artesian leased the property from White Clay. Because of the common ownership and control between Artesian and White Clay, DPA and Staff recommend that the Commission only allow rate recovery of the revenue requirement that would have been necessary had Artesian continued under its lease with White Clay. (DPA AB at 27; Staff AB at 55.)

32. DPA argues that the sale took place between a regulated utility and an unregulated affiliate and, therefore, based on Commission policy, should be priced at the lower of cost (*i.e.*, net book value) or market price. (DPA AB at 26-27.) Because the Company did not provide the book value of the facility, however, DPA based recovery on the lease payment that would be due had the Company continued to lease the facility. DPA concludes that the Commission should deny rate base recognition of the $5.2 million purchase and, instead, approve a pro forma expense of $173,9564. (DPA AB at 27.)

33. Staff argues that the headquarters purchase constituted an "affiliated transaction" and, as such, should be reviewed not by Delaware's "business judgment rule" (as argued by Artesian) but should be tested for "entire fairness." (Staff AB at 54.) The purchase fails to meet the "entire fairness" test, according to Staff, because the process Artesian followed was unfair (*i.e.*, the individuals who negotiated the purchase price stood to profit from it) and because the

price was unfair in that it constituted "double payment" by the ratepayers for improvements to the facility (once when the improvements were made and again with the purchase of the property). (*Id.*) In the alternative, Staff argues that, even if the business judgment rule applies, the purchase should not be recognized in rates because Artesian's "inexplicable" failure to renew the lease, which forced Artesian to buy the property, constitutes an "abuse of discretion."[7] Staff recommends that the Commission limit Artesian to an annual revenue requirement associated with the property of $507,153, which reflects the revenue requirement if the lease scenario had continued.[8] (Staff AB at 55.)

34. A timeline of undisputed facts relating to the purchase of the headquarters facility is as follows:

1971	State condemns Artesian's headquarters property located in Newport, Delaware in connection with the widening of Route 141.
November 1971	White Clay Realty Company is formed as a limited partnership to construct and own Artesian's new headquarters facility at 664 Churchmans Road. Ellis D. Taylor and Norman H. Taylor, Sr. are general partners and John R. Eisenbrey, Sr. is the substitute general partner; all of whom held officer positions with Artesian at one time or another.
December 1971	Commission approves Artesian's sale of 664 Churchmans Road property (10.52 acres) to White Clay for $132,000 for the purpose of leasing it back to Artesian. (PSC Order No. 1104 dated December 30, 1971.) White Clay constructs the facility at a cost of approximately $2 million. (Tr. at 358.)

[7] Under Delaware's business judgment rule, the Commission must allow the normally accepted operating expenses of a utility "unless found to have been made in bad faith or out of an abuse of discretion." (*Delmarva Power & Light Company. v. Public Serv. Comm'n*, Del. Supr., 508 A.2d 849, 859 (1986) ("*Delmarva Power*").)

[8] The Company calculated that the acquisition increases its revenue requirement by $660,633 -- the difference between $1,167,786 (the annual revenue requirement of the purchase option) and $507,153 (the revenue requirement had the Company continued to lease the property). (Staff AB at 51, *citing* Ex. 48 (Henkes) at 18.)

March 1, 1972	White Clay and Artesian enter into their lease. Ellis D. Taylor signs lease for both Artesian and White Clay. The lease contains a de-escalator clause whereby rent declines after mortgage is paid off in 25 years. The lease provides for purchase option at fair market value. The lease provides that tenant improvements become property of White Clay.
January 1973	Commission approves ratemaking treatment of lease finding that the Company's financial condition precluded it from building its own headquarters and that the lease arrangement produced significant savings to the ratepayers. (PSC Order No. 1187, January 26, 1973.)
2001	Artesian management begins to study space needs for headquarters and decides that expansion is necessary.
2002	Based on changes in ownership over time, ownership in White Clay stands at 12.25 percent for Dian C. Taylor (current President, CEO and Chair of the Board of Directors of Artesian) and 23 percent for two other persons affiliated with Artesian, for a total ownership interest of 35.5 percent held by persons with some connection to Artesian.
March 2002	Artesian commissions outside firm to appraise its headquarters property. The appraiser determines fair market value to be $3.8 million.
August 2002	Artesian sends a renewal notice for lease to White Clay. A White Clay limited partner challenges timeliness of notice and asserts that lease will terminate on December 31, 2002. (Timing requirement of notice is clouded by failure to record inception date of lease term.)
September 2002	Artesian forms Special Committee of outside directors (unaffiliated with White Clay) to consider acquisition of headquarters as well as to review the challenge raised concerning timeliness of the renewal notice. Committee retains counsel, obtains an updated appraisal of the property, obtains surveys of other available properties, and engages second appraiser. The Committee meets twenty times over 14 months.
November 2002	The Special Committee authorizes outside counsel to negotiate with White Clay to purchase property. Artesian offers $3.0 million. Because of the deaths of all its general partners, White Clay is unable to respond as an entity to the offer. A limited partner (unaffiliated with Artesian) demands $6 million for the property, admitting that he is seeking speculative value. Helena C. Taylor, who, as executrix of the estate of Ellis D. Taylor, owns 24.5 percent of White Clay, obtains appraisal of property reflecting a value of $4.8 million.
December 2002	After conducting review of other real estate options, the Special Committee decides to exercise Artesian’s power of eminent domain and Artesian institutes

	condemnation proceedings to force a purchase of the property for fair market value. An owner of White Clay files motion to dismiss the proceeding challenging the constitutionality of the taking.
February 2003	Superior Court declares that White Clay had been dissolved at the time of the last general partner's death in 2001. Individual owners, therefore, are unable to speak for the other owners. (Artesian RB at 2.)
Late 2003	Prior to the Court's ruling on the motion to dismiss, the parties agree to a purchase price of $4.5 million, which is approved by the Court. The price reflects that an additional 34,580 square feet of office space could be built on the property, which was recognized by the Helena Taylor appraisal but not by Artesian's appraisal.

(Ex. 40 (DiNunzio)(unless otherwise noted above.)

35. As further discussed below, because Artesian substantially followed the terms of the lease (including the purchase option), which were fully scrutinized and approved by the Commission, with full knowledge of the common ownership between Artesian and White Clay, the Commission should afford full rate base treatment for Artesian's purchase of its headquarters property. In addition, as addressed below, the sale of the property passes any standard of review identified by the parties.

36. On December 30, 1971, by Order No. 1104, the Commission approved Artesian's sale of the property to White Clay for $132,000 for the purpose of constructing Artesian's headquarters and leasing it back to Artesian. According to the Commission, the price was fair (based on an independent appraisal of $106,000) and the construction plan was fair to Artesian and its customers, despite the common ownership and control between the parties. On January 26, 1973, by Order No. 1187, after White Clay spent approximately $2 million constructing the facility, the Commission approved the lease agreement between White Clay and Artesian.

37. The terms of the lease provided the amount of the rent payments, the requirement that Artesian pay for improvements to the facility, and Artesian's option to purchase the property, with Commission approval, at fair market value. According to the lease, fair market value was to be determined by the three-appraisal method; *i.e.*, Artesian and White Clay would each select an appraiser and, if necessary, those two appraisers would select a third appraiser. (Ex. 40(DiNunzio) at 3-4.) In an Order issued prior to final approval, the Commission noted that the "proposed lease and financial relationship between [White Clay] and Artesian was subject to close scrutiny" in light of the common ownership between the parties. (PSC Order No. 1149 (June 21, 1972).) No one in this case has challenged the propriety of those rulings.

38. Then, over the next 30 years, in every rate case filed by Artesian, the Commission approved rate recognition of the lease payments and facility improvements, consistent with the approved lease. According to Artesian (and not disputed by the other parties), ratepayers have benefited from below market rents for the last 30 years as well as favorable regulatory treatment of the lease, in that the lease has been booked as an operating lease rather than a capital lease and, therefore, has not been included in rate base as a capital asset. (Ex. 40(DiNunzio) at 4.)

39. In 2001, management began to study Artesian's space needs and decided that it must expand its facility to accommodate both current and future space needs. (*Id*. at 6.) Artesian engaged an outside planning firm, obtained an appraisal, formed a Special Committee of outside directors (to avoid the appearance of a conflict of interest), considered other available properties, and ultimately

decided that it would be prudent to purchase the Churchmans Road property. In addition to the need for additional space, the main building needed a new roof and a new HVAC system, each of which would cost approximately $500,000. Artesian decided to purchase the property before making the expansion or completing the $1 million in required maintenance because, under the lease, Artesian would have had to pay for the improvements when made and then pay for them again upon purchase of the property by virtue of the increase in market value resulting from the improvements. (*Id*. at 7.)

40. Under the approved lease, Artesian was required to obtain approval of the purchase from the Commission, after using the three-appraisal method to determine fair market value. Artesian claims that it did not seek Commission approval because it did not purchase the property under the lease option but, rather, it exercised its statutory power of eminent domain and purchased the property pursuant to the settlement of the condemnation proceeding. (Artesian RB at 10; *citing* Ex. 40 (DiNunzio) at 16.) Artesian was unable to exercise the lease option because of the complications that arose from the dissolution of White Clay and because of one of White Clay's owner's refusal to exchange appraisals. (*Id*. at 14.)

41. The Commission's approval of the lease, however, was conditioned on Artesian getting pre-approval from the Commission before buying back the property, in all likelihood for the purpose of verifying that the purchase price was at fair market value, in light of the conflict of interest created by the common ownership. (DPA AB at 25, fn 25; Tr. at 377.) At the very least, Artesian should have notified the Commission of its intentions and, if at all possible, should have sought approval from the Commission prior to completing

the transaction. This error is mitigated somewhat by the fact that a Superior Court Judge approved the purchase price as "just compensation," which in Delaware equates to fair market value. (Ex. 40 (DiNunzio) at Exhibit JAD-6.) In addition, Artesian's failure to seek approval certainly does not warrant disallowance of rate base treatment for the purchase. After all, the reason for requiring approval; *i.e.*, verification of fair market value, has been satisfied in this proceeding, albeit after the transaction took place.

42. Because Artesian sold the property to White Clay, leased it back, paid for improvements, and repurchased the property for fair market value, all of which was contemplated by the Commission's approval of the lease, notwithstanding its knowledge of the common ownership, I cannot find any reason not to include the purchase in rate base -- just as if Artesian had purchased another property for its headquarters. Staff, however, argues that if ratepayers would be better off had Artesian continued under the below-market lease payments, and if Artesian decided to make the purchase either because of the self-interests of those who stood on both sides of the transaction or because it failed to renew the lease on time, then Artesian should not be afforded rate base treatment. (Staff AB at 51-58.)

43. There is no dispute, however, that Artesian needed more space, was facing $1 million in repairs, and would have to pay twice for these improvements if it waited until the end of the lease term to purchase the property. I cannot conclude, therefore, that ratepayers would be better off continuing under the lease. The untimely notice of renewal was simply an allegation made by one White Clay limited partner, who admitted to seeking speculative value for the property

and who was likely exploring all legal measures, however tenuous, by which he could encourage a sale. Whether the renewal notice was actually untimely was never proven by the limited partner and never conceded by Artesian. Artesian, in fact, claims that there was no set date under the lease for the notice and that, furthermore, it would have purchased the property irrespective of the allegation. (Artesian RB at 13-14, *citing* Tr. at 396.)

44. In addition, Staff argues that the "entire fairness" test, rather than the business judgment rule, applies to the purchase because it was an affiliated transaction. (Staff AB at 54.) Even if this test does apply, however, the purchase was fair because it was made for fair market value, under a lease that provided for the purchase of the property at fair market value, under lease terms that were approved by the Commission. The fact that ratepayers are effectively paying twice for improvements is a consequence of the approved lease. Moreover, if the Company had purchased another property, the ratepayers would be no better off since they would be paying for past improvements made to the purchased property.

45. Citing PSC Order No. 5469 (June 20, 2000) in Docket No. 99-582 and certain guidelines issued by the National Association of Regulatory Utility Commissioners ("NARUC"), DPA argues that the sale by a non-regulated affiliate (White Clay) to a regulated utility (Artesian) should be priced at the lower of cost or market price, (*i.e.*, "asymmetrical pricing."). (DPA AB at 21.) However, even if the purchase could be considered an affiliated transaction, which Artesian argues it is not, Artesian is not bound by PSC Order No. 5469 or NARUC guidelines. In Docket No. 99-582, the Commission approved a "Cost Accounting Manual and Code of Conduct" for Delmarva Power and

Light Company, not Artesian. Without notice or guidance from the Commission that asymmetrical pricing would be in effect, it would be unfair to impose it now, after the purchase has been completed. (Artesian RB at 6.) Furthermore, if asymmetrical pricing requirements are established in order to ensure that utilities do not overpay for goods or services purchased from affiliates (*Id*. at 14), that purpose has been served here by the Commission's requirement that Artesian pay fair market value for the property and by Artesian's compliance with that requirement.

46. For these reasons, I recommend that the Commission allow rate base treatment of Artesian's purchase of the Churchmans Road property. If the Commission accepts this recommendation, then Staff's and DPA's corresponding adjustments to the accumulated depreciation balance would not be necessary. (Artesian OB at 23.)

2. Shady Park Acquisition

47. Artesian purchased the Shady Park Water System ("Shady Park") for $140,000, which it included in its rate base request. (Ex. 11 (Minch) at 9.) DPA recommends no rate base treatment of the purchase because "acquisition of utility property should be recorded in rate base at the lower of original cost value or the purchase price" and the Company never provided information regarding the original cost of the system. (DPA AB at 29.) DPA argues that the use of original cost, which it defines as "the cost at the time that the property first enters utility service," prevents companies from buying assets at inflated prices in order to inflate its rate base. (*Id*.)

48. First, DPA cites no authority for the proposition that the Commission affords rate base treatment only to the lower of original cost or purchase price for water utility acquisitions of private water systems. Indeed, regulated water utilities have purchased dozens of small private water systems (and made improvements thereto) in Delaware over the last ten years, but there is no assertion in this case that the Commission has limited rate base treatment in those cases to original cost. Second, it is arguable that the limitation would not apply in this case anyway because a small private system likely is not considered “utility” property until it is purchased by a regulated “water utility.” (Artesian RB at 20.) Third, the reason behind the “rule” – to prevent companies from paying inflated prices – is not a concern in this case since the undisputed evidence is that Artesian paid a fair price. (*Id*.)

49. Finally, from a public interest standpoint, it is unlikely that the Commission would want to discourage water utilities (with the means to do so) from purchasing and upgrading smaller systems to bring them into compliance with environmental and public health regulations, as was done in this case. (Ex. 11 (Minch) at 10.) For these reasons, I recommend that the Commission permit Artesian to include in rate base the entire purchase price of the Shady Park Water System.

