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EXHIBIT

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ARBITRATION BETWEEN MAYOR AND CITY COUNCIL
OF BALTIMORE AND BALTIMORE COUNTY, MARYLAND,
AS TO DETERMINATION OF COSTS OF FURNISHING
WATER TO THE METROPOLITAN DISTRICT
OF BALTIMORE COUNTY

**DECISION OF BOARD OF ARBITRATION**

ARBITRATION BETWEEN MAYOR AND CITY COUNCIL OF BALTIMORE AND BALTIMORE COUNTY, MARYLAND, AS TO DETERMINATION OF COSTS OF FURNISHING WATER TO THE METROPOLITAN DISTRICT OF BALTIMORE COUNTY

## DECISION OF BOARD OF ARBITRATION

### I. Introduction

This arbitration was undertaken pursuant to the provisions of Sections 34-19 and 34-26 of the Metropolitan District Act, Baltimore County Code of 1978, as amended.

Under Section 34-26, the Mayor and City Council of Baltimore must furnish water to the Metropolitan District of Baltimore County at cost and entirely without profit or loss.

This Section further provides that if the parties do not reach an agreement as to that cost, then cost shall be determined by arbitration in the manner provided by Section 34-19 of that Code.

Section 34-19 sets forth the procedure for arbitration, which is that each party appoint one arbitrator, then the two arbitrators select a third, who shall be chairman of the board of arbitration.

In the year 1982 and thereafter, the parties disagreed as to the determination of the cost of the City's furnishing water to the Metropolitan District and the City asked for arbitration. After some years, the County declined to arbitrate so the City entered suit in 1987 to compel arbitration.

Under date of December 1, 1987, the Circuit Court for Baltimore County determined that the dispute between the

parties was subject to arbitration. The Court of Appeals of Maryland affirmed by a per curiam opinion filed September 15, 1988.

Arbitrators having been selected, the parties filed prepared testimony and exhibits prior to the hearings held in December, 1990. Counsel for the parties then filed briefs and oral argument was heard by the Board of Arbitration May 7, 1991. The matter was then submitted for decision.

## II. The Issues for Arbitration

By agreement of the parties embodied in a Memorandum as to Jurisdiction and Procedure (Joint Exhibit 1), the issues for arbitration are as follows:

A. What is the proper method, under the Metropolitan District Act, for determining the cost to Baltimore City of furnishing water to consumers in the Metropolitan District of Baltimore County.

1. Is the City's proposed use of the utility basis for determining capital costs the proper measure of Baltimore County's responsibility for its share of such costs under the Metropolitan District Act.

a. Under the utility basis, what were the values at the appropriate valuation dates of the property used and useful in furnishing water to consumers in the Metropolitan District.

b. Under the utility basis, what were the reasonable cost of capital rates at the appropriate valuation dates.

2. Is the City's proposed allocation of operational and maintenance expenses on a functional cost basis the proper measure of determining Baltimore County's responsibility for its share of such costs under the Metropolitan District Act.

B. What should be the effective date for implementation of the methodology proposed by the City for determining the cost to Baltimore City of furnishing water to consumers in the Metropolitan District of Baltimore County.

1. What is the current value of the amounts due to the City counting from the date of implementation of the methodology proposed by the City.

2. What is the appropriate rate of interest applicable to amounts due the City from the date of the decision of the Board of Arbitration to the date of payment.

## III. Summary of Testimony

The City's first witness was Howard J. Lobb, a registered professional engineer and a Senior Consultant in the engineering firm of Black & Vaetch, Kansas City, Missouri, where he has been associated since 1951. The firm was retained by the City in 1974 to conduct a water and wastewater study that culminated in its 1978 report (marked Baltimore City Exhibit 1-Schedule HJL-1). Mr. Lobb supervised coordination of the preparation of that report and also the updating for these proceedings. Its purpose was to present the revenue require-

ments, to allocate the costs of service using the utility basis, and to design rates.

From the updating, Mr. Lobb had four schedules prepared as follows:

Schedule HJL-2 shows the "Net System Investment to Be Allocated" for each of the update years 1980, 1982, 1984, 1986, 1988 and 1990 (estimated).

Schedule HJL-3 entitled "Net Allocated Rate Base" summarizes for each update the net rate base allocated to the City, to Baltimore County, and the other political subdivision's to which the City also supplies water. The utility basis of allocation was used, which Mr. Lobb espoused in his direct testimony. The Schedule shows that the net rate base allocable to Baltimore County has been decreasing since 1984 because of the County's continuing contribution of its share of new system facilities and also depreciation on the old plant.

The next Schedule, HJL-4, "City's Realized Return on Net Allocated Rate Base:", shows for each update the City's return for itself, for Baltimore County, and for the other jurisdictions (as a group). For each update year since 1980, the net realized rate of return from Baltimore County has been negative. Consequently, according to Mr. Lobb, the City of Baltimore customers have had to subsidize the cost of providing water service to Baltimore County.

On his Schedule HJL-5 "Indicated Increase in Baltimore County Revenue Reflecting Return on Net Allocated Rate Base

equal to Weighted Costs of Capital", this witness provided the increase in revenues which the City would have received if its charges to Baltimore County had been developed on the utility basis, using the weighted cost of capital developed by another City witness (Henry G. Mulle). According to Mr. Lobb and this Schedule, there has been an underpayment of $24,468,800 for water service provided by the City for the years 1982 through 1989, plus an additional $2,183,800 estimated for the year 1990.

Mr. Lobb concluded his direct testimony by criticizing the current agreement between the City and the County as inappropriate in the manner in which it provides for the recovery of both operation and maintenance costs, and capital costs. Since the increase in annual usage in Baltimore County has exceeded that of the City, the current relative use of facilities by the County is in excess of the relative use upon which the capital costs of those facilities were originally allocated. Further, there are older facilities whose debt has been retired where the County's use of these facilities far exceeds the percentage of debt service shared by the County. Thus, Mr. Lobb says the County is using facilities paid for by the City's customers, yet the City has no way under its current agreement with the County to charge it for the use of those facilities.

The County's chief witness in opposition to Mr. Lobb was Paul R. Moul, a Senior Vice President of AUS Consultants-Utility Services Group, with whom he has been employed since

1974. AUS was engaged by the County to conduct a complete review of the 1972 City/County Water Agreement, to analyze the City's proposal to amend that Agreement, and to analyze each of the 1980-1989 Annual water Statements prepared jointly by the City and the County.

The result of the engagement is the AUS "Report to Baltimore County, Maryland, regarding rates and charges for water service provided by the City of Baltimore Water Department to Metropolitan District Customers" in Baltimore County introduced in the record with Mr. Moul's testimony. The report supports his opinion that the Agreement should not be amended to provide any change in the basic methodology of setting revenue requirements for Baltimore County customers in its Metropolitan District beyond the proposed functional cost allocation procedure.

