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**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

Application of California-American Water Company (U210W) for Approval of the Monterey Peninsula Water Supply Project and Authorization to Recover All Present and Future Costs in Rates.

A.12-04-
(Filed April 23, 2012)

DIRECT TESTIMONY OF JEFFREY T. LINAM

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DIRECT TESTIMONY OF JEFFREY T. LINAM

I. INTRODUCTION

Q1. Please state your name and business address.

A1. My name is Jeffrey T. Linam and my business address is 1033 B Avenue, Suite 200, Coronado, CA 92118.

Q2. By whom are you employed and in what capacity?

A2. I am employed by California-American Water Company (“California American Water” or “company”) as the Director of Finance.

Q3. What are your responsibilities?

A3. In my capacity as Director of Finance, I oversee all financial operations for California American Water, including the rates and financial planning and analysis teams.

Q4. Briefly describe your education background.

A4. I received a Bachelor of Arts degree from Claremont McKenna College with a dual major in Mathematics and Economics. I received a Masters in Business Administration (MBA) from the Anderson School at the University of California, Los Angeles (UCLA). I am a Certified Public Accountant (CPA) in California and a Certified Management Accountant

1 (CMA). I am also a member of the American Institute of Certified Public Accountants
2 (AICPA) and the Institute of Management Accountants (IMA).

3
4 Q5. Please describe your professional experience.

5 A5. I have been employed by California American Water since October 2009 as the Director
6 of Finance. Prior to joining California American Water, I worked for Sempra Energy and
7 its regulated subsidiaries San Diego Gas and Electric Company (SDG&E) and Southern
8 California Gas Company (SoCalGas) for 15 years. The various positions I have held with
9 Sempra Energy are: Internal Auditor, Accounting and Finance Department for SoCalGas
10 – 1994; Regulatory Case Administrator, Regulatory Affairs Department for SoCalGas –
11 1995 through 1998, Business Planning Manager, Customer Services Department for
12 SoCalGas – 1998 through 2002, Manager of Financial Planning and Analysis, Accounting
13 and Finance Department for SDG&E and SoCalGas – 2002 through 2007 and Director of
14 Mergers and Acquisitions for Sempra Energy – 2007 through 2009. Prior to my
15 employment with Sempra Energy, I worked in management consulting and public
16 accounting.

17
18 Q6. Have you testified before any regulatory agencies?

19 A6. Yes. I have testified before the California Public Utilities Commission.

20
21 Q7. What is the purpose of your testimony?

22 A7. The purpose of my testimony is to provide an overview of the financial modeling used by
23 California American Water to assess the Monterey Peninsula Water Supply Project.
24 Specifically, I will address and support California American Water's: calculations of the
25 revenue requirement, including underlying assumptions, for both the 9.0 MGD
26 desalination plant and the 5.4 MGD desalination plant plus ground water recharge (GWR)
27 and determination of the cost of capital and financing considerations.

1 **II. REVENUE REQUIREMENT CALCULATIONS**

2 Q8. Please describe the project scenarios for which revenue requirement calculations were
3 modeled.

4 A8. The financial model evaluates the California American Water investment in the Monterey
5 Peninsula Water Supply Project under four scenarios. The four scenarios consider two
6 plant size alternatives, 9.0 MGD and 5.4 MGD supplemented with 3,500 AFY of
7 groundwater replenishment (GWR), and two financing alternatives. The plant size
8 alternatives are presented in the direct testimony of California American Water witness,
9 Mr. Richard C. Svindland. The financing alternatives are based on whether the project
10 qualifies for State Revolving Fund (SRF) loans or whether long-term debt is required to
11 finance the debt portion of the project. These four project scenarios can be summarized as
12 follows:

13
14 (i) 9.0 MGD plant with SRF financing

15
16 (ii) 9.0 MGD plant without SRF financing

17
18 (iii) 5.4 MGD plant plus GWR and with SRF financing

19
20 (iv) 5.4 MGD plant plus GWR without SRF financing

21
22 Q9. Please describe briefly the revenue requirement tables and other attachments included as
23 part of your testimony.