3. Deferred Taxes

50. A deferred tax balance is recorded as a liability on the balance sheet and therefore serves to lower the total amount of rate base. In this case, the Company, for the first time, has proposed to reduce its regular accumulated deferred income tax (“ADIT”) balance by its prepaid deferred taxes associated with its alternative minimum tax (“AMT”) payments. The Company proposes to offset its regular

depreciation-related ADIT balance of $15,320,734, by its prepaid AMT balance of $2,097,424, such that the rate base deduction for ADIT would be $13,233,210, rather than $15,320,734. (Ex. 48 (Henkes) at 20.) Staff and DPA object to the adjustment.

51. DPA argues that the Commission uses a utility's statutory income tax expense, rather than AMT payments, to set rates and therefore it would be inappropriate to include, as an adjustment to rate base, a deferred income tax reserve that is based on AMT payments. (DPA AB at 31.) If it did include this adjustment, then it is likely that the Company's income tax expense claim (which is made on a stand-alone basis rather than on a consolidated basis with Artesian's parent corporation) would have to be substantially reduced. DPA recommends, therefore, that if the Commission elects to adopt this adjustment, then it should also make an adjustment to calculate Artesian's income tax liability based on actual taxes paid on a consolidated basis. (*Id.*)

52. Staff makes the following argument, similar to DPA's:

> The Company says that its proposal is "merely a function of the historical rate base treatment of deferred tax liabilities." (Artesian OB at 20.) But the Company conveniently neglects to mention that in this case (and in all of the Company's prior rate cases), the pro forma income taxes used for ratemaking purposes are based on the application of the federal and state income tax rates to the Company's PSC-adopted test period pre-tax operating income, reduced by the Company's PSC-adopted pro forma interest. Thus, while any tax credits from AMT carry-forwards or AMT-related tax refunds are recorded by the Company for book purposes, those AMT credits or refunds never enter the income tax formula used for ratemaking purposes in the Company's rate cases. Since AMT tax considerations are never recognized for ratemaking purposes in determining the Company's regulated pro forma test period income taxes, it would be inappropriate to then give rate base recognition to AMT-related ADIT

> balances in the rate base. (Ex. 48 (Henkes) at 21-22.)

(Staff AB at 58-59.)

53. The mismatch identified by both DPA and Staff hurts ratepayers in that rate base recognition of prepaid AMT as a reduction to deferred taxes serves to increase rate base, while *not* recognizing the prepaid AMT as a reduction to the income tax expense serves to increase operating expenses. The AMT paid is not recognized as a reduction to the income tax expense because income taxes are calculated for regulatory purposes on a stand-alone basis rather than on an actual-taxes-paid basis. Actual taxes are not paid on a stand-alone basis but on a consolidated basis with Artesian's parent. The Company's response to this mismatch is, simply, that the Commission has consistently rejected basing the income tax calculation on an actual-taxes-paid (consolidated) basis. (Artesian at 26.) Staff and DPA are not, however, suggesting that the Commission change its practice in this case regarding the income tax calculation, *unless it accepts Artesian's AMT rate base adjustment*, and then only to eliminate the resulting mismatch.

54. Therefore, while recognition of the AMT asset in rate base may be appropriate in concept, it would not be fair to ratepayers in practice so long as the Commission calculates the income tax expense on a stand-alone basis, rather than on an actual, consolidated basis. I recommend, therefore, that the Commission reject the Company's proposal in this matter and restore its rate base deduction for ADIT to $15,320,734, rather than $13,233,210, which will reduce the Company's rate base calculation by $2,097,424.

C. Operating Revenues

55. In order to calculate the Company's revenue deficiency, the Company must determine its operating revenues under current rates. The disputed issues relating to operating revenues are the method for estimating water sales revenues, the amount of contract revenues, and purchase discounts.

1. Method for Estimating Water Sales Revenues

56. Rather than use actual test year revenues for water sales, Artesian uses a computer model that uses the historic five-year average for each customer in order to "normalize all variations in consumption caused by wet or dry weather patterns." (Ex. 11 (Minch) at 14.) While applauding Artesian's use of a five-year average, DPA recommends the use of an aggregate average for all residential customers, instead of an average based on individual customer usage. (DPA AB at 32-36.) DPA argues that in a growing system, such as Artesian's, when large numbers of customers are added during the five year period, Artesian's method ignores the expected usage for those customers during the initial years, which could be substantially different than the later years, based on weather anomalies. In other words, if per customer usage has dropped (or increased) during the five year period because of cool wet weather (or hot dry weather), then the per customer average will be skewed downward (or upward).

57. Artesian argues, however, that the record evidence does not show that DPA's method is more accurate than Artesian's noting (1) that the consumption of many of the new customers does not vary with weather changes (*i.e.*, those customers with little irrigation use) and (2) that Artesian's method more accurately accounts for each

customer’s usage pattern because it better accounts for demographic and geographic characteristics. (Artesian RB at 26-28.)

58. I agree with Artesian that the evidence does not show that DPA’s method is more accurate overall and that there is not sufficient reason, therefore, to change the method that has been used and accepted in the past. I also note that, even if DPA is correct that Artesian’s estimates are somewhat skewed (in periods of high customer growth when there are weather anomalies during the latter part of the five-year period) it does not follow that the skewing will always favor Artesian. Any inaccuracies, therefore, should even out over time. For these reasons, I recommend that the Commission accept Artesian’s method for estimating water sales revenues.

2. Contract Revenues

59. Artesian performs certain services under contract to other water systems. (Ex. 38 (Crane) at 42-43.) Artesian’s actual test year contract revenues were $158,853, to which it added $24,300 for the addition of two customers during the test period. (Ex. 10 (Minch) at RSM Exhibit 1, Schedule 3-A, Page 1; Ex. 48 (Henkes) at 27.) The Company, however, adjusted this amount downward by $16,222 because it normalized “non-recurring” contract revenues over two years, due to the variability of these charges. (Ex. 11 (Minch) at 15.) The Company considers the portion of contract revenues that are derived from one-time or start-up activities for new customers to be non-recurring.

60. I agree with Staff and DPA, however, that the non-recurring contract revenues amount should be restored to the actual test year

amount, which would result in contract revenues of $183,153.[9] The Company has not demonstrated that the test year level (adjusted for known test period additions) is abnormal in any way and, therefore, deserving of normalization. (DPA AB at 37.) After all, just because certain revenues are "non-recurring" for a particular contract, does not mean that the revenues will not recur in future years, with the addition of new contract customers. (Staff AB at 60.) In fact, overall contract revenues have increased every year since 2001, which supports Staff's and DPA's arguments that the Company should not be permitted any downward adjustments to such revenues. (Ex. 48 (Henkes) at 28.) I recommend, therefore, that the Commission use the Company's test period contract revenues of $183,153, without any downward adjustments to account for so-called "non-recurring" items.[10]

3. Purchase Discounts

61. The Company included purchased water discount revenues of $53,423, which is the actual test year amount of the discounts. (Ex. 48 (Henkes) at 30; Artesian OB at 26.) The primary source of the purchase water discount is a two percent discount from the Chester Water Authority ("CWA"), with the remainder coming from various other

[9] DPA's recommendation was actually $158,853, but DPA did not include the test period addition of $24,300, from Mr. Minch's supplemental testimony. (DPA AB at 36-37; Ex. 10 (Minch) at RSM Exhibit 1, Schedule 3-A, Page 1; Ex. 48 (Henkes) at 27.)

[10] Staff notes, on brief, that based on its upward adjustment to contract revenues, it made an upward adjustment to contract operating expenses of $17,964, to account for the increasing expenses that occur with increasing revenues. (Staff AB at footnote 37.) DPA notes, however, that the Company made no downward adjustment to its claim for contract expenses to account for its downward adjustment to contract revenues. (Staff AB at 37.) It is not clear, therefore, that Staff's increase to contract expenses should be made even if its recommendation for increased contract revenues is accepted. In any event, any adjustment to test period contract revenues ordered by the Commission may require an appropriate adjustment to test period contract expenses and the parties should address this issue in their written exceptions.

. . . (footnote continued to next page.)

purchase discounts. Staff seeks to increase purchase discounts by $3,159 based on a seven-year average for all discounts other than the CWA discount. In its brief, Staff explains that it used the five-year average from Artesian’s last rate case and simply extended that average using data from 2002 and 2003.

62. I agree with Artesian, however, that Artesian’s test–year data for purchase discounts should be used. First, Staff’s use of a seven-year average appears somewhat arbitrary as it is simply an extension of the entire term used in the last case to include the intervening years. Second, as noted by Artesian, use of a five-year average, which is the term used for water sales revenues, would yield an amount only $1,598 less than the Company’s overall purchase discount figure. Consequently, it appears that the test year data requires no normalization in this case. For these reasons, the Commission should accept Artesian’s test year purchase water discount amount of $53,423.

C. Operating Expenses

1. Charitable Donations

63. Artesian includes $31,000 of charitable donations in its claim for operating expenses. Artesian notes that the Commission allowed $31,000 in Artesian’s last rate case (PSC Docket No. 02-109). In addition, the Delaware Supreme Court, in a 1959 decision, found that modest charitable contributions that are “made to preserve community goodwill” are recoverable as operating expenses.[11] Staff recommends disallowance of all such donations and DPA seeks a 50/50

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[11] *Application of Diamond State Tel. Company.*, 149 A.2d 324, 331 (Del. 1959).
. . . (footnote continued to next page.)

sharing of the donation expense between shareholders and ratepayers. (Staff AB at; DPA AB at 45-47.)

64. I agree with Staff that the Commission should no longer allow the Company to charge ratepayers for even modest levels of charitable donations. Not only have circumstances changed dramatically since 1959, when the Delaware Supreme Court held that modest charitable donations were recoverable, but circumstances have changed even since Artesian's last rate case.[12] As argued by Staff, changes since the last rate case, which have significantly increased the overall burden on Artesian's ratepayers, include:

> 1.) The Company's expansion into areas of the state that it has never served before, which impacts rates for all ratepayers;
>
> 2.) Increased security costs and property insurance premiums as a result of the 9/11 terrorist attacks;
>
> 3.) Increased directors' and officers' insurance costs and auditing costs as a result of the passage of the Sarbanes-Oxley Act; and
>
> 4.) Increased expenses associated with stricter water quality standards.

(Staff AB at 36, *citing* (Ex. 48 (Henkes) at 32-33.)

65. Moreover, the Company has now acknowledged that the average time between its applications for rate increases has decreased to just two years, which suggests that even more rate increases will be forthcoming. (Ex. 9 (Minch) at 18.) These changes since the last

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[12] As noted by the Company, if an agency departs from prior regulatory practice, it must provide a rational explanation for the departure. *United Water Delaware, Inc. v. Publ. Serv. Comm'n*, 723 A.2d 1172, 1177. (Del. 1999).

case justify another look from the Commission at whether ratepayers should be charged for this type of discretionary spending.

66. In addition, the Delaware Supreme Court noted that the Commission may disallow contributions if they are not related to the fostering of the goodwill of the Company.[13] Judging from the public comment in this case, which reflects ever-tightening personal budgets strained by ever-rising utility rates, it is likely that in today's environment charitable donations no longer foster goodwill, at least among the ratepayers. Moreover, as Staff notes, courts will, at times, reverse their earlier positions. In fact, in 2001, the New Jersey Supreme Court reversed its position regarding recovery of charitable contributions. Finding that while the utility's charitable contributions were "commend[able]," the cost of such contributions should be borne entirely by the utility's shareholders.[14] The New Jersey Supreme Court also noted that 40 states, either by case law, statute or regulation, did not permit a utility to include charitable donations in operating expenses.[15]

67. In addition, as argued by DPA, it is inappropriate to "force captive ratepayers to foot the bill for charitable donations to entities selected by Artesian management." (DPA AB at 46.) After all, ratepayers are capable of deciding on their own how much to donate and to which organizations. I also agree with Staff and DPA that donations are not a necessary cost of utility service and that

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[13] 149 A.2d at 331.

[14] *In the Matter of Petition of New Jersey American Water Company, Inc. for an Increase in Rates for Water and Sewer Service and Other Tariff Modifications*, 777 A.2d 46, 52 (N.J. 2001). The BPU's policy, which was rejected, was to allow a 50/50 sharing of charitable donations between ratepayers and shareholders.

Artesian has failed to show what benefit, if any, ratepayers derive from the goodwill engendered from the donations. For these reasons, I recommend that the Commission deny recovery of Artesian's claim for $31,000 in charitable donations.

2. Swimming Pool Expenses

68. Artesian seeks recognition of $24,526 for operating expenses associated with its swimming pool, which it considers an employee benefit. (Artesian OB at 28.) This request consists of $18,630 in lifeguard expenses and $5,896 in maintenance expenses. Staff and DPA recommend disallowance of all swimming pool expenses because the employee swimming pool is not a normal and customary employee benefit and because there is no evidence that it improves employee morale. (Staff AB at 37-39; DPA AB at 39-41.) In Artesian's last rate case, the Commission allowed swimming pool expenses because they were "modest" and had a positive effect on employee efficiency and morale.

69. For the following reasons, I recommend that the Commission discontinue its practice of allowing Artesian to charge ratepayers for the expense of operating its employee swimming pool. First, the expense is no longer "modest," as lifeguard expenses have more than doubled since the last rate case. Second, this perquisite is not necessary to boost employee morale, as could be the case if employees were asked to forego salary increases in order to keep rates in check. (DPA AB at 40, Ex. 38.) Management personnel, in fact, have averaged 5.8 percent salary increases over the last three years and non-management has averaged 3.7 percent. (*Id.*) Other benefits, which serve to boost morale regardless of whether Artesian provides a

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[15] *Id.* at 53.

swimming pool, include pensions, post-employment benefits, medical and dental insurance, short- and long-term disability insurance, life insurance, stock options, other incentive compensation, tuition refunds, and child care expenses, all of which are paid for by ratepayers. (Ex. 48 (Henkes) at 38.)

70. Third, based on the changes since the last case that have caused significant increases in rates, as discussed above, ratepayers should no longer be saddled with paying for an expense as unnecessary to the provision of water service as a swimming pool maintained exclusively for employees. Indeed, the practice of allowing recovery of swimming pool expenses appears to be unique to Delaware. Not only has the Company yet to identify one other utility that charges ratepayers for swimming pool expenses but Staff witness Henkes has never seen it in almost thirty years of regulatory experience. (Staff AB at 38.)

71. For these reasons, I recommend that the Commission deny Artesian's claim for $24,526 in operating expenses associated with its employee swimming pool.