According to Mr. Moul, "debt service" is the method, which should continue to be used to determine revenue requirements for Metropolitan District customers of the City's water system for these reasons:

1. The debt-service approach is the basis for the City's recovering all of its costs, without profit, pursuant to the 1924 Metropolitan District Act and the 1972 Agreement.

2. This approach is particularly well suited for municipally-owned utilities and it supplies the capital attraction standard used by the financial community and by the courts and utility commissions to determine financial adequacy and revenue requirements, while the City's evidence is insufficient to support any change in approach to a utility format.

3. The 1978 Black & Veatch Report to the city used debt service to determine overall water utility revenue needs for the City and this is in accordance with the American Water Works Association Water Rates Manual (AWWA No. M1).

4. The City's proposal advocates separate rates of return for inside and outside City customers with the higher rate of return assigned the latter, which is not justified, would be discriminatory, and would be anti-competitive pricing to outside City water uses.

5. The City's evidence in support of the proposed change to the utility basis is based upon various estimates made by Black & Veatch, which are not adequate because there is no verifiable link to the actual costs of the City's water system, no reconciliation of the B & V estimates and actual City costs.

Mr. Moul pointed out that the Annual Water Statements prepared for the last 20 years show that for 15 of those years the rates established for the metropolitan District were more than adequate to cover the City's actual costs with refund payments made to the County for excess revenues made by the City. Conversely, where revenues from County customers did not match the City's cost of service, the County reimbursed the City for the shortfall.

He did recommend that the Agreement be amended to the extent that revenue requirements for Metropolitan District Customers be based upon the functional cost allocation procedure proposed by the City. Under this approach, the

County's operation and maintenance cost responsibility could increased by $2,037,010 based on Fiscal Year 1989 data. However, prior to final acceptance of this new methodology, he stated that there would have to be explicit indication of which expenses are to be considered base costs, which are extra capacity costs, which customer costs (directly assignable to a particular political jurisdiction), and which, if any, need to be allocated on some weighted average of the foregoing. Also, there will be needed a delineation of the demand ratios required for the development of the maximum day and the peak hour extra capacity allocation. Mr. Moul said that the County would accept the historical ratios developed by the A.U.S. study and described in his testimony.

Finally, he pointed out that the County will require guidelines to develop jurisdictional capacity factors, which he said the City has yet to provide. The County proposes that these factors be applicable for a minimum of five years. (Note: reference is hereby made to pages 3, 4, 5, 28 and 29 of the AUS Study for details of the AUS recommendation for adoption of the functional cost basis of allocation of expenses).

In his testimony in rebuttal to the direct testimony of Mr. Moul, the City's witness Howard Lobb joined issue over the continuing use of the 1972 Water Agreement to determine Baltimore County's revenue requirements, as recommended by Mr. Moul. Mr. Lobb pointed out that the use of a cash basis to determine charges for providing water service to the County

does not provide recovery of the City's full cost for the County's current use of facilities. Specifically, there are many facilities serving the County, which is using them at a far greater percentage than originally charged where the debt incurred for these facilities has been retired. Mr. Lobb contends that the utility basis would minimize the impact on outside charges of the method of financing of water facilities chosen by the City.

According to Mr. Lobb, the utility basis is a generally accepted methodology for assignment of costs among customers of a municipally owned utility and has been endorsed by the American Water Works Association. (Note: see pages 5-11, inclusive, of Lobb's prepared testimony as to this).

As to Mr. Moul's testimony that the utility basis is inappropriate because of the complexity of estimating the value of the rate base assignable to the County, while Mr. Lobb agrees that the calculations are complex, he contends that the utility basis is no more complex than the current method used. Rate base allocations were performed in the Black & Veatch 1978 study and subsequent updates. Such methods have been used by the Maryland Public Service Commission in evaluating charges for water to Anne Arundel County by the City.

Where the City's proposal would extend capital recovery beyond payment of the bonds financing plant and equipment, as pointed out by Mr. Moul, this will only extend the capital recovery period until the related facilities have been fully depreciated and allocated rate base reduced to zero, according to Mr. Lobb.

On Mr. Moul's contention that the City's proposal would result in discriminatory pricing of water service to Metropolitan District customers, Mr. Lobb responds that rates based upon cost of service principles would not be discriminatory. He further points out that the situation is common where outside city rates are greater than inside city rates for similar type service, referring to his Schedule HJL-9 showing that 41 out of 48 cities shown charge a greater outside city rate for the same kind of water service.

Mr. Lobb's rebuttal testimony also dealt with Mr. Moul's statement that there has not been presented by the City any verifiable link between B & V estimates and the actual costs of the City's water system. According to Mr. Lobb, these tie either to the City's audited financial statements or billing data supplied by the water utility's finance department or are based on the City/County Water Agreement.

Responding to the County's data requests in this regard, Mr. Lobb offered his Schedules HJL-7A through 7F plus HJL-10 and 11.

Mr. Moul testified that the City cannot support its higher rate of return claim for outside the city customers and maintain that a lower rate of return is adequate for inside City customers. Mr. Lobb's response is that the actual return realized from City customers is greater than that realized from service to Baltimore County, as shown by his Schedule HJL-4 Revised, but he does not state that such returns are adequate.

He also disputed the statement in the AUS report that a higher rate of return to County customers results in anti-competitive pricing by the City, contending that rates based on cost of service may result in different returns, but are not per se anti-competitive.

Mr. Lobb went on to testify that his exhibits give full credit to Baltimore County for annual depreciation and plant contributed where Baltimore County shares equitably in the City's total accumulated depreciation reserve.

The City's next witness was Henry G. Mulle, an independent financial and economic consultant with his own firm, specializing in risk analyses, cost of capital, and fair rate of return in public utility rate proceedings. His employment experience includes some eight years with waterworks service companies. His assignments have familiarized him with utility systems including American Waterworks, General Waterworks, and other water companies.

His testimony dealt with the "cost of capital "for Baltimore City in furnishing water service to its customers. His study covered the period from the late 1970's to the present to develop the costs of debt and of equity during that period. He found that the embedded cost of debt has averaged 4.3%, while new bonds today would cost about 7.8%. Where his equity cost rate has averaged 9.8% over the same period, his overall 1989-90 capital cost rate (after weighting) is 7.11%.

Mr. Mulle supports a shift to a utility basis of price regulation because it is the most certain way for a municipal

utility to recover its full effective cost of service, including the cost of its equity investment in its plant. It is his opinion that this shift is not unique to Baltimore where American cities can no longer afford to provide public services to non-residents at less than cost (including cost of equity). His schedule (HGL-16) shows other municipalities in 17 other areas with returns greater than Baltimore's.