24 A9. Attachment A includes the revenue requirement and rate base calculation for each of the
25 four scenarios described above. Also included are two cost of capital scenarios for each
26 of the four scenarios, the current authorized capital structure and cost of equity and the
27 settlement position related to capital structure and cost of equity in the current proceeding
28

1 (A.11-05-003). A decision in the 2012 Cost of Capital proceeding for California
2 American Water is expected shortly and the company's position is that the approved
3 revenue requirement should reflect the current effective cost of capital and capital
4 structure. The revenue requirement calculations are for 2017, the first year of operation,
5 but also present information during the construction period, 2013 through 2016.
6 Attachment B provides a listing of the key assumptions used in the financial model.
7

8 Q10. What are the capital costs for each of the two plant size alternatives used to determine the
9 revenue requirements for California American Water?

10 A10. The capital costs modeled are \$260 million and \$213 million for the 9.0 MGD and 5.4
11 MGD plant, respectively. These costs include all the costs to permit, design and construct
12 the slant intake wells, the source pipelines, the desalination plant, the brine disposal
13 pipeline and facilities and the finished water pipeline. These costs are referenced from
14 Section III of the direct testimony of Mr. Richard C. Svindland. The capital costs for the
15 5.4 MGD plant do not reflect any capital expected to be incurred by the Monterey
16 Regional Water Pollution Control Agency (MRWPCA) to construct and deliver the 3,500
17 AFY of GWR. Rather the revenue requirement calculation treats all costs associated with
18 MRWPCA's delivery of the 3,500 AFY of GWR as purchased water costs under the 5.4
19 MGD plant scenario. These purchased water costs are described in more detail under the
20 O&M cost assumptions discussed below. The capital costs described above exclude
21 allowance for funds used during construction (AFUDC), which is discussed in more detail
22 in the financing assumptions section of my testimony (Section III).
23

24 Q11. What are the operations & maintenance (O&M) costs of this project for the first year of
25 operation?

26 A11. In 2017, the first year of operation, the net O&M costs range from \$9.7 million for the 9.0
27 MGD plant to \$15.7 million for the 5.4 MGD plant supplemented with 3,500 AFY of
28

1 GWR and including SRF financing. Components of O&M costs are from the RBF
2 Consulting report dated April 20, 2012 as referenced in Section III of the direct testimony
3 of Mr. Richard C. Svindland. For 2017, the O&M costs included in the revenue
4 requirement calculation include: 1) fuel and power, 2) chemicals, 3) repairs and
5 maintenance, 4) labor, 5) purchased water and 6) an estimate of avoided costs. Purchased
6 water costs only apply to the 5.4 MGD plant with GWR and are based on the price from
7 MRWPCA of \$2,500 per acre foot and assume SRF financing. GWR is assumed to cost
8 \$3,000 per acre foot without SRF loans. This is based on estimates provided by
9 MRWPCA. The total net O&M costs for 2017 include an estimate of avoided costs of
10 \$2.3 million. Avoided costs are related to Company's reduced operation of the Begonia
11 Iron Removal Plant, Segunda and Seaside Basin facilities, as presented in the direct
12 testimony of Mr. Eric J. Sabolsice. Thus the O&M costs in 2017 would have been \$2.3
13 million higher but for the costs that the project allows California American Water to
14 avoid. California American Water proposes that costs for 2018 and beyond would be
15 updated and requested in future general rate cases or other appropriate proceedings.
16

17 Q12. Before discussing financing costs, are there any other revenue requirement assumptions
18 that you want to present?