3. Payroll Expenses

a. New Positions

72. Artesian seeks payroll expenses for 201 full-time employees, which includes ten new positions that had yet to be filled by the end of the test year (September 30, 2003). According to the Company, in rebuttal testimony filed on September 13, 2004, seven of those positions were filled by the end of the test period (June 30, 2004.) (Ex. 11 (Minch) at 17.) DPA considers these unfilled positions as normal vacancies, which the Company will experience on a regular

basis, and should not, therefore, be included in rates. (DPA AB at 37-39.) DPA recommends that the Commission decrease the requested payroll expense by three positions, using the Company's average cost per employee to calculate the adjustment. Artesian argues that the Commission should follow its decision in the last case, where it allowed recognition of all positions without any disallowance to account for the likelihood of vacancies. (Artesian RB at 33.)

73. In the last case, however, the Commission only allowed recovery of positions filled by the end of the test period. (Ex. 33 at ¶ 51, Ex. 36 at ¶ 11.) In the instant case, the Company could only confirm that seven of the ten new positions had been filled by the end of the test period. In order to include the positions, therefore, the Company must show these changes to be "known and measurable."[16] Simply stating their intention to fill the positions does not rise to the level of known and measurable, especially in light of the fact that the Company had yet to fill the positions a full nine months after stating (in its application) its intention to fill the positions. In addition, as argued by DPA, even if these positions are eventually filled, other vacancies will have likely occurred by then, which would serve to lower payroll expenses.

74. DPA also notes that Artesian's test year claim already includes the expense of temporary labor, which the Company asserts is necessary when there are vacancies. (DPA AB at 39; Artesian OB at 30.) To include both temporary labor and the cost of unfilled positions, therefore, would constitute double recovery. For these

[16] See ¶ 79 below for a discussion of the "known and measurable" standard. Generally, the Commission will only recognize changes to rate base or . . . (footnote continued to next page.)

reasons, I recommend that the Commission limit recovery of payroll expenses for new positions to the seven that were filled by the end of the test period.

b. Grass Cutting

75. Artesian claims $62,335 in payroll expenses for four part-time grass cutters. Noting that Artesian's claim is more than three times the actual test year expenses for grass cutters and that Artesian has failed to justify the amount of the increase, Staff argues that recovery should be limited to a three-year average of actual expenses, or $11,585. (Staff AB at 39-41; Ex. 48 (Henkes) at 39.)

76. Artesian asserts that it has more properties now and, therefore, more grass to cut. (Tr. at 45.) According to Company witness Minch, in rebuttal testimony, Artesian "currently has two individuals on the payroll in that function" and it "intends to fill the other two positions and, therefore, [Staff's] adjustment should be rejected." (Ex. 11 (Minch) at 19.) The two grass cutters currently on payroll total $34,178, and the two positions that Artesian intends to fill total $28,224. (Tr. at 144-145; Ex. 24.)

77. Artesian also claims that "Staff's argument is based upon a misconception of the burden of proof on expenses." (Artesian RB at 34.) According to Artesian, its projections for grass cutting expenses should be allowed because, under the business judgment rule, legitimate expenses are recoverable absent a showing that such expenses were made in "bad faith or out of an abuse of discretion."[17]

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operations expenses that occur outside the test period if those changes are known and measurable.

[17] *Id.*, *citing Delmarva Power* at 859.

. . . (footnote continued to next page.)

78. Artesian's reliance on the business judgment rule in this context, however, is misplaced. The business judgment rule, as its name might imply, protects management decisions that involve business judgment.[18] For example, a decision to hire grass cutters rather than use outside vendors would be protected under the business judgment rule and would not be "second-guessed" by the Commission (short of "bad faith" or "abuse of discretion"). In this instance, however, what Staff challenges is not any decision by management, but the reasonableness in amount and the accuracy of an accounting entry. Under Delaware law, the burden in this context could not be clearer:

> The public utility shall have the burden of proof in justifying every accounting entry of record questioned by the Commission.

26 *Del. C.* § 307(b).

79. Moreover, because this accounting entry involves expenses that did not occur during the test period, but are projected by the Company to occur thereafter, the Company faces an even stiffer burden. As mentioned above, the Commission will not allow changes to test period expenses that are not known and measurable. (Ex. 33 at ¶ 46.)[19] The Commission has described this standard as follows:

> This Commission has permitted expenses that will be incurred outside of the test period, or items that will be placed into service outside of the test period, to be included in operating expenses or rate base for the purpose of establishing rates when it is reasonably certain that the expense will be incurred or the item will be placed in service during the rate effective period and where the amounts associated therewith are sufficiently ascertainable. Thus, for

[18] 508 A.2d at 859.
[19] Exhibit No. 33 is the Commission's decision in Artesian's last rate case, PSC Order No. 6147 (April 15, 2003), PSC Docket No. 02-109.

> example, we have approved post-test period adjustments for such items as wage increases that are contractually scheduled to become effective during the rate effective period, and we have approved the inclusion in rate base of equipment that will be placed into service shortly after the close of the test period.

PSC Order No. 4104 (Dec. 19, 1995) at ¶ 99 (emphasis in original).[20]

80. Regarding the additional grass cutters, Artesian has shown neither that the expense is "reasonably certain" nor that the amount of the expense is "sufficiently ascertainable." In fact, the Company's only attempt at justification was Mr. Minch's testimony, on cross-examination by Staff, (followed by redirect):

> Q. Now the total corrected cost for these four part-time and seasonal Grass Cutters total $62,402, correct?
>
> A. I believe so.
>
> Q. And this is more than three times as high as the Company actually spent on Grass Cutters in 2003; isn't it?
>
> A. Yes, but we also have more properties. We're not using outside services as much.

(Tr. at 145.)

> Q. I think you referred to outside -- in response to a question, I'm sorry, you referred to outside services and I think additional properties, but the question is, as the years have progressed and in more recent years is Artesian cutting more grass than it used to?
>
> A. Oh, no doubt. Right.

[20] *In re Application of the Delaware Division of Chesapeake Util. Corp. for a General Increase in Natural Gas Rates and Charges Throughout Delaware and for Approval of Other Tariff Changes*, PSC Docket No. 95-73.

(Tr. at 150.) These passages are the record evidence relied upon by Artesian for justification of the expenses. (Artesian RB at 34.) As Staff notes, there is nothing in the record to indicate how much more grass Artesian must cut or how much less Artesian uses outside services. (Staff AB at 40.)

81. I do not agree with Staff, however, that a five-year average ($11,585) should be used in place of Artesian's actual test period expenses of $34,178. While Artesian has failed to show that its expenses would go up in the amount claimed, there is certainly no indication that expenses will go down, especially in light of the fact that Artesian now has more properties to cut. In addition, Staff has not provided a rationale (such as weather-related variations) for normalizing the expense level for grass cutting. For these reasons, I recommend that the Commission limit Artesian's claim for grass cutters to the two employees on the payroll at the end of the test period, which totals $34,178 (thereby rejecting both Artesian's claim of $62,335 and Staff's recommendation of $11,585).

c. Courier/Custodian Position

82. The Company's pro forma test period labor expenses include $38,701 of salary expense for a Courier/Custodian who is out of work on long term disability. It is unknown if and when this employee will return to work. (Ex. 48 (Henkes) at 39.) The Company's labor expenses also include the salary expense for a "newly-to-be-hired" Courier/Custodian to take the place of the Courier/Custodian who is on disability leave. (*Id.*) Artesian included a salary for the replacement Courier/Custodian as well as for the disabled Courier/Custodian because of a belief that it must, under law, keep the position of the original employee open should his return be

possible. In addition, Artesian asserts that the Courier/Custodian was a productive employee for over 20 years and that, as an appropriately compassionate employer, Artesian wishes to reward this employee by keeping his job open. (Artesian at 35.)

83. Under the business judgment rule, the Commission should not "second guess" a management decision to carry a second Courier/Custodian out of loyalty to a long-time employee who has returned to work from a temporary disability after a replacement has already been hired. According to the record evidence, however, this is not the case here. Here, the Company wants to expense *an empty position* -- *just in case* the original Courier/Custodian recovers and wishes to return to work.[21] According to Staff witness Henkes (and not corrected by any Artesian witness), "it is unknown if and when" this employee will return. (Ex. 48 (Henkes) at 39.) The evidence, in fact, suggests that Artesian is not confident of his timely return since it hired a permanent replacement rather than simply employ temporary help during his absence. Under the "known and measurable" standard, therefore, as discussed above, there can be no recovery from ratepayers of this unfilled position.

84. For these reasons, I recommend that the Commission deny Artesian's claim for $38,701 in payroll expenses for a duplicate Courier/Custodian position.

4. Pension Expense

[21] In its reply brief, Artesian states that "Artesian wishes to continue paying the disabled employee…," which implies that the Company is, in fact paying wages to the employee in his absence. (Artesian at 35.) There is no evidence in the record, however, indicating that Artesian is paying him wages – only that he is receiving payments from long-term disability insurance. (Ex. 48 (Henkes) at 39.)

85. Artesian seeks pension expenses in the amount of 6.9 percent of direct payroll. Given the fluctuations that occur in the pension to payroll ratio from year to year, DPA recommends using the average ratio over the last five years, or 6.36 percent. The ratios provided were as follows:

1999	6.40 percent
2000	6.34 percent
2001	5.97 percent
2002	6.41 percent
2003	6.67 percent

(DPA AB at 41.)

86. In his rebuttal testimony (dated over two months after the end of the test period), Company witness Minch describes the requested ratio of 6.9 percent as "actual," which normally I would interpret to mean the actual test period expense ratio. (Ex. 11 (Minch) at 19.) In its brief, however, Artesian describes the requested ratio as "estimated." (Artesian RB at 35.) If it is, in fact, estimated, then Artesian should have provided the calculation for the estimate, and why it was based on either reasonable pro forma adjustments to the test period ratio or on known and measurable changes to the test period ratio, once it was challenged by the DPA.

87. Whether it is actual or estimated, however, I find Artesian's 6.9 percent ratio to be better supported in the record than DPA's 6.36 percent. Company witness Minch described the pension plan as consisting of two components; the 401(k) defined contribution plan and a supplemental defined contribution plan for certain eligible employees. (*Id.* at 20.) He testified that the pension expense increases over time because the Company's matching contributions increase with increasing years-of-service for eligible employees in the supplemental plan. In addition, the Company has made a concerted

effort to encourage participation in the defined contribution plans (which increases Artesian's matching contribution) because it is the only source of retirement funds made available by the Company. (*Id*.)

88. The requested 6.9 percent, therefore, is more accurate than the five-year average because it is very close to the last reported actual figure (6.67 percent in 2003) and it reflects the increasing nature of the pension expense. Therefore, while it would be preferable to start with the actual test period ratio and then make any appropriate changes for normalization or for known and measurable changes, the best supported number in the record is 6.9 percent.

89. For these reasons, I recommend that the Commission accept Artesian's pension to payroll expense ratio of 6.9 percent. In addition, the pension expense itself must be adjusted for any changes to the payroll expense accepted by the Commission, since it is based on a percentage of the payroll expense.

5. Allocation to Affiliates

90. The Company is in the process of assembling a Cost Allocation Manual due to the increased activity in some of its subsidiaries. (Ex. 11 (Minch) at 21.) For this rate case, the Company uses a direct cost and allocation methodology to capture costs attributable to its subsidiaries, which results in a total allocation of $88,501. Staff recommends that, instead of using Artesian's method, the Commission should allocate three percent of all of the Company's expenses to the Company's affiliates. (Ex. 48 (Henkes) at 58; Staff AB at 42.)

91. Staff notes that four of Artesian's officers are also officers of its parent company, Artesian Resources Corp. ("Resources"), and its affiliates, Artesian Wastewater Management,

Inc., Artesian Water Pennsylvania, Inc., and Artesian Development Corp., but that only two percent of the entire allocation went to the parent company. (*Id.*) In addition, the entire allocation ($88,501) consists solely of payroll and payroll related overhead expenses. No allocation is made for such common expenses as auditing and tax, property and liability insurance, directors' fees and expenses, bank fees, or stock transfer fees. (*Id.*) Staff's proposed allocation of three percent of all expenses would reduce operating expenses by $58,611.

92. Artesian argues that Staff's concern regarding the small amount of expenses allocated to its parent is misplaced because Resources is simply a holding company and has no business of its own. (Artesian RB at 36.) Artesian, therefore, allocated expenses from Artesian directly to its affiliates, rather than allocate to Resources first and then re-allocate down to the affiliates. Artesian also claims that Staff's selection of three percent as the overall allocation percentage has no factual basis. Although three percent was used in the last case, it was accepted by Artesian solely as a compromise in order to streamline the issues in that case. (Artesian OB at 33.)

93. While both approaches are flawed, Artesian's method appears less flawed than Staff's at this time. First, Artesian's relatively small allocation to its parent appears reasonable since, as a holding company, Resources has no business of its own. Second, while Artesian fails to allocate non-payroll-related expenses, there has been no quantification of the affiliate's sharing of such items and therefore no way of knowing whether it would make a significant difference to the overall allocation. Third, Staff's selection of three percent for

the allocation percentage is not based on any quantification of the actual sharing of services taking place and, therefore, lacks factual support in the record -- albeit because Artesian was unable to provide an appropriate accounting at this time.

94. DPA also addressed this issue. (DPA AB at 50-51.) Although DPA has concerns about Artesian's allocation methodology, it does not recommend any changes to the proposed allocation for this case. Instead, DPA recommends that the Commission direct Artesian to file its Cost Allocation Manual within six months of the Order in this case and that it include, at a minimum, the following items:

> • A description of each corporate entity, including a description of the organizational structure and a description of the services provided;
>
> • For each operating expense account, a description of how costs will be allocated or charged among various affiliates;
>
> • For each capital cost that is used to provide service to multiple entities, a description of how those costs will be allocated or charged among various entities;
>
> • A process for periodically reporting on costs allocated or charged to other entities; and
>
> • A process for periodically reviewing cost allocations to determine if adjustments are required.

(*Id.*)

95. DPA also recommends that Artesian file the Cost Allocation Manuel with Staff and DPA and that Artesian commit to working with these other parties to resolve issues regarding the manual prior to the Company's next base rate case. Artesian supports DPA's recommendations and I, too, find it to be a reasonable course of action. (Artesian OB at 33.) Under DPA's recommendation, Staff will have the opportunity to verify whether the non-payroll-related costs

are properly allocated and, if not, may either work with Artesian on the matter or recommend changes before the Commission.

96. For these reasons, I recommend that the Commission accept Artesian's allocation for this case but direct Artesian to file its Cost Allocation Manual consistent with DPA's recommendations.