The County's opposition witness was Dr. John J. Boland, a Professor in the Department of Geography and Environmental Engineering at The Johns Hopkins University with extensive experience in utility ratemaking, including cost and rate studies for a number of water utilities.

His conclusion is that while the Metropolitan District may benefit from what may be termed equity capital in the City's water utility, the City does not bear the cost of that capital and is not entitled to earn a return on it. This is because there are no investors in the City water system, although Dr. Boland finds that there is a use of equity capital in that system. This capital is the result of involuntary customer contributions obtained primarily from the discrepancies between debt principal payments and depreciation charges.

Dr. Boland opines that since these transfers are involuntary, the City needed to do nothing to attract or retain this capital and so no return is applicable to customer-contributed equity capital. He does admit that all rate payers, i.e., customers, benefit from the existence of equity in the utility, primarily cost savings from lower-cost debt capital.

However, as he sees it, where the City-County Agreement insulates the City from all financial risk as regards County customers, there is no need for any reserve fund equivalent to an equity capitalization.

Testifying in rebuttal to Dr. Boland, Mr. Mulle stated that the fact that equity capital exists on the balance sheet of the City's water system governs its getting a return on that capital if the necessary debt capital is to be attracted at reasonable rates. He also quotes Bonbright that "cost" must include a capital-attractive rate of return on the total investment so a return on equity is part of the cost of Capital and of operations.

Mr. Mulle pointed out that there is an equity capital base provided by the City taxpayers, who have the ultimate overall, total risk of the enterprise. For him, there must be revenue to cover the risk by meeting all costs of operation, including a return on equity, which is not "profit", but a "cost" in the regulatory/utility sense.

Mr. Mulle concluded his rebuttal to Dr. Boland's testimony by declaring that the shift from cash-based to accrual accounting since 1980 has made a rate of return/rate base method a necessary change in defining the overall cost of service for most municipal enterprises. He says that the time has passed for this change to be recognized in the Agreement between the City and the County.

The third and last witness for the City was Jerry Silhan, Chief of the Water Engineering Division of the

Baltimore City Bureau of Water and Waste Water. He has been employed by the City since 1962. He has the degree of Bachelor of Science from The Johns Hopkins University, is a registered Professional Engineer in the State of Maryland, and a member of the American Water Works Association.

Mr. Silhan gave a historical overview of the relationship between Baltimore City and Baltimore County in the area of water supply, including the 1972 Agreement and the annual statements issued pursuant to that Agreement.

The Baltimore County Metropolitan District was created in 1924 by act of the Maryland State Legislature. The present day boundaries of the District reflect a great deal of extension since 1924, which continues today due to increasing development in the County. Under that act, the City was required to make extensions of water supply lines for and in the District whenever and wherever requested by the County. The City was required to make the extensions at cost (to include a proper charge for overhead). Water service rates were to be established by the City for all customers, such rates to be based on the cost of providing service (without defining "cost").

In 1945, another act amended the provision regarding the cost of water service, requiring the City to furnish water to County customers at cost, entirely without profit or loss. In 1972, the City and the County entered a formal written agreement (entered in evidence as Schedule JS-3, part of City Exhibit 6). Under that agreement, each party is responsible

for the construction of new facilities within its own borders, but the City is responsible for construction of the central system facilities. Costs of such construction are to be shared by agreement, but no formal agreements have been consummated. The City has spent millions of dollars on central system improvements with Baltimore County sharing those costs on a current year volumetric basis.

Back in 1953, a joint board found that the area's residential and industrial growth was outstripping the capacity of the system's feeder mains. At that time the City's population peaked, while that of Baltimore County has continued to grow so that by the year 2000 the estimated service populations of the City and the County will be substantially equivalent. Usage of water has grown in the County to 101.3 MGD in 1988 versus 138.9 MGD in the City. The result is that the County is now using excess capacity in raw water source, filtration and distribution system facilities that the City had previously provided for its own anticipated growth.

Mr. Silhan says that there are substantial facilities that are used and useful in rendering water service to the County for which the City has not been compensated because they were financed and built prior to 1972 and the County is paying only on a volumetric basis. Many of the upgrades and improvements to the water system were necessitated by the development occurring in the County. Much of this construction was financed by the City through general obligation bonds. Under the debt service method, once the bond has been paid off, the

County ceases to reimburse the City, but continues to benefit from these facilities constructed to benefit county customers.

Under the 1972 Agreement, the parties prepare jointly an Annual Statement of Cost with the County paying any deficit to the City when operating costs exceed revenues, while the City remits the difference to the County when revenues exceed those costs. According to Mr. Silhan, the volumetric sharing of debt service under this procedure does not fully compensate the City for its past investment.

The City undertook to get the County to change to the utility approach as a fair and equitable way for the County to reimburse the City. The County took the position that any rate of return earned in excess of actual interest paid out by the city for County-used facilities would be profit. In 1982, the parties agreed that the arbitration provided by the 1945 Act and by the 1972 Agreement should be the way to resolve their differences.

However, no progress was made on going to arbitration so the City filed a mandamus action in 1987 to compel the County to arbitrate. In 1988, the Court of Appeals of Maryland affirmed the order of the Circuit Court for Baltimore County to proceed to arbitration. Since that time, it appears that the parties have been engaged in preparing their respective cases for arbitration, including the selection of the arbitrators.

The only challenge made by the County to Mr. Silhan's testimony and exhibits appears to be the contention in the AUS Report (County Exhibit 6) at page 21 that the City had an

"over-built" water system initially designed for heavier City usage, which is not "over-built" today because County customers have "picked up the slack "through their growing usage. In his rebuttal testimony to this, Mr. Silhan points out that the City has had a legal obligation to provide water service to County customers since 1924 and built its system over the years to meet the growth and projected growth of the entire Metropolitan Area of Baltimore.

## IV. Findings of Fact

1. Baltimore City, Maryland, is a body corporate and politic of the State of Maryland legally denominated as the Mayor and City Council of Baltimore (hereinafter "the City").

2. Baltimore County, Maryland is a separate corporate body politic of the State of Maryland so named (hereinafter called "the County").

3. The County adjoins the north, east, west and part of the southern boundaries of the City as shown by Schedule JS-1 of the City's witness, Jerry Silhan.

4. In 1853, the City was given the power of condemnation to acquire real estate for its water system, which was not restricted to land within the City. Subsequently, it acquired the properties, which have been and are now, the two principal reservoirs of its water system (Loch Raven and Prettyboy), each being in the County.

5. When the City extended its geographical limits by annexation in the year 1918, there were nine private water companies operating in the parts of Baltimore County acquired. These water systems were not designed to match the City's system and the City had to spend large sums to rehabilitate and improve them.