19 A12. Yes. In addition to the capital and O&M cost assumptions used in the financial model,
20 other underlying assumptions include: 1) a composite depreciation rate of 2.50%,
21 reflecting the 40 year estimated useful life of the plant, 2) an Ad Valorem tax rate of
22 1.05%, 3) an uncollectible rate based on the current authorized rate for the Monterey
23 District of 0.2643%, 4) a federal income tax rate of 35.00%, state income tax rate of
24 8.84% and effective income tax rate of 40.75%, based on current statutory rates and 5) a
25 2.00% labor and 3.23% non-labor inflation factor, based on a projected five year
26 compound annual growth rate using the 2011 through 2015 projections from the CPUC
27 Escalation Memorandum, December 2011. These factors are based on current
28

1 assumptions and effective rates. If any of these projected rates change through
2 governmental or future Commission decisions, California American Water would seek
3 appropriate adjustments to the revenue requirement in future proceedings.
4

5 **III. FINANCING ASSUMPTIONS**

6 Q13. What are California American Water's proposals with respect to how it will fund the
7 Monterey Peninsula Water Supply Project?

8 A13. Funding for the project will come from three key sources: 1) Surcharge 2, as described in
9 the direct testimony of Mr. David P. Stephenson, 2) long-term debt, and 3) equity. Short-
10 term debt will also be used during construction. Surcharge 2 is expected to collect \$99.1
11 million over the 3.5 year construction period from July 1, 2013 through December 31,
12 2016. Based on the \$260 million capital cost for the 9.0 MGD plant, the surcharge will
13 collect 38% of the capital costs. Based on the \$213 million capital cost for the 5.4 MGD
14 plant, the surcharge will collect 47% of the capital costs. As Mr. Stephenson describes in
15 his testimony, Surcharge 2 will be collected through a memorandum account and directly
16 offset costs during construction. This will in effect reduce the total project cost by
17 accounting for the surcharge collection as a reduction of costs. Long-term debt and equity
18 will be employed based on the then current effective capital structure, as approved by the
19 Commission for California American Water. The revenue requirement calculation is
20 based on the current capital structure of 58% long term debt, 42% equity and cost of
21 equity of 10.2%.¹ The rate for long term debt depends upon whether the project qualifies
22 for SRF financing. The revenue requirement calculations assume a rate of 2.5% for SRF
23 financing and a rate of 5.0% if California American Water is required to obtain long-term
24 debt for the project. California American Water would likely obtain this financing from
25 American Water Capital Corporation. The long-term debt rate of 5.0% is based on current
26 market conditions. The SRF financing rate of 2.5% is based on the average historical
27

28 ¹ A settlement in the current Cost of Capital Proceeding (A.11-05-003) for California American Water if approved
would result in a long-term debt ratio of 47%, equity ratio of 53% and cost of equity of 9.99%.

1 interest rate charged by the State Water Resources Control Board since the beginning of
2 2008. Please see the testimony of Mr. Svindland for an explanation of the availability for
3 California American Water to secure SRF financing for the project, including all related
4 infrastructure needs.

5
6 Q14. Please describe the assumptions used to finance the project during construction and the
7 calculation of AFUDC.

8 A14. As Mr. Stephenson describes in his testimony, California American Water proposes that
9 the net average monthly investment carried in the memo account be subject to a carrying
10 cost determination that is added to the overall net cost in the memo account. California
11 American Water offers two proposals to reduce AFUDC during construction. As
12 previously described, the collections under Surcharge 2 are designed to offset the cost of
13 the facilities as constructed, thereby reducing the amount of the plant that needs to be
14 financed. California American Water will also provide up to \$20 million in short-term
15 debt financing during the 3.5 year construction period to further reduce AFUDC. This is
16 because the short-term debt rate, estimated at 1.0% over the 3.5 year construction period,
17 is well below long-term rates. Only when construction costs exceed the surcharge
18 collections and the \$20 million short-term debt financing limit, will California American
19 Water employ long-term debt and equity. The combination of Surcharge 2 collections and
20 use of short-term debt serves to reduce interest during construction. In the case of the 5.4
21 MGD plant, long-term debt and equity are not needed until late 2015, at least two years
22 into construction. In the case of the larger 9.0 MGD plant, long-term debt and equity is
23 not needed until 2015 as well. Lastly in addition to the contributions and short-term debt,
24 use of SRF loans estimated at 2.5% interest also serve to reduce AFUDC under the
25 scenarios that assume SRF financing.