6. Rate Case Expenses

97. The original rate case expense claimed by Artesian includes an estimate of $10,000 for a depreciation study that was to be performed by Company witness Guastella. As it turns out, no formal study was needed or completed because the parties agreed to use, with two minor exceptions, the same rates that were accepted in the last rate case. (Staff AB at 44.) Staff, therefore, seeks to reduce rate case expenses by $10,000, while Artesian claims that its consultant's overestimate in one area is likely balanced by an underestimate in another area, which results in a reasonable overall expense. (Artesian RB at 37-38.) Mr. Guastella's total estimate for his work was $60,000. (Tr. at 502-503; Artesian RB at 38, fn 31.)

98. In his rebuttal testimony, Company witness Minch testified that "the total proposed fee for services provided by Guastella and Associates related to matters in this filing has been confirmed with Guastella and Associates as an appropriate expectation for all services rendered." (Ex. 11 (Minch) at 23.) He added that "other components of their services in this case have required more effort and cost than originally anticipated, such as those associated with two additional intervenors in this case addressing cost of service." (*Id.*)

99. In its opening brief, Artesian asserts that Mr. Guastella "obviously provided some services related to depreciation rates."

(Artesian OB at 33.) In addition, Artesian argues that it would be unreasonable to expect Artesian to produce invoices from its consultants in order to prove the reasonableness of the expense because of the intrusion into Artesian's litigation work product and because its consultants continue to work, and bill time to Artesian, during the post-hearing briefing stage. (Artesian RB at 37.)

100. In my view, however, it would not be unreasonable to expect Artesian to provide a statement from the consultant (either in testimony or an affidavit) that the overestimate pertaining to the depreciation study was absorbed by extra work in another area. The Commission may, in fact, prefer to disallow this expense on the theory that Mr. Minch's third-party statement is too unreliable and that the Commission requires something more before passing an expense through to the ratepayers.

101. My recommendation, however, is to allow the expense because there is nothing in the record to contradict Mr. Minch's sworn statement supporting the accuracy of the overall estimate. In addition, the $10,000 is not a major portion of Mr. Guastella's total expenses and it is understandable that unanticipated work in other areas absorbed the savings realized under the depreciation rate work.

7. Chemical Expenses

102. Staff witness Henkes recommended two downward adjustments (totaling $57,441) to the Company's claim for chemical expenses to account for the fact that two water treatment facilities would not operate at full capacity for some time. (Ex. 48 (Henkes) at 46-47.) The first adjustment was to limit recovery for the Choptank facility to actual test period expenses because Artesian did not expect Choptank to be at full capacity until late 2005. This adjustment

resulted in a reduction from $43,600 to $3,959. The second adjustment reflected Artesian's projection that the Chesapeake City Road facility would average 2.0 MGD (million gallons per day) over the next year rather than the 3.0 MGD used in Artesian's original claim. The second adjustment, therefore, was to reduce the test period estimate proportionately (or by one-third), from $52,000 to $35,000. These adjustments resulted in a recommendation of $385,572 for chemical expenses. Artesian accepted these adjustments.[22] (Artesian OB at 34.)

103. DPA recommends that the Commission allow only the actual test year chemical expenses of $344,201. (DPA AB at 44-45.) DPA argues that the Company's chemical expense levels for the last five years have been very stable and that the test year figure is very close to the actual expense for the most recent 12-month period (ending August 31, 2004) of $308,785, plus $35,000 for the addition of the Chesapeake facility.

104. Company witness Kraeuter, on the other hand, notes that the test year expense of $344,201, plus $35,000 to account for the Chesapeake facility, is very close to Mr. Henkes' figure of $385,572. (Ex. 4 (Kraeuter) at 4-5.) He also states that the test year was wetter than average, resulting in less production and lower chemical usage, and that one facility (Middle Run) was brought into production during the test year (and therefore was understated in test year data) and one (Chesapeake) would be brought in during the test period (and therefore was not reflected in test year data).

[22] Artesian has also accepted Staff's recommendation for power expenses, which Staff adjusted consistent with chemical expenses, for a pro forma test period amount of $1,191,502. (Artesian RB at 38; Staff AB at 45.)

105. I agree with Staff and Artesian that Mr. Henkes' adjustments to the test period data reasonably account for the known increases to capacity of Artesian's water treatment facilities and are therefore appropriate. In addition, as noted above, Mr. Henkes' figure is very close to the test year figure, if $35,000 is added to account for the addition of the Chesapeake facility. I recommend, therefore, that the Commission accept Artesian and Staff's recommendation of $385,572 for chemical expenses rather than use the unadjusted test year amount.

8. Lobbying Expenses

106. Artesian's claim for operating expenses includes $21,920 in dues to the National Association of Water Companies ("NAWC"), which has identified 27 percent of its 2002 and 2003 dues as being for lobbying expenses. (DPA AB at 47.) DPA recommends that the Commission disallow 27 percent of the test year NAWC dues (*i.e.*, $5,918), as well as $3,539 for the "Committee of 100," as unnecessary lobbying expenses.

107. DPA argues that lobbying expenses are not necessary for the provision of safe and adequate utility service and therefore should be disallowed. (*Id.*) Moreover, the lobbying activities of a regulated utility may be focused on policies and positions that enhance shareholders' interests but may not benefit, and may even harm, ratepayers. According to DPA, regulatory agencies generally disallow costs involved with lobbying, since most of these efforts are directed toward promoting the interests of the utilities' shareholders rather than their ratepayers. (*Id.*)

108. Artesian argues that DPA mistakenly assumes that its lobbying efforts only benefit shareholders and notes that it has successfully lobbied in recent years to prevent the addition of a

surcharge on water bills to expand Hoopes Reservoir and to repeal the federal tax on contributions in aid of construction. (Artesian RB at 38-39.) Artesian claims that these lobbying efforts benefited ratepayers.

109. I agree with DPA, however, that whether ratepayers actually benefit from any particular lobbying effort is irrelevant. The point is that ratepayers do not necessarily share the Company's position behind any particular lobbying effort, and even if they did (by chance), lobbying still has no relationship to the provision of water service. The only ratepayer interest that the Commission is charged with protecting when fixing rates, after all, is that rates are "just and reasonable" and that the service is adequate; not whether the federal government taxes contributions-in-aid-of-construction. (26 *Del. C.* § 311, 308.) As argued by DPA, the NAWC is not a ratepayer organization so there is no reason to assume that its lobbying efforts benefit ratepayers. In addition, as noted by DPA, the reason NAWC identifies its lobbying expenses is because regulatory agencies routinely disallow such expenses. (Ex. 38 (Crane) at 58-59; DPA AB at 47-48.)

110. I note that Artesian's membership in NAWC is not being challenged, as DPA only requests disallowance of that portion of dues that are identified as being used for lobbying activities. For these reasons, and in particular because lobbying efforts have no connection to the provision of water service, these expenses should be disallowed. As such, I recommend that the Commission accept DPA's recommendation and reduce Artesian's operating expenses by $9,457, which, adjusted for income taxes, equals $5,699. (Ex. 38 (Crane) at Schedule ACC-28.)

9. Consulting Fees

111. Artesian seeks consulting fees in the amount of its actual test year expense, or $155,556. Staff recommends that recovery be limited to the five-year average of consulting fees, which results in a reduction of $71,174. (Staff AB at 46-47.) Staff argues that normalization of the expense is necessary because consulting fees vary significantly from year to year and that the test year figure is abnormally high.

112. Artesian notes that in the last rate case the Commission rejected staff's five-year average because with the passage of the Sarbanes-Oxley Act of 2002, a historic average is "probably not a good predictor of the Company's potential liability for these types of services in the future." (Ex. 33 at ¶ 37.) Staff, on the other hand, argues that the Sarbanes-Oxley requirements were in effect by 2003, when the Company expended only $82,224 on consulting fees, or approximately half of its test year expenses.

113. In rebuttal testimony, however, Company witness Minch offered undisputed testimony that the Company has entered into a contract for consulting services that will result in approximately $200,000 in costs in 2004 in order to achieve compliance with Sarbanes-Oxley. (Ex. 11 (Minch) at 26.) He testified that the new law requires extensive documentation as well as testing of internal controls that will result in significantly increased consulting costs in the current and future years. Having entered into a contract that will result in known increases in costs and having identified the extra duties required by Sarbanes-Oxley, Artesian has shown that the test year data is a more accurate estimate of expenses for the rate-effective period than a five-year average. I recommend, therefore,

that the Commission reject Staff's use of a historic average and accept Artesian's actual test year expense for consulting fees, or $155,556.

10. Advertising, Marketing and Public Relations Expenses

114. The Company seeks to recover $11,919 of advertising, marketing and public relations expenses. Examples of these expenses are promotional gifts with the company logo, golf tournament sponsorships, and promotional advertisements in trade magazines and Chamber of Commerce directories. Staff witness Henkes removed these expenses on the ground that they have nothing to do with the provision of safe and reliable water service. (Ex. 48 (Henkes) at 59 and Sch. RJH-21.)

115. The Company asserts that "[a]ny business, including public utilities, needs to remain involved in the community and disseminate information about itself. An effective public affairs program provides multiple benefits including enhancing the utility's ability to respond to the community's needs, support community organizations, and reassure its customers of the adequacy of its water supply." (Artesian OB at 37, *citing* Ex. 11 (Minch) at 27-28). The Company further asserts that Staff has gone too far in excising expenses related to conservation that are required by law. (Artesian OB at 37.) In addition, the Company cites the Commission's request that Artesian provide bottled water for the Commission's booth at the Delaware State Fair as a recoverable expense. (*Id.* at 38.)

116. Staff argues that Artesian has an exclusive service territory, with captive customers, and therefore has no need to market

itself to customers.[23] (Staff AB at 48.) Staff notes that customers do not require any more information than what is already included in the stuffer in a customer's bill and for which ratepayers are already paying. In addition, Staff asserts that the Company does not identify one expense that Mr. Henkes has disallowed as conservation-related and required by law.

117. DPA also argues that these costs, which include marketing gifts, Christmas gifts, and a hospitality room for Delaware officials, should be disallowed because they are unnecessary for the provision of safe and adequate utility service. (DPA AB at 48-49.) DPA notes that these public relations costs are generally directed toward promoting the corporate image of the public utility, which is unnecessary in a regulated environment.

118. These costs were disallowed by the Commission in the last case and I recommend that the Commission disallow them again in this case. (Ex 36 at ¶¶ 97-98.) While I agree with the Company that any conservation-related advertising that is required by law should be recoverable, the Company failed to identify and separate any such expenses. Other than conservation-related advertising, these activities simply enhance the name recognition of the Company, which provides no discernable benefit to the ratepayers and which has nothing to do with the regulated service Artesian provides. For

[23] Staff notes that the Pennsylvania PUC has disallowed such expenses for a water company in that state, holding that "[s]ince customers have no competitive alternative to [the utility], the Company has no ascertainable need to promote itself." *Pennsylvania Public Utility Commission v. Consumers Pennsylvania Water Company – Roaring Creek Division*, 182 PUR 4th 237, 251 (Pa. PUC 1997) (quoting ALJ).

these reasons, I recommend that the Commission disallow the $11,919 sought for these expenses. [24]

11. Miscellaneous Expenses

119. The Company includes $56,392 of "miscellaneous expenses" in its claim for operating expenses. These expenses, which were disallowed in Artesian's last rate case, include items such as monthly dinners for the Committee of 100, the Delaware Contractors' Association Golf and Clay Shoot outings, and the Delaware Contractors' Association's Annual Crab Feast. (Staff AB at 49, *citing* Ex. 48 (Henkes) at 62; Sch. RJH-23; Ex. 11 (Minch) – Company's response to PSC-A-37.) The Company asserts that ratepayers should pay for these expenses because they are "a reasonable and necessary part of Artesian's public affairs and outreach efforts…." (*Id.*)

120. Mr. Henkes testified on direct examination that he had mistakenly disallowed approximately $12,700 of meals and entertainment related to working lunches and training costs. (Artesian OB at 38, citing Tr. at 482-83.) Thus, he reduced his recommended disallowance from $69,126 to $56,392. The Company claims that the meals and entertainment amount of $12,700 now allowed by Mr. Henkes should be increased to $24,031. (Artesian OB at 38.) Staff replies, however, that the difference between the Company's proposed meals and entertainment expense of $24,031 and Staff's allowed meals and entertainment expense of $12,700 consists of unexplained Christiana Country Club expenses and unspecified AMEX charges that should not be

[24] If the Company is going to cite its donation of a few dozen water bottles to the Commission as grounds for recovery of $11,919, then Staff may wish to return an equal number of water bottles to Artesian and refrain from making such a request of Artesian in the future.

allowed for ratemaking purposes. (Staff AB at 49, fn 29, *citing* Tr. at 483.)

121. Again, other than the training-related expenses, which Staff has removed from its adjustment, these expenses provide no discernable benefit to ratepayers and are wholly unrelated to the provision of water service. I agree with Staff, therefore, that they should be disallowed in this case, just as they were disallowed in Artesian’s last rate case. Regarding the disagreement over which expenses relate to training, Staff eliminated all such expenses that it could find, based on that data Artesian provided. (*Id*.) If Artesian, once questioned by Staff, does not adequately identify the Christiana Country Club charges and unspecified AMEX charges, then Artesian may not recover them. For these reasons, I recommend that the Commission accept Staff’s position and disallow $56,392 of these expenses.

E. Cost of Service and Rate Design

122. In an effort to streamline the proceedings, the parties executed an agreement entitled “Stipulation of Parties and Order of the Hearing Examiner Regarding Cost of Service and Rate Design” (the "COS Stipulation.")(Ex. 50.) In addition to providing that all prefiled testimony of the cost of service and rate design witnesses would be admitted into the record, without cross-examination, the COS Stipulation outlines the following terms:

> • Final rates will reflect a reallocation of miscellaneous revenues in accordance with the method proposed by Staff, as described on page four of Mr. Kalcic's written testimony (Ex. 54);
>
> • For the Artesian rate case, there will be no requirement for the installation of special metering equipment to gather the load profile for customers subject to Artesian's Wholesale Industrial Rate;

• For the Artesian rate case, Artesian may rely on estimated maximum day and maximum hour profiles as a single customer class derived from monthly billing data for all customers subject to Artesian's Wholesale Industrial Rate;

• General Motors and Christiana Care shall receive service under Artesian's Wholesale Industrial Rate;

• Rate case expenses shall be allocated based on the “O&M - EXCL POWER, CHEM & PURCH WATER” factor, as described in Schedules 7 and 9 of Exhibit 2 of the Guastella Supplemental Testimony (Exs. 52, 58), which equates to operation and maintenance expenses reduced by the expenses for power, chemicals and purchased water;

• Purchased water expenses and electric power expenses shall be allocated entirely based on the Base allocation factor, as described in Schedules 7 and 9 of Exhibit 2 of the Guastella Supplemental Testimony (Exs. 52, 58) and to each customer class on the basis of their average consumption;

• There shall be no rate decreases in any rate element for any class of customer based on any reduced revenue requirement allowance or revised cost of service and rate design analyses conducted in the Artesian rate case;

• Artesian's method of billing quarterly and monthly customers will remain unchanged; and

• The COS Stipulation applies solely to the Artesian rate case and is not binding on any party in any future rate case and shall not affect or prejudice the ability of any party to adopt any position or make any argument in any future rate cases, including but not limited to any position or argument that may appear inconsistent with the positions contained in the COS Stipulation.