6. Four years later (1922), the first legislation was enacted by the Maryland General Assembly giving the County the right to hook into water lines into the City's water mains at the County's expense. Payment to the City for this service was the actual cost of delivering the water at the points of connection and meter with five per cent added and the actual cost of purifying the water with five per cent added, such costs to be determined by the Maryland Public Service Commission.

7. The Metropolitan District Act was enacted in 1924 by the Maryland General Assembly. It created the Metropolitan District of Baltimore County for the purpose of a water supply and sewage system within the District to be connected and to be part of the City's water and sewage systems. The City was required to extend water supply lines for and in the District whenever and wherever requested by the County. These extensions were to be made at cost and including a proper charge for overhead. Operating control was vested in the City with authority to establish rates for consumers in the District, such rates to be first approved by the Public Service Commission.

8. In 1931, a jointly sponsored cost study of the water system was completed by Dr. Abel Wolman for the County and Ezra B. Whitman for the City. This put cost allocation for both fixed and variable costs on a volumetric basis with fixed costs determined at original cost, reflected by outstanding indebtedness. At that time, a volumetric allocation was thought to be appropriate because the County's use of only 2% of the water system was considered insignificant and not having a major effect on plant capacity. The report was silent on the apportionment of the cost of major capital improvements to the water system.

9. In the year 1945, the Maryland General Assembly amended the Metropolitan District Act to provide what are its present terms, particularly Section 332 (c) as follows:

"The Mayor and City Council of Baltimore shall furnish water to the Metropolitan District of Baltimore County at cost and entirely without profit or loss. The Commissioners and the Mayor and City Council of Baltimore shall, from time to time, determine by agreement, if possible, the cost to Baltimore City of furnishing water to consumers in the Metropolitan District of Baltimore County. If no agreement is reached, then cost shall be determined by arbitration in the manner herein provided in Section 329. Cost, however, determined, shall be subject to revision from time to time by agreement of the respective authorities, or by arbitration on the demand of either of them."

10. Prior to enactment of the 1945 statute, there was a proposed amendment offered by the County's delegation that would have expressly prohibited a return on the City's investment in its water system. This amendment was not adopted.

11. Also, before the statute passed, the Baltimore Sun reported that the then City Solicitor, Simon Sobeloff, stated, during negotiations over the legislation with the County's representative, that he believed it to be true that the City had made a profit and that it was not fair to charge more than the water cost the City. This followed newspaper reports of claims by the Baltimore County Legislative Delegation that the City was earning more than $600,000 a year off of water supplied to County residents.

12. Due to increased development in Baltimore County after the year 1945, water shortages had occurred there. A Board of Advisory Engineers on Future Water Supply was created in 1951 for the City and the County.

13. In its 1953 report, the Board found that the water shortages were not of recent origin, but rather were the result of poor supply conditions in Baltimore County dating from before the time Baltimore City began operating the properties of the former Baltimore County Water and Electric Company. Although the City had financed the extension of feeder mains into County areas to interconnect and reinforce the water distribution systems in and to the County communities, the area's residential and industrial growth was outstripping the capacity of the feeder mains. The Board found that:

> if the Baltimore water distribution system is not immediately improved so that suitable water pressure can be maintained under peak demand conditions, the expected industrial development commensurate with the obvious industrial potential will not materialize. New industries will be discouraged and expansion of present manufacturing and processing plants will be deterred.

14. Pursuant to the recommendations of that report, the Susquehanna River Supply project was undertaken.

15. Another study on the cost of Furnishing Water Service to Baltimore County by Baltimore City was published in

1962. This study affirmed the principles of the 1931 report and recommended that they be continued.

16. Over the years until 1972, the City and the County had agreed informally on the determination of the cost of the City's furnishing water to County residents, modifying that determination from time to time. In 1972, they entered a formal written agreement which embodied the accumulated informal understandings. (Note: A copy of the Agreement is Schedule JS-3 part of the City's Exhibit 6).

17. The 1972 Agreement apportions responsibility for operation and repair of the total water system. The City is responsible for almost all of the operation and repair of the system, including the County's pumping stations, pipelines, reservoirs, meter reading, etc. County personnel perform some minor maintenance on the system located in the County. The Agreement provides a detailed breakdown of cost responsibility and the County reimburses the City for those operations in and benefiting the County. This includes the City's engineering services, field inspections, investigation of complaints, repair of water meters and all other services performed by City personnel for the County.

18. The 1972 Agreement does not cover the costs of new central system facilities. The cost for the rehabilitation of existing central system facilities is shared volumetrically. New filtered water facilities

that are built to benefit only one party are the responsibility of that party. For new facilities that are built to benefit both the City and one or more Counties, the cost responsibility is divided according to projected future use of the facility.

For all new construction, each political subdivision makes concurrent cash contributions for their share of costs as the facilities are constructed. This applies whether or not the project is allocated volumetrically or by future use.

For improvements which were finished or under way prior to June 30, 1970 and the capital expenditures are included in the 1970 Annual Water Statement for allocation of debt service, the apportionment is continued in the same manner as it was prior to 1970. Some of these allocations for mutually beneficial projects were done according to future use, but the majority of expenditures were allocated volumetrically.

19. To finance the construction and improvements to facilities serving both the City and the County, the City issued general obligation bonds which are paid for by City taxpayers. The life of the general obligation bonds is shorter than the life of the facilities financed by the bonds. This results in the bonds being amortized over a shorter period and paid off long before the end of the facility's useful life. As stated before, prior to 1972 most of the County's share

of the financing costs was allocated on a volumetric basis which did not adequately compensate City taxpayers for the County's ultimate responsibility for use of city funds during each bond's amortization period.

20. For facilities constructed after the 1972 Agreement, the City is compensated for construction costs because the City now requires the County to pay its share of those costs concurrent with construction. Under the proposal advanced by the City, the County's capital payments for post-1972 facilities would be credited to the proposed rate base and, hence, excluded from any cost of capital or depreciation expense charges. Nevertheless, there still are substantial facilities that are used and useful in rendering service to the County for which the City has not been compensated because they were financed and built prior to 1972 and the County is paying only on a volumetric basis.

21. The 1953 Report recommended significant improvements, at that time projected to cost more than $25,000,000, due to increased consumption by residences and businesses located in the County. The report found that "in the last decade, water consumption has increased more rapidly in the Towson area than in any other part of the Baltimore County Metropolitan District. This area is still growing apace and its potential for growth is great: (1953 Report, p. 57).

In addition, the report found that inadequate suction pressure at the Catonsville Pumping Station could be corrected "only by increased facilities in a zone of lower elevation" (id.). The report also found inadequate pressure in various parts of Baltimore County and, to correct these deficiencies, recommended upgrades to the existing water system, as well as installation of additional mains (id., pp. 55-58). Much of this construction was financed by the City's residents through the general obligation bonds, even though much of the construction was for the primary benefit of County residents. The County's level of payment is derived from a volumetric allocation which is based on its water consumption. Under the debt service method, once the general obligation bond has been paid off, the bond is removed from the allocation and the County ceases to reimburse the City for use of the City's funds. Nevertheless, the County continues to benefit from these facilities which were constructed to benefit County residents.