Q15. Please provide an example of how the sources of financing align with the costs over the construction period.

A15. Table 1 provides an example of the sources and uses of cash over the construction period for the 5.4 MGD plant assuming SRF financing. The uses of cash include two components: 1) capital expenditures of \$213 million, and 2) AFUDC of \$5.9 million. The sources of cash include four components: 1) Surcharge 2, 2) short-term debt, 3) long-term debt, and 4) equity. Upon completion and project in-service, the net cost in the memo account is transferred to plant in service, short-term debt is paid off and long-term debt and equity are used to balance the capital structure at authorized.

**Monterey Peninsula Water Supply Project
5.4 MGD Plant with SRF Financing ⁽¹⁾**

	2013	2014	2015	2016	Total
Uses of Cash					
Capital Expenditures	\$11.9	\$27.5	\$50.0	\$123.6	\$213.0
AFUDC	0.0	0.1	0.0	5.8	5.9
Total Uses of Cash	<u>\$11.9</u>	<u>\$27.6</u>	<u>\$50.0</u>	<u>\$129.4</u>	<u>\$218.9</u>
Sources of Cash					
Surcharge 2	\$7.5	\$27.0	\$31.8	\$32.8	\$99.1
Net Short-Term Debt	4.4	0.5	15.1	(20.0)	0.0
Net Long-Term Debt	0.0	0.0	1.5	54.7	56.2
Net Equity	0.0	0.0	1.7	61.9	63.6
Total Sources of Cash	<u>\$11.9</u>	<u>\$27.5</u>	<u>\$50.1</u>	<u>\$129.4</u>	<u>\$218.9</u>

(1) Based on 47%/53% debt/equity, 9.99% cost of equity from 2012 Cost of Capital proceeding (A.11-05-003)

Table 1

Table 2 provides an example of the sources and uses of cash over the construction period for the 9.0 MGD plant assuming SRF financing. The uses of cash include two components: 1) capital expenditures of \$260 million, and 2) AFUDC of \$9.5 million. The sources of cash include four components: 1) Surcharge 2, 2) short-term debt, 3) long-term debt, and 4) equity. Upon completion and project in service, the net cost in the memo account is transferred to plant in service, short-term debt is paid off and long-term debt and equity are used to balance the capital structure at authorized.

**Monterey Peninsula Water Supply Project
9.0 MGD Plant with SRF Financing ⁽¹⁾**

	2013	2014	2015	2016	Total
Uses of Cash					
Capital Expenditures	\$13.1	\$32.9	\$61.5	\$152.5	\$260.0
AFUDC	0.0	0.1	0.3	9.1	9.5
Total Uses of Cash	<u>\$13.1</u>	<u>\$33.0</u>	<u>\$61.8</u>	<u>\$161.6</u>	<u>\$269.5</u>
Sources of Cash					
Surcharge 2	\$7.5	\$27.0	\$31.8	\$32.8	\$99.1
Net Short-Term Debt	5.6	6.0	8.4	(20.0)	0.0
Net Long-Term Debt	0.0	0.0	10.1	69.8	79.9
Net Equity	0.0	0.0	11.4	79.0	90.4
Total Sources of Cash	<u>\$13.1</u>	<u>\$33.0</u>	<u>\$61.8</u>	<u>\$161.6</u>	<u>\$269.5</u>

(1) Based on 47%/53% debt/equity, 9.99% cost of equity from 2012 Cost of Capital proceeding (A.11-05-003)

Table 2

Q16. Please provide the revenue requirement for 2017 under each of the four scenarios.

A16. Table 3 provides a summary of the revenue requirement for the plant for 2017 under each of the four scenarios.

**Monterey Peninsula Water Supply Project
2017 Revenue Requirement ⁽¹⁾**

	----- 5.4 MGD -----		----- 9.0 MGD -----	
	SRF	w/o SRF	SRF	w/o SRF
1 st Year Revenue Requirement	\$22.4	\$24.2	\$31.4	\$34.2
Purchased GWR Annual Cost ⁽²⁾	8.7	10.5		
Total ⁽³⁾	<u>\$31.1</u>	<u>\$34.7</u>	<u>\$31.4</u>	<u>\$34.2</u>

(1) Based on 47%/53% debt/equity, 9.99% cost of equity from 2012 Cost of Capital proceeding (A.11-05-003)

(2) Based on assumed cost of \$2,500/AF with SRF and \$3,000/AF without SRF.