(Artesian OB at 39-40, *citing* Ex. 50.)

123. All of the parties in this case, representing a wide variety of interests, agree to the terms of the COS Stipulation. With respect to Christiana Care’s service classification, I agree that its user characteristics qualify it for Artesian’s “Wholesale Industrial” rate, rather than the “All Other” classification under which it is currently served. (Christian Care AB.) For these reasons, and because I find the entire agreement to be reasonable, I recommend that the Commission accept the terms of the COS Stipulation as in the public interest.

(26 *Del. C.* § 512, providing that the Commission may approve settlements when found to be in the public interest.)

F. Rate of Return

1. Capital Structure - Recognition of Short Term Debt

124. In order to determine a fair rate of return, the Commission must determine the cost of capital for each element of the Company's capital structure, which means that the Commission must first ascertain the Company's capital structure, or its ratio of debt to equity. The question of whether to recognize the Company's use of short-term debt as part of the Company's capital structure for ratemaking purposes was a contested issue in the last case and is again in this case. Because short-term interest rates are lower than long-term interest rates, recognition of short-term debt would serve to lower the Company's cost of capital and, therefore, its allowed rate of return.

125. The Company argues that including short-term debt ignores both the long-term nature of ratemaking and the fact that the Company's assets that are financed by short-term debt (*i.e.*, infrastructure and plant improvements) are long-term Company assets. (Artesian OB at 40-48; Artesian RB at 45-53.)[25] General Motors supports Artesian's proposed capital structure because it is "reasonable for setting rates in this proceeding because the capital structure is adequate to maintain its financial integrity and access

[25] Artesian also argues that because Artesian competes with Aqua Pennsylvania, Inc. (formerly Philadelphia Suburban Water Company) in the capital markets, and the Pennsylvania PUC excludes short-term debt, Artesian would be at a competitive disadvantage if this Commission included short-term debt. (Artesian OB at 41-42.) I agree with Staff and DPA, however, that isolating this one factor, in relation to one other utility, in order to assess . . . (footnote continued to next page.)

to capital.” (Ex. 37 (Gorman) at 6.) Staff and DPA argue that because Artesian carries short-term debt on its books regularly and consistently, it would be unfair to ignore it for ratemaking purposes.

126. In support of its position that short-term debt should be included because of the consistency of its use, DPA notes the following:

- Artesian has a $35 million short-term debt credit line;
- In the past three years, the Company’s short-term debt averaged $8.6 million in 2003, $16.5 million in 2002, and $14.2 million in 2001;
- Although the Commission rejected the inclusion of short-term debt in the last case because Artesian stated that it did not regularly utilize short-term debt, in fact, it has continued to utilize short-term debt since the last case;
- In spite of three long-term debt issuances since the last case, Artesian continued to have significant amounts of short-term debt every month;
- If the Commission continues to eliminate short-term debt from the capital structure, it will set rates based on a capital structure that is not representative of how the water utility is actually capitalized.

(DPA AB at 8.)

127. DPA recommends that the Commission include the average balance of short-term outstanding during the past three years, or 13.1 million. Its capital structure, then, would be as follows:

Class of Capital	Amount	Capital Ratio
Long-Term Debt	$84,473,614	55.09 percent
Short-Term Debt	$13,100,000	8.54 percent
Common Equity	$55,761,603	36.37 percent

(*Id.*)

Artesian’s overall competitive stance in the capital markets, is not appropriate. (Staff AB at 9; DPA AB at 7.)

128. Staff agrees with DPA and adds that Standard & Poor's, which Staff describes as the preeminent ratings agency, includes short-term debt as permanent capital when it is used as a bridge to permanent financing, as in this case. (Staff AB at 8.) In addition, in *Principles of Public Utility Rates*, a well-known and often-cited treatise, Professor Bonbright states that short-term debt is more likely to be included in a utility's capital structure "if it is permanent in nature, that is, it represents a reasonably constant proportion of total capital over time." (*Id.*, *quoting* J. BONBRIGHT, A. DANIELSON & D. KAMERSCHEN, *Principles of Public Utility Rates (*2d ed. 1988) at 312.)

129. Staff also notes that every month from October 2003 through August 2004, Artesian has carried a substantial balance of short-term debt on its books (I have added the balances for the rest of 2003):

January 2003	$2,843,484
February 2003	$4,254,614
March 2003	$5,885,040
April 2003	$6,860,602
May 2003	$7,860,883
June 2003	$3,843,716
July 2003	$6,560,916
August 2003	$6,084,035
September 2003	$6,714,806
October 2003:	$13,084,758
November 2003:	$11,905,608
December 2003:	$12,499,476
January 2004:	$14,458,385
February 2004:	$13,263,740
March 2004:	$11,711,625
April 2004:	$12,869,260
May 2004:	$11,801,821
June 2004:	$11,369,403
July 2004:	$13,758,225
August 2004:	$10,797,468

(Exs. 30, 34.)

130. The Commission, in the last case, agreed with the Hearing Examiner's recommendation to exclude the test period short-term debt from the Company's rate structure:

> Although the Commission has some concern that the proposed long-term financing post-dates the test period by several months, we believe that long-term debt issuance is the most relevant debt component in determining how those assets in the rate base at the end of the test period will be financed throughout the rate effective period. Thus, we agree with the Hearing Examiner that short-term debt should not be included in the capital structure where there is evidence that it is being replaced with long-term financing.

(Ex. 33 at ¶ 14.)

131. In the last case, Artesian had already gained Commission approval for a long-term debt issuance to replace the short-term debt that it had on its books at the end of the test period. (Ex. 36 at ¶ 53.) The Hearing Examiner, therefore, found that the replacement of the short-term debt with long-term debt was a known and measurable change to the test period capitalization and appropriate to recognize in rates. In this case, however, there is no specific proposal to retire the debt – only Company witness Mülle's testimony that the short-term debt will be replaced "by the end of 2005." (Ex. 28 (Mülle) at 5.) Therefore, if the Commission were concerned in the last case that the proposed long-term financing post-dated the test period by several months, then it may be even more wary of accepting such a change in this case when there is no specific plans for retirement. As such, it would be reasonable for the Commission, in this case, to recognize short-term debt, while still maintaining consistency with its last decision.

132. My recommendation, however, is that the Commission again remove the short-term debt in this case in order to maintain an appropriate matching between the capitalization supported by the ratepayers and the capitalization used for setting rates, as explained below.

133. I agree with DPA that removing the short-term debt leads to rates based on a capitalization not actually used by the Company at any given time. However, removing the short-term debt *does* result in the actual capitalization used by the Company *for the rate base that the ratepayers are supporting*. Between rate cases, the Company uses short-term debt to finance new construction. The new construction, however, is not placed in rate base, and reflected in rates, until the next rate case.[26] Therefore, because the short-term debt for that new construction is replaced (with long-term debt or equity) by the next rate case, or shortly thereafter, the actual financing for the plant included in rate base and supported by ratepayers is the new long-term debt (or equity). Company witness Mülle explains it this way:

> For example, if Artesian borrows short-term from a bank for even one year at a temporary cost of 3 percent, it will not be paying 3 percent for the rate-base related items first placed in service; but will, by the time the construction is in rate base, be paying a much higher, long term cost of debt; equity, or some combination of each. It is the permanent, long-term costs that must be recovered through rates in each rate case.

(Ex. 28 (Mülle) at 5.) At the hearing, he stated that "the short-term debt that's building up today is paying for capital that's being built today, but will not be in the rate base until the next rate case is filed." (Tr. at 229.)

134. Therefore, while it is true that the Company begins accumulating short-term debt as soon as the prior debt is retired, the

[26] I am aware that the Company is able to achieve a return on certain types of non-revenue producing new plant between rate cases by virtue of the Distribution System Improvement Charge ("DSIC"), under 26 *Del. C.* § 314. Mr. Mülle, however, testified that the short term-debt is primarily a result of the plant and infrastructure required by Artesian's growing customer base, which means that the new construction is revenue producing and ineligible for DSIC recovery. (Ex. 28 (Mülle) at 4.)

new debt is used to finance construction that again is not yet in rate base and, therefore, not seen in rates. As can be seen by the monthly balances provided above, it does appear that after the last rate case, Artesian started out with relatively little short-term debt and built up, between rate cases, until it reached current levels. Over that time, however, the plant financed by that debt had yet to be placed in rate base and therefore was not reflected in rates.

135. For this reason, I recommend that the Commission remove the Company's short-term debt component and accept its (and General Motors') proposed capital structure.

2. Cost of Short-term Debt

136. If the Commission decides to include short-term debt, I agree with the Company that the rate applied should reflect the last known actual rate in the record, or 2.46 percent (August 2004). (Artesian RB at 54, *citing* Ex. 11 (Minch) at 30.) In her direct testimony, DPA witness Crane used a rate that the Company actually uses for short-term debt, which is the federal funds rate plus 1 percent, and which was at 2.27 percent at the time of her testimony (Ex. 38 (Crane) at 8-9). That rate, however, has been updated in rebuttal testimony, and the Company claims that the last known actual rate that it obtained was 2.46 percent. (Ex. 11 (Minch) at 30.) The Company argues, though, that an upward adjustment should then be made to account for "significant evidence" that the rate will increase during the rate effective period. (Artesian RB at 54.) Artesian cites a November 2004 *New York Times* article, which it attached to its opening brief, as evidence of rising short-term interest rates.

137. I agree with Staff, however, that the Company has not offered sufficient *record* evidence that the rate would rise in the

rate effective period (and if so to what level) to warrant any upward adjustment. (Staff AB at 11.) For these reasons, I recommend a short-term interest rate of 2.46 percent if the Commission decides to include short-term debt in the Company's capital structure.[27]

3. Cost of Long-term Debt

138. In its reply brief, the Company states that it believes that its cost of long-term debt is 6.67 percent, but it "readily admits" that this number is not supported in the record because of various mistakes it made in its calculation. (Artesian RB at 55-56.) The Company recommends that the Commission approve the methodology advocated by the Company and then direct the parties to determine the effective rate from undisputed components of the cost of long-term debt. The Company's methodology consists of dividing the actual interest paid on the stated principal issued by the net principal outstanding, after deducting issuance expenses. Then, where a sinking fund associated with the retirement of principal over the life of the bond exists, an adjustment is made to increase the effective cost of the bond (which is known as the "average net proceeds ratio," as opposed to the "net proceeds ratio.") (*Id.*)

139. In addition, the Company objects to the inclusion of a rebate paid by CoBank relative to certain debt issuances. Artesian argues that it has no contractual or legal right to the rebate and that it should not, therefore, be used to reduce the long-term interest rate calculated for the Company. (*Id.*)

[27] If the Commission decides to include short-term debt, *and all parties agree* to use a more recent short-term debt rate not now in the record, then I would recommend that the Commission use that updated rate.

140. Staff argues that while the Company admitted to miscalculating the effective interest rate for its Series P debt, it refuses to admit that it has also miscalculated (in the same way) the effective cost rates of the Series M, N, O and SRF debt. (Staff AB at 11.) According to Staff, the Company calculated the proposed effective cost of long-term debt the proper way for the most recent debt issuances (by dividing the Stated Interest Rate by the Net Proceeds Ratio) and some other way, not described in the record, for the older issuances. Staff, therefore, recommends that the Commission use Mr. Henkes' proposed interest rates, which have been corrected, and which result in a long-term debt cost of 6.34 percent. (Ex. 59 at Sch. RJH-2 (revised).)

141. Regarding the CoBank rebate, Staff argues that it has been issued to the Company every year since 1997 and that it is, therefore, fully known and measurable. (Staff AB at 12-13.) According to Staff, if the Commission were to project that the rebate would not be issued in the future, it should also project other changes that would serve to reduce long-term interest rates. Staff notes that the Commission determined the Company's long-term debt cost for the last rate case to be 7.37 percent, while the actual cost has, with hindsight, trended down to a current overall effective rate of 6.73 percent. (*Id.*)

142. DPA recommends a cost of long-term debt of 6.48 percent, which it derived by taking the Company's originally proposed rate of 7.18 percent and making certain adjustments. (DPA AB at 9.) First, DPA made a correction for the misstated Series P debt. Second, it removed the adjustment Artesian made to account for sinking funds because approximately 90 percent of the Company's debt has no sinking

fund requirement. Third, DPA included the rebate Artesian received from CoBank, in the amount of the test year rebate of $277,000. DPA argues that inclusion of the rebate is appropriate because Artesian has received it every year for the last seven years, which is as long as Artesian has had the CoBank loan.

143. First, I agree with Staff and DPA that the test year rebate from CoBank should be included in the calculation of long-term debt. Because it appears during the test year (and for six years prior), it is the Company's obligation to show that a known change will result in its not receiving the rebate during the rate effective period. Just because the rebate is not a legal or contractual right, does not change its likelihood of continuing during the rate effective period. Second, I agree with Staff that because Artesian failed to correct the debt rate for its older issuances in the same manner that it corrected its rate for the Series P debt, and it did not explain how it performed its calculations for the older issuances, its long-term debt proposal cannot be accepted. In addition, because DPA relied on Artesian's inaccurate (or untested) debt rates, its recommendation likewise cannot be accepted.

144. The Commission may wish to accept Artesian's proposal for the parties to work out a cost of debt after the Commission deliberates. I recommend, however, that the Commission only take this route if DPA and Staff agree that it would be helpful. Otherwise, my recommendation would be to accept Staff's proposed cost of long-term debt of 6.34 percent because Staff took the CoBank rebate into account and made appropriate corrections to the debt rates provided by Artesian.