22. The City's water Utility is a separate utility within the City's Bureau of Water and Waste Water, one of four bureaus in the City's Department of Public Works. Effective July 1, 1979, an amendment of the Baltimore City Charter established the Utility as a separate enterprise to be self-sustaining and operated without profit or loss to other funds or programs of the City.

23. This Water Utility supplies water to the City, as well as portions of Baltimore, Anne Arundel, Carroll and Howard Counties. It serves over 1,500,000 people by supplying approximately 97 billion gallons of water annually. Approximately 56% of its customers and usage are currently located within the City so the remaining 44% are in the surrounding County service areas. (Note: as of June, 1990).

24. Estimates of service area population and water usage for the years 1980, 2000, and 2025 are as shown at Page B-15 of the County's Exhibit No. 2 (Prospectus for the 1990-A Bond Offering) as follows:

| | | City of Baltimore | Percent of Total | Counties[2] | Percent of Total | Total |
|---|---|---|---|---|---|---|
| 1980: | Population | 786,800 | 52.1 | 722,900 | 47.9 | 1,509,700 |
| | Water Use | 150 mgd[1] | 60.0 | 100 mgd | 40/0 | 250 mgd |
| 2000: | Population | 757,400 | 46.1 | 884,800 | 53.9 | 1,642,200 |
| | Water Use | 156 mgd | 49.7 | 158 mgd | 50.3 | 314 mgd |
| 2025: | Population | 738,000 | 39.6 | 1,128,000 | 60.4 | 1,866,000 |
| | Water Use | 160 mgd | 44.5 | 200 mgd | 55.5 | 360 mgd |

25. As shown by the City's Exhibit 6-Schedules JS-4 and JS-5, since the year 1950, the growth of population and the companion growth in consumption of water has been mostly in the suburban areas of Baltimore City, particularly Baltimore County. By the year 2000, the City's population is estimated to be 757,000 while the estimated service population of Baltimore County is 723,940.

[2]Baltimore, Anne Arundel, and Howard Counties.
[1] million gallons per day

26. This growth trend in population of the Baltimore Area is reflected clearly in the water consumption by the respective governmental entities. Schedule JS-5 shows consumption, i.e., annual water demand for the period 1950-1988.

27. As shown by this Schedule and as testified by the City's witness, Jerry Silhan, Baltimore City's demand has declined from 161.7 million gallons per day ("MGD") in 1950 to 138.9 MGD in 1988. Baltimore County's demand has increased from 17.7 MGD in 1950 to 101.3 MGD in 1988. Expressed on a volumetric percentage basis, the demand also is showing a reversal over the same period of time. In 1950, Baltimore City used 89.9% of total system demand, compared to Baltimore County's 9.8%. In 1988, Baltimore City used 52.5% compared to Baltimore County's 38.30%. In 1950, Baltimore County's volumetric percentage was just under 10%. 38 years later, its percentage has climbed to 38%. Thus, in less than 40 years, the County's volumetric percentage has nearly quadrupled. Baltimore County's use of the central system facilities is approaching equality with the City's use.

28. Customers in the Metropolitan District of Baltimore County are served through individual meters, but are billed by the City at rates set by the County rather than on the basis of the Rates and Charges established by the City.

29. While the City had executed the 1972 Agreement with the County, the then chief of its Water Engineering Division did not like its terms. It was noted that, over the previous ten years, the water consumption in the City had decreased in relation to the use of water in Baltimore, Anne Arundel and Howard Counties. To review the arrangements between the City and the County, the firm of Black & Veatch was engaged.

30. Black & Veatch submitted its report in February, 1978, which was under the direction of Howard J. Lobb, one of the City's witnesses in this proceeding.

31. The report recommended adoption of the utility basis approach to provide a return on the annual cost of capital devoted to water service, saying:

> "The value of the facilities in service is a measure of the capital which the owner has immobilized in commitment to providing service. If the owner could liquidate this capital through the sale of the facilities, he would have the equivalent capital to invest to offset other capital requirements at current costs of money. The current costs of capital, together with appropriate recognition of costs related to ownership risk, normally represents the return element of cost of service for a municipally-owned utility."

32. The report had found that the City's Water Department needed a 2-3% annual revenue increase to meet anticipated future expenses and that the required adjustment be made to water sales receipts from the political subdivisions (including Baltimore County). Otherwise, the revenue deficiency would have to be met by increased revenue from charges to City of Baltimore customers.

33. The year after the Black & Veatch report was published, the City's then Mayor wrote the respective County Executive of Anne Arundel, Baltimore and Howard Counties under date of August 10, 1979, saying:

> "owing to a continual decline in the City's population and water consumption, we believe the [methods which have evolved during the last 20 years for apportioning costs of new facilities] are now inequitable." Noting that the City had for more than 100 years financed construction of the water system through the sale of its general obligation bonds and that these past investments have purchased "a capacity in the system far beyond the expected City needs, the City cannot justify any further expenditures to build additional capacity that will be used to meet growing water demands in the

Counties, nor can the City permit the Counties to utilize existing system capacity without compensation."

34. In 1981, the then County Executive of Baltimore County responded by a letter opposing the utility method of accounting for costs of the water system, interpreting as "profit" any rate of return earned in excess of actual interest paid out by the City for county-used facilities, while objecting to the depreciation schedules.

35. The City's then Mayor responded by letter dated September 9, 1982, concluding that the Black & Veatch approach provided an equitable answer to prior City investments and the Mayor requested initiation of arbitration proceedings.

36. One month later, by letter dated October 8, 1982, the County Executive agreed that arbitration appeared to be the only way remaining to resolve the differences over determination of costs, stating that "any change in the 1972 Water Agreement should cover events from this time forward."

37. The City's proposed amendments to the 1972 Agreement (requested by the County's letter of October 8, 1982) were forwarded to County by letter dated November 16, 1982, requesting immediate negotiations or proceed to arbitration. It concluded that: "It is most important to the financial integrity of the water system that this matter be resolved at the earliest possible date."

38. Notwithstanding, over four and a half years passed, during which there were discussions between the parties and further requests by the City's Mayor for arbitration, many of which received no response from the County. Then, under date of July 14, 1987, contrary to its earlier agreement to proceed to arbitration, the County advised the City by letter that it would not do so (i.e. arbitrate).

39. On July 31, 1987, the City filed its Complaint in the Circuit Court for Baltimore County against the County to compel arbitration. After a hearing before Judge John Fader of that Court, he ordered the County to proceed to arbitration by judgment entered December 2, 1987. The Judge also ordered the County to select its arbitrator on or before January 20, 1988 (the City having previously done so with the County so advised).