(3) Excludes conveyance pipeline revenue requirement.

Table 3

Q17. What is the rate base estimate for 2017 for the project under the four scenarios?

A17. Table 4 provides a summary of the rate base for 2017 under each of the four scenarios.

**Monterey Peninsula Water Supply Project
2017 Rate Base**

	----- 5.4 MGD -----		----- 9.0 MGD -----	
	SRF	w/o SRF	SRF	w/o SRF
2017 Weighted Avg Rate Base	\$56.5	\$114.6	\$79.6	\$162.7

(1) Based on 47%/53% debt/equity, 9.99% cost of equity from 2012 Cost of Capital proceeding (A.11-05-003)

(2) Excludes conveyance pipeline

Table 4

Q18. Is it possible that your revenue requirement estimate could change with time?

A18. Yes.

Q19. Identify what factors might cause you to change your revenue requirement estimate.

A19. The revenue requirement includes many assumptions, including all of the cost estimate assumptions. Any change in the cost estimates will cause a change in the revenue requirement. The current estimated cost of the project could change based on factors such as construction advancements, changes in commodity prices and engineering costs and savings enhancements. Interest rates, income tax rates and Ad Valorem tax rates could also change. Other impacts on the annual cost of the project could occur due to changes in the proposed capital structure to finance the project and changes in the method of recovery of the project cost (depreciation). Lastly, changes to the proposed surcharge 2 could affect the year 1 revenue requirement in terms of financing costs, property tax payments and other costs.

Q20. Do you have any additional comments?

A20. Yes. The Monterey Peninsula Water Supply Project will be the single largest capital project in the history of California American Water. It is important that the revenue requirement allow the company to recover all just and reasonable costs in a timely manner and be afforded the opportunity to earn a fair return on the capital it has invested on behalf

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of customers. Decision No. 10-12-016 recognized the need to ensure the financial viability of California American Water and we request the same consideration herein.

Q21. Does this complete your testimony?

A21. Yes it does.

ATTACHMENT A

Depreciation Reserve - SRF Funded	0.00	0.00	0.00	0.00	0.00	0.00
Deferred Taxes	0.00	0.00	0.00	0.00	(0.23)	(1.25)
Rate Base	0.00	0.00	0.00	0.00	167.50	162.28
Plant Operating Expenses						
Labor	0.00	0.00	0.00	0.00	0.00	3.33
Fuel & Power	0.00	0.00	0.00	0.00	0.00	7.40
Chemicals	0.00	0.00	0.00	0.00	0.00	0.82
Repairs & Maintenance	0.00	0.00	0.00	0.00	0.00	0.44
Total Plant Operating Expenses	0.00	0.00	0.00	0.00	0.00	12.00

Depreciation Reserve - SRF Funded	0.00	0.00	0.00	0.00	0.11	1.48
Deferred Taxes	0.00	0.00	0.00	0.00	(0.23)	(1.24)
Rate Base	0.00	0.00	0.00	0.00	64.56	60.76
Plant Operating Expenses						
Labor	0.00	0.00	0.00	0.00	0.00	3.33
Fuel & Power	0.00	0.00	0.00	0.00	0.00	7.40
Chemicals	0.00	0.00	0.00	0.00	0.00	0.82
Repairs & Maintenance	0.00	0.00	0.00	0.00	0.00	0.44
Total Plant Operating Expenses	0.00	0.00	0.00	0.00	0.00	12.00