4. Cost of Equity

145. The cost of equity is a prospective-looking opportunity cost and, therefore, must be estimated. (Ex. 36 at ¶ 56.) The Company seeks approval of a common equity cost rate of 12.70 percent. (Ex. 27 (Mülle) at 7.) DPA and General Motors recommend 9.14 percent and 9.8 percent, respectively. Staff recommends that the Commission leave the return on equity at the currently authorized level of 10.5 percent.[28]

146. To derive his recommended cost of equity, Company witness Mülle examined a proxy group composed of nine water companies located throughout the United States.[29] He then used four different approaches to derive his recommended cost of equity: a DCF (discounted cash flow) approach; a CAPM (capital asset pricing model) approach; a risk premium "A" and "Baa" Bond Yield Spread approach; and the Fama-French Three-Factor model. (*Id*. at 26.) In his CAPM calculation, Mülle included an upward adjustment to account for the additional risk for investors created by Artesian's small size. He averaged the results of each approach (obtaining a cost of equity of 11.12 percent for his proxy group), and then employed three methods to convert the market-required equity return rates to their "regulatory-required book value equivalent return rates;" *i.e.*, his "market-to-book" adjustment. (*Id*. at 44-48 and Sch. 3.)

[28] As in the last case, Staff has provided an extensive summary of the parties' use of the various cost-of-equity models, at pages 14 to 28 of its brief. Much of my summary is taken directly from Staff's brief, without reference thereto.

[29] The proxy group consists of American States Water Company, Aqua America, Inc., Artesian Resources Corp., California Water Service Group, Connecticut Water Service, Inc., Middlesex Water Company, SJW Corp., Southwest Water Company, and The York Water Company. (Ex. 27 (Mülle) at Ex. HGM-1 App. B.)

147. Mr. Mülle claimed that a market-to-book adjustment was necessary because of what investors expect in the way of returns. (*Id*. at 43-44.) According to Mr. Mülle, investors expect at least an 11.5 percent (achieved not awarded return on equity, and increasing from 10.63 percent to 11.88 percent over the next five years, which would require an awarded return on equity between 10.95 percent and 12.24 percent), based on a Value Line Investment Survey. (*Id*. at 43-44.)

148. In its post-hearing briefs, Artesian states that "at a minimum," the Commission should award a return on equity of 11.06 percent, which is Mr. Mülle's proposed cost of equity before he made his market-to-book adjustment. (Artesian OB at 60; Artesian RB at 71.)

149. **b.** **Staff**Using a DCF and CAPM methodology, DPA recommended a cost of equity of 9.14 percent for the Company. (Ex. 38 (Crane) at 9.) For her DCF analysis, DPA witness Crane used a comparison group of the water companies followed by the *Value Line* Investment Survey. Those companies are the same as those used by Mr. Mülle, except that Ms. Crane's group did not include Artesian Resources Corp. (*Id*. at Sch. ACC-12.) Ms. Crane's DCF analysis resulted in a recommended cost of equity of 8.70 percent (3.20 percent dividend yield + 5.50 percent dividend growth rate). Performing the CAPM analysis with these inputs, Ms. Crane derived a cost of equity of 9.48 percent. (*Id*. at 17.) Ms. Crane updated her CAPM results on cross-examination using the Ibbotson 2004 Handbook, which resulted in a CAPM-derived cost of equity of 9.91 percent.[30] (Tr. at 293-94.) She testified in this case that she would no longer apply the 25 basis point small company premium to her CAPM

[30] In its brief, however, DPA states its CAPM result as 9.48 percent. (DPA AB at 18.)

result (although she would still apply it to her DCF result). (Tr. at 294, 321.)

150. Ms. Crane testified that because the Commission has generally relied primarily upon the DCF, she weighted her results 75 percent for the DCF and 25 percent for the CAPM. (Ex. 38 (Crane) at 17-18; Tr. at 322.) This weighting resulted in a recommended cost of equity of 8.90 percent. She also recognized that in the past the Commission has considered a small company premium for some utilities, and so testified that if the Commission determined that such a premium was justified for Artesian, a 25 basis point premium was appropriate. (*Id.* at 18.) With that adjustment, Ms. Crane recommended a cost of equity for the Company of 9.14 percent. (*Id.*)

151. Mr. Gorman also calculated the Company's cost of equity using the DCF and CAPM methodologies. (Ex. 37 (Gorman) at 8.) He used the same comparison group of water companies that Mr. Mülle used. (*Id.*) Mr. Gorman's DCF analysis yielded a cost of equity of 10.19 percent for the comparison group. (*Id.* at 11 and Ex. MPG-3.) The cost of equity resulting from his CAPM analysis was 9.4 percent. (*Id.* at 16 and Ex. MPG-5.) Based on the results of his DCF and CAPM analyses, Mr. Gorman estimated the appropriate return on equity for the Company to be 9.8 percent. (*Id.*)

152. With respect to Mr. Mülle's CAPM analysis, Mr. Gorman disagreed that a small size adjustment was necessary (and especially the 225 basis-point adjustment recommended by Mr. Mülle) because this adjustment did not reflect the Company's risk. He noted that the adjustment was based on the risk of small competitive companies, as reported by Ibbotson and Associates, that have much greater risk than the Company, and that Mr. Mülle had not performed any analysis to show

that the Company was risk-comparable to any of the companies included in the Ibbotson study. (*Id*. at 19-20.) Because the Ibbotson companies are substantially more risky than the Company and Mr. Mülle's comparison group, employing the small company risk premium based on this grouping of companies significantly inflated Mr. Mülle's CAPM estimate of the cost of equity. (*Id*.) In addition, Mr. Gorman found both the Fama-French three-factor model and the risk premium model employed by Mülle to be inappropriate because, among other things, Mr. Mülle failed to account for the fact that, as a regulated Company, Artesian's risk is lower than that of the proxy group and the overall market. (*Id*. at 21-24.)

153. Mr. Gorman also rejected Mr. Mülle's DCF analysis as unreasonable because it included an adjustment based on generic flotation costs for companies, rather than based on Company-specific flotation costs. Mr. Gorman testified that this adjustment was not known and measurable and should not be included in the Company's cost of service. In Mr. Gorman's view, it is inappropriate to adjust a utility's return to allow for generic estimates of flotation costs. If this adjustment were removed from Mr. Mülle's DCF calculation, his resulting cost of equity would be 9.82 percent. (*Id*. at 24.)

154. The following table summarizes the parties various results and positions:

	Artesian	**DPA**	**GENERAL MOTORS**	**Staff**
DCF	10.11%	8.70%	10.19%	
CAPM	9.25% (without small size adjustment)	9.48%	9.43%	
Fama-French	10.01%			

Risk Premium	11.88%			
Market-to-Book	yes	no	no	no
Small Size Adjustment	yes (225 basis pts)	yes (25 basis pts)	no	no
Final Recommendation	**12.7%** (averages 4 approaches, then adjusts for market-to-book)	**9.19%** (75% - DCF, 25% - CAPM, plus 25 points)	**9.8%**	**10.5%** (currently authorized)

155. The Commission rejected the Company's small-company adjustment in the last case and I find no reason for the Commission to change course here. (Ex. 33 at ¶ 21.) I agree with Staff and General Motors that the Company's small-size adjustment is inappropriate because it is based on the risk of small *competitive* companies, as reported by Ibbotson & Associates, that have much greater risk than Artesian. (Staff AB at 31, Ex. 37 (Gorman) at 19-20.) The Ibbotson small companies on which the Company based its adjustment have risks higher than the overall market (*i.e.*, beta estimates of greater than one) whereas Artesian has a risk significantly lower than the overall market (*i.e*, a beta estimate of well below one.) (Ex. 37 (Gorman) at 19-20.) In addition, the Company's flawed risk analysis taints both its Fama-French and Risk Premium results. (Ex. 37 (Gorman) 21-23.) Therefore, the Company's risk premium analyses and, in particular, its small company adjustment, significantly inflate its cost of equity for three out of four of the models it used.

156. Furthermore, I agree with Staff that, in light of all the factors that suggest that Artesian is less risky than even other water utilities, the Company has not shown that any risk adjustment is necessary. (Staff at 34.) As a result of amendments to the Public

Utilities Act, the Company now has the benefit of collecting from customers a return on certain types of infrastructure investments, without going through a rate case, via the Distribution System Improvement Charge. (*Id.*, *citing* 26 *Del. C.* § 314.) In addition, the Commission can no longer impute revenues to Artesian in the case of a new development that will not be fully utilized for some time, even though Artesian is able to earn a return on the investment. (*Id.*, *citing* 26 *Del. C.* § 302.) Finally, the Company (unlike most water utilities) recovers 100 percent of its customer-related costs in its customer charges, which reduces the risk that those costs will not be recovered. (*Id.* at 35.)

157. The Commission rejected the Company's market-to-book adjustment in the last case and, again, I recommend that the Commission reject it here. According to the Company, an upward adjustment to a utility's cost of equity is necessary so that its return on book value reflects the market rate of return expected by an investor. (Ex. 27 (Mülle) at 44.) Most jurisdictions do not apply the conversion. (Staff AB at 33.) Moreover, there is no reason to believe that investors are unaware that a water utility's rates are based on the book value of their assets (rate base) and they should not be compensated for any difference between book value and market value. (*Id.* at 34.) As noted by Staff, if the Company's market to book ratio exceeds 1.0, then it simply means that the Company is earning a return on equity that exceeds its cost of equity. (*Id.*) For these reasons, I recommend that the Commission follow its decision from Artesian's last rate case and reject both its small-size and its market-to-book adjustments.

158. Judging from all the results of the various models, unadjusted for market-to-book differences or small company size, I recommend that, for purposes of this case, the Commission adopt the Company's unadjusted DCF result. The Commission, after all, has not by Order changed its stance that the DCF is the method most relied upon in Delaware. (Staff AB at 29-30.) In addition, as seen in the table above, Artesian's unadjusted DCF result appears reasonable because it falls between DPA's and General Motors' DCF results and it falls between the two highest and the two lowest overall recommendations.[31] For these reasons, I find that the Company's unadjusted DCF result of 10.11 percent is reasonable and recommend its adoption by the Commission.

159. If the Commission decides to incorporate the CAPM model, which was utilized in part by Artesian, General Motors, and DPA, then a reasonable approach would be to adopt DPA's 75/25 weighting for the Company's unadjusted DCF result (10.19 percent) and its unadjusted CAPM result (9.25 percent). This calculation leads to a final result of 9.90 percent return on equity for the Company.

III. SUMMARY OF RECOMMENDATIONS

160. In addition to recommending that the Commission adopt the undisputed portions of Artesian's application, including the proposed changes to its Rules and Regulations, I recommend the following:

A) That the Commission permit Artesian to include in its rate base all costs associated with the purchase of the Churchmans Road property ($5,022,238).

[31] General Motors argues that the Company's DCF result includes an adjustment for flotation costs, which was rejected in the last case, and which should be rejected here. (General Motors AB at 11-12.) While I agree with General Motors in principal, the Company's 10.11 percent DCF result is actually lower than General Motors' DCF result of 10.19 percent and, therefore, I find that the Company's final DCF result is not overstated.

B) That the Commission permit Artesian to include in its rate base all costs associated with the purchase of the Shady Park Water System ($140,000).

C) That the Commission reject Artesian's rate base proposal to offset its regular accumulated deferred income tax ("ADIT") balance by its prepaid alternative minimum tax ("AMT") balance ($2,097,424).

D) That the Commission accept Artesian's use of its computer model for estimating water sales revenues.

E) That the Commission reject Artesian's $16,222 adjustment to its test period contract revenues for its normalization of non-recurring revenues.

F) That the Commission accept Artesian's use of its test year purchase water discount level of $53,423.

G) That the Commission deny recovery of Artesian's claim for $31,000 in charitable donations.

H) That the Commission deny Artesian's claim for $24,526 in operating expenses associated with its employee swimming pool.

I) That the Commission limit recovery of payroll expenses for new positions to the seven that were filled by the end of the test period.

J) That the Commission limit recovery of payroll expenses for grass cutters to the two employees on the payroll at the end of the test period.

K) That the Commission limit recovery of payroll expenses for the Courier/Custodian position to one such position.

L) That the Commission accept Artesian's proposed pension to payroll expense ratio of 6.9 percent.

M) That the Commission accept Artesian's allocation of expenses to its affiliates for this case but direct Artesian to file a Cost Allocation Manual within six months of the date of the Commission's Order, consistent with DPA's recommendations.

N) That the Commission accept Artesian's estimate of $60,000 for rate case expenses associated with Guastella Associates, Inc.

O) That the Commission accept Artesian's entire claim (as adjusted by Artesian) of $385,572 for chemical expenses.

P) That the Commission deny Artesian's claim for $9,457 in lobbying expenses.

Q) That the Commission accept Artesian's use of its actual test year expense of $155,556 for consulting fees.

R) That the Commission deny recovery of $11,919 of advertising, marketing and public relations expenses.

S) That the Commission deny recovery of $56,392 of miscellaneous expenses.

T) That the Commission accept the rate design set out in the parties' Cost of Service Stipulation, as described herein.

U) That the Commission accept Artesian's removal of its short-term debt from its capital structure for ratemaking purposes.

V) That, if the Commission decides to include short-term debt in the Company's capital structure, then it use 2.46 percent as the cost of short-term debt.

W) That the Commission adopt Staff's proposed cost of long-term debt of 6.34 percent.

X) That the Commission reject the Company's market-to-book and small-size adjustments to its proposed cost of equity and adopt the Company's (unadjusted) DCF result of 10.11 percent for the Company's return on equity.

161. Prior to Commission deliberation on this matter, the parties should provide the Commission with an issues matrix, which identifies each of the parties' positions on every disputed issue. In addition, if practicable, the parties should provide, with their written exceptions, the overall rate increase proposed by each party, as well as the rate increase that would result if the Commission adopted the Hearing Examiner's recommendations.

Respectfully submitted,

/s/ William F. O’Brien
William F. O’Brien
Senior Hearing Examiner

Dated: February 23, 2005

E X H I B I T "B"

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF ARTESIAN WATER COMPANY, INC. FOR AN INCREASE IN WATER RATES (FILED FEBRUARY 5, 2004)	) PSC DOCKET NO. 04-42

IN THE MATTER OF THE APPLICATION OF ARTESIAN WATER COMPANY, INC., FOR EXPEDITED RATE CHANGE FOR PURCHASED WATER COSTS (FILED AUGUST 16, 2005)	) PSC DOCKET NO. 05-293

FINDINGS AND RECOMMENDATIONS OF THE HEARING EXAMINER ON REMAND FROM THE COMMISSION

DATED: MARCH 23, 2006

WILLIAM F. O'BRIEN
SENIOR HEARING EXAMINER

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BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

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William F. O'Brien, duly appointed Hearing Examiner in these Dockets pursuant to 26 *Del. C.* § 502 and 29 *Del. C.* ch. 101, by Commission Order No. 6378 (March 16, 2004), as reassigned by the Executive Director, and by Commission Order No. 6728 (September 20, 2005) reports to the Commission as follows:

I. BACKGROUND

1. On April 5, 2005, the Delaware Public Service Commission (the "Commission") met at its regularly-scheduled meeting to hear oral argument and deliberate on the February 2004 application for a 24 percent rate increase from Artesian Water Company ("Artesian" or "Company"). The Commission considered and voted on approximately

thirty disputed issues, as outlined in the Hearing Examiner's February 23, 2005 Findings and Recommendations. One of the issues involved Artesian's claim that its incurrence of alternative minimum tax ("AMT") reduces its accumulated deferred income tax ("ADIT") liability related to plant and therefore increases its rate base. At its April 5, 2005 meeting, the Commission voted to deny Artesian's request to adjust its rate base by its accumulated AMT balance, which Artesian had calculated (based on the statutory tax rate, rather than on actual taxes paid) as $2,097,424.