40. Unconvinced, the County appealed, but the Court of Appeals of Maryland, by per curiam order on September 15, 1988, affirmed the judgment below. The City then had to get Judge Fader to order the County to designate its arbitrator by November 14, 1988, which was done.

41. Thereafter, counsel for the parties negotiated between themselves selection of a chief arbitrator, which was accomplished in March, 1990, after which these proceedings went forward on a schedule of mutual agreement.

42. Hearings were held in December 1990, after which briefs were filed and then oral argument heard May 8, 1991, with this matter then submitted for decision by the Board of Arbitration.

43. During almost nine years since the City first demanded arbitration in 1982, it has honored the 1972 Agreement and continued to provide water service to its County customers, even paying back monies to the County shown to be due by the year-end "true-up".

V. **Conclusions of Law**

1. This arbitration is subject to common law rules of arbitration and is a quasi-judicial proceeding.

2. The arbitrators are not bound by the Maryland Rules of Procedure or of admission of evidence.

3. The arbitrators may make a retroactive award in this proceeding.

4. Chapter 539 of the Acts of 1924 created the Metropolitan District of Baltimore County and authorized Baltimore City to construct water supply lines and a sewage system within the District. Under Section 6 of the Act, as soon as the water extensions had been constructed in the District, operating control became vested in the authorities of Baltimore City.

5. In 1945, the 1924 Act was repealed and reenacted by Chapter 1017 of the Acts of 1945 with amendments to certain sections, one being Section 332 (c) reading as follows: "The Mayor and City Council of Baltimore shall furnish water to the Metropolitan District of Baltimore County at cost and entirely without profit or loss. The

Commissioners and the Mayor and City Council of Baltimore shall, from time to time, determine by agreement, if possible, the cost to Baltimore City of furnishing water to consumers in the Metropolitan District of Baltimore County. If no agreement is reached, then cost shall be determined by arbitration in the manner herein provided in Section 329. Cost, however determined, shall be subject to revision from time to time by agreement of the respective authorities, or by arbitration on the demand of either of them."

6. Under the statute, the parties (Baltimore City and Baltimore County) may agree on any methodology or accounting principles to be used in determining "cost".

7. If the parties are unable to agree as to the determination of "cost", that is to be determined by arbitration and so is to be determined in this proceeding.

8. "Cost", as set forth in the statute, does not include "profit", which means net income after expenses, so the City cannot receive a return on its equity investment because of the statutory prohibition of "profit".

9. "Cost" may include depreciation and that is a proper expense of "cost" under the utility basis for determining costs. The statute's use of "cost" allows depreciation to be taken in that determination.

10. The statute (Metropolitan District Act) makes the determination of "cost" subject to revision from time to time.

11. Baltimore City and Baltimore County are not partners in the provision of water service to the Metropolitan District by Baltimore City. The District's water users are customers of the City's water system utility and the County is their agent in the provision of water service to them by the City.

12. The utility basis methodology is a reasonable method of determining the cost of providing water service to the Metropolitan District of Baltimore County but must exclude return on equity capital as "profit"

13. The functional cost allocation proposed by Baltimore City and accepted by Baltimore County for the Metropolitan District of Baltimore County is reasonable and properly allocates to the Metropolitan District of Baltimore County its proper share of operation and maintenance expenses.

14. The Metropolitan District of Baltimore County is not, and has not been, paying to Baltimore City the full cost of providing water service to Baltimore County as required by the Metropolitan District Act, when the utility basis method is applied (excluding return on equity).

15. It is within the Board's authority pursuant to Issue No. II, as submitted by the parties, to award retroactive implementation of the utility basis methodology (excluding return on equity) and functional cost allocation.

16. Cost, as set forth in the Metropolitan District Act, henceforth shall be defined by the utility basis methodology (excluding return on equity) and functional cost allocation. Baltimore City and the Metropolitan District of Baltimore County immediately shall revise the 1972 Agreement to so provide.

17. The definition of cost, as set forth in Paragraph 16, shall be deemed to have been implemented in fiscal year beginning July 1, 1983.

18. The Metropolitan District of Baltimore County shall pay to Baltimore City the cumulative sum of the amounts due to Baltimore City beginning with the fiscal year 1983 with interest to accrue at the statutory rate of 6% per annum

beginning sixty (60) days from the date of decision until the date of payment.

19. The arbitrators have authority to provide for interest on the monetary award herein.

## VI. Decision of Arbitrators

### A. The Board of Arbitration has the power and authority to change the method of determining costs

The parties (the City and the County) have stipulated that the threshold issue for arbitration is: "What is the proper method, under the Metropolitan District Act, for determining the cost to Baltimore City of furnishing water to consumers in the Metropolitan District of Baltimore County."

Yet the County has taken the position that the Arbitrators may not order any change to the Agreement dated September 20, 1972 between the parties (which embodies the historic debt-service methodology for determining costs) unless certain findings were to be made from the record. (See pages 53 and 54 of the County's Brief).

That position is contrary to the stipulation. It is contrary to the Metropolitan District Act's provision-repeated in the 1972 Agreement-that the Arbitrators may amend the agreement if proceedings are initiated, as they have been-where either party demands arbitration, as the City did in 1982. Further, such position appears contrary to the decision and opinion of Judge Fader in the 1987 action brought by the City to compel arbitration.

Even if the County's position were sound, the Board has concluded that the City is clearly not recovering its actual costs of service through the current debt-service methodology and that changes in usage alone have mandated adoption of the utility basis for determining costs. The County's third condition that the Board determine if the Public Service Commission would adopt that basis is irrelevant and facetious.

B. This is a cost-of-service proceeding

This is not a rate case, i.e. a determination of the rates which customers in the Metropolitan District should have paid or should pay now or in the future. The parties determine the rates paid or to be paid by these customers, subject to approval by the Public Service Commission of Maryland under Section 34-25 of the Metropolitan District Act.

Rather, this proceeding is to determine the "cost-of-service" for these customers, who constitute a class of customers of the City, based on political boundaries and the 1945 Statute, as amended, and as supplemented by the 1972 Agreement.

Black & Veatch were employed for this hearing by the City, not to develop rates, but to develop the cost of providing service to Baltimore County and that is what they did (T.40).

As part of their analysis to determine that cost, they had to determine the costs to every class of customer on the system which they did by a prorata allocation of the total cost to all the different jurisdictions (T.93-4).

C. The Utility Basis is the better method for developing costs for service to another political jurisdiction

Historically and under the 1972 Agreement to date, the parties (City and County) have used the cash or debt service methodology to determine the City's cost of service to customers in the Metropolitan District of Baltimore County.