Depreciation Reserve - SRF Funded	0.00	0.00	0.00	0.00	0.00	0.00
Deferred Taxes	0.00	0.00	0.00	0.00	(0.16)	(0.88)
Rate Base	0.00	0.00	0.00	0.00	117.97	114.29
Plant Operating Expenses						
Labor	0.00	0.00	0.00	0.00	0.00	2.91
Fuel & Power	0.00	0.00	0.00	0.00	0.00	5.30
Chemicals	0.00	0.00	0.00	0.00	0.00	0.64
Repairs & Maintenance	0.00	0.00	0.00	0.00	0.00	0.36
Total Plant Operating Expenses	0.00	0.00	0.00	0.00	0.00	9.20

Depreciation Reserve - SRF Funded	0.00	0.00	0.00	0.00	0.07	1.04
Deferred Taxes	0.00	0.00	0.00	0.00	(0.16)	(0.88)
Rate Base	0.00	0.00	0.00	0.00	46.00	43.31
Plant Operating Expenses						
Labor	0.00	0.00	0.00	0.00	0.00	2.91
Fuel & Power	0.00	0.00	0.00	0.00	0.00	5.30
Chemicals	0.00	0.00	0.00	0.00	0.00	0.64
Repairs & Maintenance	0.00	0.00	0.00	0.00	0.00	0.36
Total Plant Operating Expenses	0.00	0.00	0.00	0.00	0.00	9.20

Depreciation Reserve - SRF Funded	0.00	0.00	0.00	0.00	0.00	0.00
Deferred Taxes	0.00	0.00	0.00	0.00	(0.23)	(1.26)
Rate Base	0.00	0.00	0.00	0.00	167.93	162.69
Plant Operating Expenses						
Labor	0.00	0.00	0.00	0.00	0.00	3.33
Fuel & Power	0.00	0.00	0.00	0.00	0.00	7.40
Chemicals	0.00	0.00	0.00	0.00	0.00	0.82
Repairs & Maintenance	0.00	0.00	0.00	0.00	0.00	0.44
Total Plant Operating Expenses	0.00	0.00	0.00	0.00	0.00	12.00

Depreciation Reserve - SRF Funded	0.00	0.00	0.00	0.00	0.09	1.21
Deferred Taxes	0.00	0.00	0.00	0.00	(0.23)	(1.25)
Rate Base	0.00	0.00	0.00	0.00	83.68	79.61
Plant Operating Expenses						
Labor	0.00	0.00	0.00	0.00	0.00	3.33
Fuel & Power	0.00	0.00	0.00	0.00	0.00	7.40
Chemicals	0.00	0.00	0.00	0.00	0.00	0.82
Repairs & Maintenance	0.00	0.00	0.00	0.00	0.00	0.44
Total Plant Operating Expenses	0.00	0.00	0.00	0.00	0.00	12.00

Depreciation Reserve - SRF Funded	0.00	0.00	0.00	0.00	0.00	0.00
Deferred Taxes	0.00	0.00	0.00	0.00	(0.16)	(0.88)
Rate Base	0.00	0.00	0.00	0.00	118.23	114.55
Plant Operating Expenses						
Labor	0.00	0.00	0.00	0.00	0.00	2.91
Fuel & Power	0.00	0.00	0.00	0.00	0.00	5.30
Chemicals	0.00	0.00	0.00	0.00	0.00	0.64
Repairs & Maintenance	0.00	0.00	0.00	0.00	0.00	0.36
Total Plant Operating Expenses	0.00	0.00	0.00	0.00	0.00	9.20

Depreciation Reserve - SRF Funded	0.00	0.00	0.00	0.00	0.06	0.85
Deferred Taxes	0.00	0.00	0.00	0.00	(0.16)	(0.88)
Rate Base	0.00	0.00	0.00	0.00	59.40	56.52
Plant Operating Expenses						
Labor	0.00	0.00	0.00	0.00	0.00	2.91
Fuel & Power	0.00	0.00	0.00	0.00	0.00	5.30
Chemicals	0.00	0.00	0.00	0.00	0.00	0.64
Repairs & Maintenance	0.00	0.00	0.00	0.00	0.00	0.36
Total Plant Operating Expenses	0.00	0.00	0.00	0.00	0.00	9.20

ATTACHMENT B