2. On June 29, 2005, before the Commission issued a written order reflecting its vote, Artesian filed a Petition for Post-hearing Relief, citing a June 28, 2005 amendment to 26 *Del. C.* §102(3), which specifies that the determination of a utility's rate base includes an adjustment against ADIT liability for its payment of AMT. At its July 5, 2005 meeting, the Commission heard Artesian's Petition regarding the statutory amendment, and the objections thereto made by Commission Staff, the Division of the Public Advocate ("DPA"), and General Motors Company, and decided to remand the AMT issue to the Hearing Examiner for further proceedings. PSC Order No. 6681 (July 19, 2005).

3. Also at the July 5, 2005 meeting, Artesian requested that the Commission's final order reflect a "true-up" of its overall rate base in order to include the actual amount of plant-in-service at the end of the test period, or June 30, 2004. Staff, DPA and General Motors objected, maintaining that because Artesian failed to move the final "true-up" figure into the hearing record, the Commission could not include the "true-up" as part of the approved rate base. The Commission voted to include the plant-in-service "true-up" issue in

the remand that it had already ordered. PSC Order No. 6681 (July 19, 2005).

4. On August 15, 2005, Artesian filed a petition to further increase its rates to include its increased purchased water expenses, in the amount of $131,529, which result from rate hikes that the Chester Water Authority and the City of Wilmington placed into effect on July 1, 2005. On September 20, 2005, by Order No. 6728, the Commission consolidated Artesian's August 15 petition regarding purchased water costs (PSC Docket No. 05-293) with the Docket No. 04-42 remand and permitted Artesian to raise its rates by the proposed amount on a temporary basis, subject to refund.

5. On February 2, 2006, after a period of discovery and submission of pre-filed testimony, a duly noticed remand hearing was conducted.[32] Representatives of Artesian, Commission Staff, and DPA introduced their prefiled testimony and presented witnesses for cross-examination. No members of the public attended the hearing or offered written comments. The parties filed post-hearing briefs on February 24 and March 8, 2006.[33] I have considered all of the record evidence, as well as the post-hearing briefs and, based thereon, I submit for the Commission's consideration these findings and recommendations.[34]

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[32] The affidavits of publication of notice of the remand hearing from the *Delaware State News* and *The News Journal* were added to the existing Exhibit 1.

[33] With its opening brief, Artesian submitted its response to DPA-AMT-(II)-15, which I have entered into the record as Exhibit No. 69, in accordance with an evidentiary ruling made at the hearing. (Tr. at 8-9.)

[34] Exhibits will be cited as "Ex.__ at __" or "Ex.__ (witness name) at __" and references to the hearing transcript will be cited as "Tr. __." The opening briefs and reply briefs will be cited as "[name of party] OB at __" and "[name of party] RB at __."

II. SUMMARY OF EVIDENCE AND DISCUSSION

A. AMT

6. **Staff Testimony.** Lane Kollen, Staff's consultant, testified that the Commission should allow rate base treatment of $439,350 of the requested $2,097,423 in AMT asset ADIT and should allow the Company to increase its revenue requirement by $25,146, which reflects recovery of the return on a levelized, five-year basis. (Ex. 67 at 3.) Mr. Kollen's recommendation reflects three adjustments to the amount initially requested by the Company, in addition to his recommendation regarding levelization.

7. First, Mr. Kollen recommended a reduction of $179,931 to remove the AMT asset ADIT that was caused not by the Company but by other affiliates of Artesian Resources Corporation, which is the Company's parent company. (*Id.*) Mr. Kollen noted that Artesian has agreed that this adjustment is necessary. Second, he recommended a reduction of another $425,643 to remove the AMT asset ADIT that is no longer outstanding because it was utilized in Artesian's amended 2001 federal tax return. Mr. Kollen noted that Artesian also agreed that this adjustment is necessary.

8. Third, Mr. Kollen recommended a reduction of $1,052,499 to remove the AMT asset ADIT that was not caused by tax depreciation. (*Id.* at 4.) According to Mr. Kollen, the AMT asset ADIT was caused by the "diminished value" of all deductions in the AMT computation as compared to the regular tax computation. Mr. Kollen disagreed, therefore, with the Company's claim that the AMT asset ADIT was caused entirely by plant-related tax depreciation. The Company's claim is premised on an assumption that tax depreciation is the deduction "on

the margin” and that no other deductions impact the AMT despite the fact that other deductions represent 80 percent of total deductions for all AMT years. (*Id.* at 10.)

9. In addition, Mr. Kollen recommended that the revenue requirement associated with the remaining portion of the AMT asset ADIT that was caused by tax depreciation be quantified on a levelized basis to reflect the temporary nature of the AMT carryforward amount and the Company’s ability to utilize the carryforward in the rate effective period over the next five years. (*Id.* at 4.) Mr. Kollen testified that the AMT asset ADIT is a temporary amount due to the nonrecurring nature of the AMT and the revenue requirement effect of the AMT asset ADIT will decline as the AMT carryforward is utilized. (*Id.* at 13.) Mr. Kollen selected five years because the carryforward should be reduced to zero within the next five years. He calculated the revenue requirement impact, after his adjustments, to be an increase of $25,146. (*Id.* at 15.) Without levelization, the revenue requirement impact would be $46,557.

10. **DPA Testimony.** Andrea C. Crane, DPA’s consultant, recommended that the Commission deny Artesian’s request to include AMT in rate base. (Ex. 65 at 18.) Ms. Crane testified that Artesian does not actually pay any taxes on a stand-alone basis. (*Id.* at 15.) Because Artesian files its tax returns on a consolidated basis, the tax loss generated by the group impacts the federal income tax calculation for the group, as well as the AMT calculation. For its AMT claim, Artesian now proposes to calculate AMT liability as if it filed on a stand-alone basis. (*Id.* at 16.) In addition, Artesian has neither a tax sharing agreement with its parent, wherein it would pay it the taxes it would have owed on stand alone basis, nor a Cost

Allocation Manual identifying apportionment of income tax expense among the group members. Artesian, therefore, has not shown that it paid any of the AMT, according to Ms. Crane. (*Id.* at 15-16.)

11. **Artesian Testimony.** David B. Spacht, Treasurer and Chief Financial Officer of Artesian, submitted rebuttal testimony on January 9, 2006. (Ex. 60.) Regarding the AMT issue, Mr. Spacht disagreed with much of Mr. Kollen's and Ms. Crane's testimony. First, he testified that in Artesian's view, the statutory definition of rate base always included the AMT asset and that the recent legislation (Senate Bill 175) clarified, rather than revised, the definition. (*Id.* at 3.) Second, while Mr. Spacht agreed that only those deferred taxes related to the depreciation of utility plant in service are subtracted from rate base, he asserted that the AMT that Artesian seeks to add back to rate base was caused entirely by the disallowance of accelerated depreciation of utility plant in service. (*Id.* at 4.) He noted that "but for" the reduction in tax depreciation expense required under the AMT calculation, Artesian would not have incurred the additional tax. The entire AMT claim, therefore, is related to plant.

12. In addition, Mr. Spacht testified that Mr. Kollen's analysis is inconsistent because he applied the "but for" standard of causation to deduct from the AMT asset ADIT balance the $179,931 credit associated with the contribution from Artesian's affiliates but used a "diminished value" standard of causation elsewhere. (*Id.* at 5.) Using the "but for" standard for the AMT asset results in the amount requested by Artesian, or $1,491,849.

13. Mr. Spacht argued that under Ms. Crane's reasoning, because the Company cannot prove that it paid any taxes, it should eliminate

the deferred tax balance of approximately $13 million from its rate base calculation. (*Id.* at 13.) Regarding allocation of tax expenses among the affiliates, Mr. Spacht asserted that its independent audit firm renders an opinion on the fairness of Artesian's allocation. In addition, despite Ms. Crane's assertions that the tax was not paid, the tax was recorded appropriately and since the Company is not a cash flow regulated utility, the tax asset should be offset against the liability in rate base.

14. William A. Santora, CPA, Artesian's consultant, testified that to the extent that the Delaware Code permits AMT as an allowable cost in determining rate base, Artesian's calculation of AMT should be accepted as a permissible cost. (Ex. 64 at 10.) He asserted that AMT is a statutory tax calculation, just like regular corporate tax. As long as Artesian continues to calculate its tax obligation correctly, AMT allowed in a current period will automatically reverse itself and lower Artesian's tax obligations in later years. (*Id.*)

15. Mr. Santora testified that, in general, AMT income is the Company's regular taxable income subject to a number of special adjustments or preferences. (*Id.* at 2-3.) Artesian, however, has only one preference, and that is depreciation. Its AMT income, therefore, is its book income plus a depreciation adjustment, which is equal to the statutory difference between the depreciation expense calculated for regular tax purposes and the depreciation expense calculated for AMT purposes, which is based on longer depreciation lives. (*Id.* at 4-5.) Depreciation, however, is a temporary preference and, therefore, will reverse itself in future years.

16. Mr. Santora agreed with Mr. Kollen's calculations but disagreed with his conclusions. (*Id.* at 5.) The only adjustment that

Mr. Kollen made to Artesian's taxable income was for depreciation but then Mr. Kollen claims that the AMT asset ADIT is caused by the "diminished value" of all deductions, rather than solely by tax depreciation. There are no other deductions, however, because taxable income, which is the starting point for the AMT computation, already reflects deductions for business expenses. (*Id.* at 6.) Mr. Kollen's reliance on "diminished value based on margin," therefore, is "patently wrong." (*Id.*)

17. **Discussion.** Artesian seeks to adjust its rate base to account for the AMT that it has "incurred" since 1990 but has neglected to claim in rates as a reduction to its ADIT liability, until this rate case. (Ex. 67 (Kollen) at 4-5.) ADIT liability related to plant is subtracted from rate base, in accordance with 26 *Del. C.* § 102(3). Recognition of AMT would reduce ADIT liability (because less tax would be deferred), which would increase Artesian's rate base, which of course would increase the amount of the return on rate base that Artesian collects in rates. The parties refer to the AMT as "incurred" rather than "paid" because Artesian pays no federal income taxes and, therefore, pays no AMT.

18. Artesian pays no federal income taxes because Artesian's parent company pays federal taxes on a consolidated basis and Artesian's taxable income is offset by its affiliates' losses, leaving the parent company without federal tax liability. (DPA IB at 14.) The Commission, however, permits Artesian to collect income taxes from ratepayers as if it pays taxes on a stand-alone basis, at the statutory 34 percent federal income tax rate. Because Artesian's plant is depreciated for tax purposes faster than for ratemaking purposes, Artesian incurs tax liability relating to a plant asset

slower than it depreciates the asset and slower than it collects the taxes in rates. Artesian records the tax it has collected, but not yet incurred, as a deferred tax liability, or ADIT, which it then subtracts from rate base until ratemaking depreciation catches up to tax depreciation for a particular asset. In this way, the ratepayers who use and pay for an asset over the depreciation life of the asset are the ones who benefit from the tax advantage derived from accelerated tax depreciation. In addition, by offsetting rate base by the deferred tax balance, the utility does not earn a return on funds not supplied by shareholders. (Artesian RB at 8, footnote 3.)

19. After initially objecting to the AMT adjustment to rate base, Staff now agrees with Artesian that the plant-related ADIT should be included in rate base. Staff witness Kollen, however, made several downward adjustments to Artesian's $2,097,424 AMT claim. Artesian accepted two of the adjustments, excluding from its claim: (1) the AMT incurred by Artesian's affiliates; and (2) the AMT Artesian already recognized in its 2001 amended tax return (completed for state tax purposes). Together, the two adjustments reduced Artesian's AMT rate base claim by $605,574, to $1,491,850.

20. Staff also made two adjustments that Artesian has not accepted. First, Staff excluded approximately 70 percent of the AMT asset ADIT from the claim, arguing that only 30 percent of the AMT balance is related to plant. (Staff OB at 4-13.) As mentioned above, only plant-related deferred taxes, or ADIT, are subtracted from rate base and, therefore, only plant related AMT is eligible as an offset to ADIT liability. According to Staff, the AMT asset ADIT is caused by the diminished value of *all* deductions under the AMT calculation, rather than just plant-related tax depreciation. In general, the

regular tax calculation is income less deductions times the 34 percent tax rate. The AMT calculation is income less deductions plus certain preferences (which, for Artesian, consists solely of plant-related tax depreciation) times the 20 percent AMT tax rate. Under the 20 percent AMT rate, all deductions are worth less to the taxpayer than under the 34 percent rate and all deductions therefore contribute to AMT liability, according to Staff. (*Id.*)

21. Under 26 *Del. C.* § 102(3), "rate base" means:

> a. The original cost of all used and useful utility plant…; less…
>
> d. Any accumulated deferred and unamortized income tax liabilities and investment credits, **adjusted to reflect any accumulated deferred income tax assets including, but not limited to, those arising from the payment of alternative minimum tax**, related to plant included in paragraph a. above, plus….

(The bold-faced language was added by the amendment proposed by Artesian and signed into law on June 28, 2005.) As seen under § 102(3)d, rate base is reduced by ADIT liability, which itself is adjusted to reflect ADIT assets (such as AMT), "related to" plant.