In the early history of water rates, the utility operated out of the municipality's General Fund (T.53). For some years now, the City's Water Division has been an Enterprise Fund. Over the years, there has been a trend to base charges for water service on costs and the better manner to develop those costs is the utility basis, particularly where service is provided to other jurisdictions (T. 53-4).

Today, the majority of water utilities are under an enterprise fund basis and they are designing rates to cover their cost of capital on the utility basis (T.158-9).

The American Water Works Association (AWWA) is an organization of people involved in the water industry. It is recognized as the first and foremost water organization in the United States (T.142). It now has a number of manuals associated with developing rates and financing of water utilities (T.144) and they are recognized as the "bible of water rate making throughout the country" (T. 144).

AWWA endorses the utility basis of cost allocation to determine cost-of-service to customers in a particular political jurisdiction receiving water service from another. The AWWA Revenue Requirements Manual M35 states the following on page 4:

"Utility Approach

> The utility approach to measuring revenue requirements is mandated for all investor owned water utilities and mandated or permitted for government-owned utilities in states where the utility is under the jurisdiction of state commissions or other regulatory bodies.
>
> The term "utility approach" or "utility basis" tends to have two uses in water utility rate making. One use involves the measuring of the revenue requirements of a utility, without concern for the allocation of those requirements among classes of customers served. Utility based revenue requirements may consist of operation and maintenance expenses, depreciation expense, return on rate base, and taxes and or other payments to the municipality's general fund. The second use of the term "utility basis" in rate making is in allocating revenue requirements, or total costs of service to be derived from water rates, among the classes of customers served."

See also the AWWA Water Rates Manual M1 (Second Edition, 1972) at pages 6 and 7:

> "Revenue Requirements of Suburban Areas
>
> Where water service to suburban areas is supplied by municipally owned utilities, it is suggested that the basis for rates in those areas should be determined on the utility basis. The assumption may be made that the water utility is the property of the citizens within the municipality and that outside users should pay a rate providing for operation and maintenance expense, plus local taxes, depreciation, and a reasonable return on the value of all property devoted to the service of the user outside the city. Such property would include an appropriate share of all production, transmission, and other facilities required to produce and transmit the water to that user, but would exclude those distribution mains and customer and fire facilities provided solely for serving the area within the City."

The AWWA Revenue Requirements Manual M 35 (First Edition, 1990) further states at page 5:

"As described in Manual M1, the utility basis of cost allocation is an appropriate method for calculating the costs of service applicable to all classes of customers. It is particularly applicable to those customers located outside the geographical limits of a government-owned utility. **When a government-owned utility provides service to customers outside its geographical limits, the situation is similar to the relationship of an investor-owned utility to its customers because the owner (political subdivision) provides services to non-owner customers (customers outside its geographical limits). In this situation, the government-owned utility, like an investor-owned utility, is entitled to a reasonable return from non-owner customers based on the value of its plant required to serve those customers.** Some states have laws or guidelines intended to regulate the rates that government-owned utilities charge customers located outside their limits." (emphasis furnished)

D. Recommendations of the parties

The city's witness, Howard J. Lobb, testified in favor of the use of the utility basis and presented exhibits applying this method to the financial statements of the City's Water Division for the past ten years. In his rebuttal testimony, he stated why the City believes that capital costs for outside City non-owner customers should be recovered through depreciation expense and rate of return applied to allocated rate base:

"The City has over the years made investment in the water system to serve both inside and outside City customers. The City is entitled to reimbursement from outside City customers based on the portion of facilities used by outside City customers. Charging the County

capital costs on a utility basis for annual depreciation expense and return provides the City the opportunity to recover its capital costs based on units of service which should reflect the estimated ultimate use of facilities by outside City customers.

It is the City's prerogative as to the method of water utility financing it chooses. The City may elect to revenue finance or debt finance improvements over a short or long period of time or pay for improvements out of general tax revenue, and the method of financing may change or be restructured. The method chosen will determine the level of water rates charged to inside City customers. Because outside City customers have no voice in controlling City financing decisions, they should be insulated from the method of financing chosen by the City. The utility basis of charging for annual depreciation expense and return minimizes the impact on outside City charges of the method of financing of water facilities chosen by the City. This is because outside City customers are charged annual depreciation expense and return only on their allocated rate base.

"Outside City customers should pay through charges for annual depreciation expense for the value of facilities financed by the City which is used up during the year or which is lost due to decay, inadequacy, or obsolescence. They should pay a return on the City's investment devoted to serving the outside City customer the same as a non-owner customer should pay a return to an investor-owned utility which utilizes and commits its funds to provide service to those non-owner customers."

"The utility basis of cost allocation is a generally accepted methodology for assignment of cost among customers of a municipally owned utility and has been endorsed by the American Water Works Association."

The County's witness, Paul R. Moul, opined that a shift to a rate base/rate of return method ( i.e. the utility basis) is not an appropriate charge for establishing revenue requirements for the Metropolitan District. He testified:

"No. Rather, debt service is both the historically accepted and appropriate methodology to use to determine revenue requirements for Metropolitan District water customers. The debt service method is particularly well suited for municipally-owned utilities. The

debt service approach fulfills the capital attraction standard used by the financial community to determine revenue adequacy. Standard & Poor's Corporation, a major bond rating agency, has indicated that debt service coverage is the key to financial analysis for municipally-owned utility systems issuing revenue bonds--a procedure followed by the City of Baltimore."

To this, Mr. Lobb replied that debt service by itself is not necessarily adequate to determine total capital cost cash needs, saying:

"The current method of assigning volume related capital costs to Baltimore County based on current year's usage is inadequate. This is because the County's percentage usage of the capacity of joint use facilities has increased over time, and since historically the County has only been charged capital costs in proportion to its usage in a particular year, the County has cumulatively over history underpaid the City. There is no way in the current Water Agreement for the City to fully recover from the County the County's total share of the cost of joint use facilities."

E. <u>The Conclusions and decision of the Board</u>

The Board concludes that the utility basis method is the proper measure of the revenue requirements of the City's Water Division. It has become the preferred method for municipal utility operations which provide service to customers outside of the City limits. Its handling of capital related expenses substitutes long term depreciation for annual estimates of cash flow that can vary widely from year to year. This handling of capital related expenditures also allows the recovery of initial capital investment from future customers, an important consideration where the Metropolitan District's usage has grown so much and will continue.

F. Effect of the Metropolitan District Act

The Metropolitan District of Baltimore County was created by the Maryland General Assembly in 1924 requiring the City to extend water supply lines for and in the District whenever and wherever requested by the County, doing so "at cost, and including a proper charge for overhead" with water services rates for District customers to be first approved by the Maryland Public Service Commission.