22. Therefore, if Artesian's AMT asset is "related to" plant, then it is properly included as an adjustment to ADIT liability. I agree with Artesian that under the plain meaning of "related to" (which arguably is an easier test to satisfy than "caused by") the entire AMT amount is "related to" plant and is, therefore, appropriate as an offset to ADIT liability. It is difficult to argue that the AMT claimed by Artesian, which is only the *difference* between regular tax liability and tax liability under the AMT calculation, is not related to plant, when plant-related tax depreciation is the only AMT preference added back to income and, therefore, the only trigger for

Artesian's AMT liability. Furthermore, even if the appropriate standard were "caused by," then Artesian's claim still stands because AMT is "caused by" tax depreciation, under the "but for" standard of causation. It is undisputed, after all, that "but for" the tax depreciation preference, no AMT would be incurred.[35]

23. In contrast, Staff argues that the AMT is caused by all of the components behind the entire AMT tax calculation. Staff asserts that the "diminished value" of all of the deductions, which is a result of applying the 20 percent tax rate under the AMT calculation versus the 34 percent regular tax rate, causes a portion of Artesian's AMT liability because the "diminished value" of the deductions serves to increase the AMT. (Staff OB at 7.) Staff, therefore, allocates a portion of the AMT amount to each deduction, in proportion to the size of the deduction, and concludes that 70.55 percent of the AMT balance was caused by non-plant-related deductions. (*Id*. at 13-14.)

24. I agree with Artesian, however, that attributing any AMT liability to the "diminished value" of the regular deductions under the AMT calculation simply fails to make sense. (Artesian OB at 13-17.) If the U.S. Congress lowered my personal income tax rate by 14 percentage points, I would not lament the diminished value of my itemized deductions. I would celebrate my lower tax bill. Similarly, the taxpayer corporation benefits by using a 20 percent tax rate under the AMT calculation, because it pays less tax than it would if it simply lost the preference items but still applied the 34 percent tax rate. (See Artesian RB at 14.) Therefore, to attribute any portion of AMT liability (*i.e*., a bad thing) to the diminished value of the

[35] Citing *Culver v. Bennett*, 588 A.2d 1094, 1097 (Del. 1991), Artesian notes . . . (footnote continued to next page.)

regular deductions, which is simply an arithmetic consequence of the lower 20 percent tax rate (*i.e.*, a good thing), defies logic.

25. Furthermore, because AMT liability consists only of the difference between regular tax liability and tax liability under the AMT formula, it would be inappropriate to attribute AMT to all components of the entire tax liability. (Ex. 64 (Santora) at 6.) And to attribute any portion of the difference in the tax calculations (*i.e.*, the AMT) to the lower 20 percent AMT tax rate (which is the genesis for the diminished value of the deductions) does not make sense because the 20 percent tax rate actually lowers the AMT amount, as discussed above. From a broader perspective, even if the "diminished value" analysis made sense, to carve out any portion of AMT liability as unrelated to plant, based on the AMT tax rate's effect on the value of regular deductions, unduly restricts the meaning of "related to" and adds unwarranted complexity to the ratemaking calculus. It is more reasonable, and frankly inescapable, to relate Artesian's AMT liability, in total, to the sole preference item that triggered every dollar of its AMT liability; *i.e.*, plant-related tax depreciation.

26. The second adjustment made by Staff witness Kollen, which was not accepted by the Company, involves levelization of the AMT asset ADIT. Based on his opinion that the AMT carryforward will likely be reduced to zero within the next five years, Mr. Kollen recommended levelizing the return on the unamortized AMT asset ADIT over the next five years, which reduced Artesian's revenue requirement for AMT asset ADIT from $46,557 (which reflects Staff's above 70/30

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that the "but for" test is commonly used in Delaware to establish causation.

allocation) to $25,146. (Staff OB at 14-15.) Artesian argues that changes to the test period data are only allowed for operational expenses and, even if rate base items could be adjusted for changes beyond the test period, the changes cited by Mr. Kollen should not be accepted because they are not “known and measurable.” (Artesian RB at 16-20.)

27. I agree with Staff, however, that levelization in this instance is appropriate. The AMT asset ADIT may be a rate base item, but it differs fundamentally from the tangible plant-in-service assets that should be included in rate base as they stand at the end of the test period, without reaching into the future for anticipated changes. The AMT asset ADIT is an accounting offset to deferred taxes that is dependent entirely on the existence of the ongoing AMT carryforward, which, according to Mr. Kollen, will be eliminated, with nearly 100 percent certainty, within five years. (Staff RB at 10; Tr. 154.) This conclusion, in fact, is supported by Company witness Santora’s testimony that the tax depreciation preference, which is the cause of the AMT asset ADIT, is a temporary preference and will reverse itself in future years. (Ex. 64 (Santora) at 4-5.) It is also supported by the sharp decline in AMT liability from $3.6 million in 2000 to $1.6 million in 2004. (Staff OB at 15.) For these reasons, I recommend that the Commission accept Staff’s proposed levelization of the unamortized AMT asset ADIT over the next five years.

28. DPA made several legal and policy arguments against inclusion of the AMT as an offset to ADIT liability. First, DPA argues that the AMT legislation was not passed until after the close of the test period and after Commission deliberations and, therefore, should not be applied in this case. (DPA OB at 13.) However, without

further briefing on this issue (Artesian and Staff were silent on the timing issue), and because the Commission acts by written order (and no written order had issued as of the time the legislation became effective), and because Artesian's argument that ADIT liability under § 102(3) included an offset for AMT even before the amendment passed holds some merit,[36] I cannot recommend rejection of this issue based solely on the timing of the legislation.

29. Second, DPA argues that the statutory amendment calls for an ADIT adjustment for AMT "paid" and, because Artesian has not actually "paid" any AMT, no adjustment is warranted. (DPA OB at 14.) As noted by Artesian, however, the Commission has already determined to allow recovery of taxes on a statutory basis, rather than an actual-taxes-paid basis (Artesian OB at 19), and it is highly unlikely that the statutory reference to AMT "paid" signals a legislative attempt to reverse the Commission's practice of allowing recovery of taxes on a statutory basis. In addition, as noted by Artesian, to rely on the statutory reference to AMT "paid" as a requirement that rates be based on actual taxes paid would undo the $13 million in ADIT already included as a subtraction from rate base, which no one has proposed in this case. (Ex. 60 (Spacht) at 13.)

30. In addition, DPA raises the broader issue of whether to allow Artesian to continue to collect income tax from ratepayers using the statutory corporate tax rate, rather than its actual taxes paid. (DPA OB at 15.) I agree with DPA that, at some point, the disadvantages of permitting the Company to base its rates on the

[36] *See* Staff OB at 6, footnote 3; "Whether the prior version of the statute did or did not include the AMT asset ADIT is immaterial: Staff agrees that the AMT asset ADIT that is plant-related should be included in rate base."
. . . (footnote continued to next page.)

statutory tax rate, rather than its actual tax paid (which is zero) outweigh any benefit that was once found to exist. After all, rather than simply acknowledging the benefit to shareholders of using the artificial 34 percent tax rate and keeping its tax claim easily verifiable and not unduly burdensome on ratepayers, Artesian chooses to press complex IRS tax changes to its advantage and to obtain legislative fixes when the Commission shows any resistance. These efforts bear substantial administrative costs, which are borne by the ratepayers, and may well tip the balance against allowing Artesian to base its rates on the artificial statutory tax rate, rather than on actual taxes paid.

31. However, because the policy behind allowance of the statutory tax rate (and the effect of abandoning the policy now) was not a fully-litigated issue in this case, it would be inappropriate for the Commission to change course on this matter in this proceeding.[37] I recommend, therefore, that the Commission, in Artesian's next rate case, direct Staff to revisit the policy behind allowing Artesian to base its rates on the statutory tax rate, rather than on actual taxes paid, and to investigate whether the Commission should abandon this policy. On brief, the DPA and Staff noted that Artesian has already provided the Commission with notice of its next rate case, which it intends to file in April of 2006. (DPA RB at 4; Staff RB at 11.)

[37] Artesian cited a fourteen-year-old decision, PSC Order No. 3389 (March 31, 1992), Docket No. 91-20, *Re Delmarva Power and Light Company*, as establishing the Commission's practice of allowing recovery of taxes on a statutory, stand-alone basis, rather than on actual taxes paid. (Artesian OB at 19.)

B. Rate Base "True-up"

32. **Staff Testimony.** Connie S. McDowell, PSC Chief of Technical Services, testified that she verified the accuracy of Artesian's claimed rate base as of June 30, 2004 (*i.e.*, the end of the test period), which included Artesian's "true-up" regarding construction costs. (Ex. 66 at 3.) Ms. McDowell recommended that the Commission accept Artesian's claimed rate base, including the plant-in-service "true-up." (*Id.* at 5.)

33. **DPA Testimony.** Ms. Crane recommended that the Commission reject Artesian's updated plant-in-service figures because they were not placed into the record of the proceeding at the hearing. (Ex. 65 at 8-9.) She argued that, as a matter of public policy, utilities should not be permitted to update their rate case claims after the close of the record, except under extraordinary circumstances. Ms. Crane noted that the updated figures, if accepted, would increase Artesian's authorized rates by approximately $124,000. If the Commission does allow Artesian to update the rate base, then Ms. Crane agrees with the numbers proposed by Artesian, with the exception of the adjustment for AMT.

34. **Artesian Testimony.** Mr. Spacht testified that Artesian provided the actual figures for the end of the test period in response to data request PSC-A94, dated September 8, 2004. (Ex. 60 at 2.) Noting that Company witness Minch stated in his rebuttal testimony [dated September 13, 2004] that the parties had agreed to "true up" the rate base, Mr. Spacht argued that there was no need to provide the figures again. Mr. Spacht attached a copy of the discovery response that included the actual, trued up figures to his written testimony,

which he believed should satisfy prior concerns that the actual figures were not in the evidentiary record. Mr. Spacht also asserted that to use the actual information, rather than the projected data, would be fair to both the Company and its customers. (*Id.* at 3.)

35. **Discussion.** After providing the parties with updated, actual end-of-test-period rate base figures in a September 2004 data response (*i.e.*, prior to the hearing), and after mentioning in pre-filed testimony (without objection) that the parties had agreed to use the updated figures, Artesian neglected to move the updated figures into the record evidence. Staff and DPA argued before the Commission that because the update was not in the evidentiary record, it should not be used for setting rate base. After the Commission remanded the issue, Staff decided to accept the updated figures. (Staff RB at 12.) DPA, however, maintains its position that no justification exists to warrant re-opening the record to permit inclusion of the updated, actual figures. (DPA IB at 8-9.)

36. Given that the parties agree that rate base should reflect the actual test period figures (consistent with the Commission's Minimum Filing Requirements, § IV(F)(1)) and given that the parties agree that the figures provided by the Company are accurate, common sense would dictate that a motion to reopen the record (either oral or written) to include the numbers, and correct the Company's oversight, would have been uncontested and would have averted additional litigation on the matter. For whatever reason, that did not happen in this instance. Now that the issue has been remanded, the record reopened, and the updated, actual figures placed into the record, suffice it to say that the actual, end-of-test-period figures should be used to set rate base. (Ex. 60, at Exhibit 1; Ex. 69.)

C. Purchased Water Expenses

37. **Staff Testimony.** Ms. McDowell testified that she verified Artesian's claims regarding its increased purchased water expenses. (Ex. 66 at 4-5.) Based on July 1, 2005 rate increases from the City of Wilmington and the Chester Water Authority, Artesian's purchased water expense increased $131,529. Ms. McDowell recommended that the Commission approve Artesian's request for a rate increase based on this increase in purchased water expenses.

38. **DPA Testimony.** Ms. Crane recommended that, as a matter of public policy, the Commission reject Artesian's request to increase its purchased water expense to reflect increases effective July 1, 2005. (Ex. 65 at 11.) Ms. Crane testified that the increases fall well outside the test period from the rate case and that there is no statutory authority to increase operating costs outside of a base rate case filing. In addition, the base rate included in the Company's rate case filing included no base meter charges while its purchased water adjustment application requests $3,643 for cost increases relating to base charges.

39. **Artesian Testimony.** Mr. Spacht acknowledged that the Company inadvertently omitted the base meter charge in its rate case, as noted by Ms. Crane. (Ex. 60 at 15.) Mr. Spacht explained that, because of this omission, Artesian seeks now to recover only the *increase* in the base charge, not the charge itself. According to Mr. Spacht, this additional expense is currently being incurred by the Company and he urged its approval.

40. **Discussion.** Staff agrees with Artesian that the Commission should permit Artesian to increase its rates to recover increases in

its purchased water costs resulting from July 2005 rate hikes imposed by the City of Wilmington and the Chester Water Authority. DPA, however, argues that no statutory authority exists to grant Artesian's request. According to DPA, even if Artesian's application constitutes a "single issue rate case" (which is permitted by statute), it should not be allowed during an ongoing full rate case. (DPA RB at 8.) In addition, DPA asserts that the cost increases should be considered as part of Artesian's upcoming rate case, which Artesian intends to file shortly. Finally, DPA argues that permitting this limited-issue rate case would encourage other utilities to make similar filings, to the detriment of ratepayers. (*Id.*)

41. It is undisputed that the Commission has the authority, under 26 *Del. C.* § 304(b), to consider limited issue rate proceedings. One reason that the Commission would hesitate to allow a limited issue proceeding is the potential that the petitioning utility seeks to recover a cost that has risen but ignores other costs that have fallen, which could lead to over-earning. In this case, however, such a concern is minimal because all of Artesian's costs have recently been investigated and litigated. In addition, because the increase in purchased water costs is discrete, easily verifiable, and has no corresponding impact on revenues, it is the type of cost that is suitable for recovery via this mechanism. For these reasons, I agree with Staff and Artesian that the Commission should allow the requested rate increase to recover Artesian's increase in purchased water expenses, in the amount of $131,529.

III. SUMMARY OF RECOMMENDATIONS

42. In summary, and for all of the above reasons, I recommend the following:

A) That the Commission permit Artesian to offset its accumulated deferred income tax ("ADIT") liability by its alternative minimum tax ("AMT") asset in the amount of $1,491,850.

B) That the Commission reject Staff's proposed 70 percent reduction of the AMT asset ADIT based on its allocation of causation to the "diminished value" of non-plant-related, regular tax deductions.

C) That the Commission accept Staff's recommendation that Artesian's return on the unamortized AMT asset ADIT be levelized over the next five years.

D) That, based on DPA's position on the AMT issue, the Commission direct Staff to revisit, in Artesian's next rate case, the policy behind allowing Artesian to base its rates on the statutory tax rate, rather than on actual taxes paid, and to investigate whether the Commission should abandon this policy.

E) That the Commission accept Artesian's and Staff's recommendation to accept the end-of-test-period "true-up" of actual plant-in-service for purposes of calculating Artesian's rate base.

F) That the Commission accept Artesian's and Staff's recommendation to increase Artesian's rates to recover increases in its purchased water expenses resulting from July 2005 rate hikes imposed by the City of Wilmington and the Chester Water Authority, in the aggregate annual amount of $131,529.

Respectfully submitted,

/s/ William F. O'Brien
William F. O'Brien
Senior Hearing Examiner

Dated: March 23, 2006