In 1945, another statute was enacted by the General Assembly. Section 332(c) of the 1945 Act provides:

"The Mayor and City Council of Baltimore shall furnish water to the Metropolitan District of Baltimore County at cost and entirely without profit or loss. The Commissioners and the Mayor and City Council of Baltimore shall, from time to time, determine by agreement, if possible, the cost to Baltimore City of furnishing water to consumers in the Metropolitan District of

Baltimore County. If no agreement is reached, then cost shall be determined by arbitration in the manner herein provided in Section 329. Cost, however, determined, shall be subject to revision from time to time by agreement of the respective authorities, or by arbitration on the demand of either of them."

Under the utility method for determining the revenue requirement, also known as the rate base/rate of return method, a utility is entitled to a return on its equity capital.

The threshold and critical question in this proceeding is whether or not a return on the City's equity in its Water Utility is a "cost" or a "profit" within the meaning of the 1945 Act.

To answer this question, one must go back to the year 1945 and decide what the General Assembly intended by these words in the circumstances preceding and attendant to the enactment of Section 332(d). The evidence of record is found in the Journal of Proceedings of the House of Delegates of Maryland and certain newspaper articles in the Baltimore Sunpapers. The latter show that Baltimore County officials and legislators were seeking lower water rates where the City was said to be making more than $600,000 a year. They also show that the then City Solicitor, Simon Sobeloff, believed it true and so stated that "rates are excessive and yield the City a profit". On the other hand, the Journal extracts show that the legislation included, at one point before enactment, a provision "to exclude from the determination of Baltimore County water service costs any return to Baltimore City on its capital investment in water facilities", which provision was deleted before final enactment.

The City argues that this deletion evidences legislative intent that there be no prohibition of a return on the City's equity investment. Its Reply Brief cites various Maryland appellate decisions for the proposition that "while a committee's rejection of an amendment is clearly not an infallible indication of legislative intent, it may help for understanding of overall legislative history" citing NCR Corp. v. Comptroller 313 Md. 118, 544 A. 2d 7764 (1988) as the current state of the Maryland law. At best, the deletion is some evidence of legislative intent.

Taking into account, the history of the situation, that is, the parties themselves, Baltimore City and Baltimore County, the commencement and continuation of the supply of water by the City to the County with the City's operating from its General Funds and with no accounting after 1936, the admission of excessive rates and profit, the use of methodology set forth in the Whitman-Wolman Report of 1931, and other circumstances, a majority of the Board concludes that the word "profit" meant and means "the excess of income or revenue over expenditures" Webster's International Dictionary - Second Edition cited in U.S. Mintzes 304 F. Supp. 1305 (D. Md. 1960). See also Kaufman v. Liss 186 Md. 634 (1946) to the effect that "profits" arise after provision of expenses.

"In construing the meaning of a word in a statute, the cardinal rule is to ascertain and carry out the intent of the General Assembly. It is well settled that when the Legislature has chosen not to define a term used in a statute, that term should be given its ordinary and natural meaning". Dean v. Pinder

312 Md. 154 at 161, 538 A.2d 1184. In the present statute, there is no definition of the word "profit".

While a return on invested equity may be a cost for rate-making purposes of a utility operation, it is not an actual expenditure. In 1945 the members of the General Assembly were not dealing with a utility, but with a large municipality that they intended to be paid its actual costs, but no "profit" or income over expenses in supplying water to this particular neighboring county. Indeed, the City's own witness, Henry G. Mulle, speaking of profit in the sense of a utility, says (T. 334): "My definition of profit, which is a return on equity".

A majority of the Board agrees with the County's witness, Paul R. Moul, that the cost of equity is not a cost on the financial statement. Rather, "profit" is the amount shown at the bottom of that statement reflecting a return on equity (T.761-763).

In giving the term "profit" its ordinary meaning, it is clear to a majority of this Board that allowing the City to earn a return on the equity interest in property used to serve the County would permit the City to profit on its sale of water to the County. In public utility terms, it is the rate of return on common equity which is the traditional source of profit to the utility which is used to pay dividends, that is, to compensate the owners of the utility, its shareholders. While the dissent argues that a return on equity is a cost, just like any other cost to a utility, the analogy to the City's water operation fails. The City is not a public utility, nor is its water operation. While

it is the majority's view is that the proper method of accounting in order to permit the City to recover its costs is that of public utility accounting, we must construe and apply the statutory mandate that the service be provided "entirely without profit or loss." The City water system is not a public utility. It does not have individual investor owners. It is statutorily prohibited from earning a "profit" from its sale of water to the County. So if we accept the City's contention that it should be treated as a public utility for its accounting purposes, as we have, we must similarly deny the City the opportunity to reap a profit from its selling of water to the County by denying it any return on equity, the source of public utility profits, in order to carry out the mandate of the statute.

G. Application of the Board's decision

The Board's decision is that the utility basis method is the proper method of determining the costs of the City's Water Division, and, according to the majority decision, there can be no return on its equity capital as far as customers in Baltimore County's Metropolitan District are concerned, because of the prohibition of any "profit" in the present Metropolitan District Act.

This means that the City is free to include a return on that equity in determining charges for water to other customers, including its own citizens and the other surrounding counties that are supplied water by the City.

It also suggests that the City seek relief from the Maryland Legislature if it wishes a return on its equity in its revenue requirement for its Baltimore County customers.

It must be noted that use of the utility basis permits the inclusion of depreciation expense with the concomitant removal of Baltimore County's obligation to participate in the direct payment of principal and interest on bonded indebtedness of the City heretofore jointly shared on a volumetric proportionate basis by the County and the City. Inclusion of depreciation expense will substantially benefit the City, as hereinafter set forth. (Note: this does not relieve the County of its obligation to pay its proportionate share of the embedded cost of the City's debt used to fund construction of jointly used plant and equipment).

Determination of depreciation expense requires determination of the values at the appropriate valuation dates of the City's property used and useful in furnishing water to consumers in the Metropolitan District. The Board has prepared an Appendix to this decision setting forth an effort to determine these values based on the evidence of record.

However, the rate base calculations which were provided during the proceeding used average figures, rather than actual, for certain years. Thus, the Board is not in a position to rely upon those figures to calculate the dollar amount which will flow from the decision of the Board majority. Rather, the Board expects that the City and the County will be able to promptly reach agreement on those calculations, as well as the impact of adoption of the functional cost allocation method for assigning costs, for the years for which the Board is awarding relief to the City. The Board offers to be of whatever assistance

it can to the parties in resolving any ongoing disputes regarding costs upon which agreement cannot be reached.

The same functional cost method of allocating to the County its share of operation and maintenance expense must also be used for determining the amount of rate base allocable to the County to determine the amount of annual depreciation and return of interest costs of the County.

H. The Arbitrators have the authority to order that the utility basis for determining costs be made retroactive.

The County has argued that the Arbitrators may not order any payment for service rendered prior to the final date of their decision because retroactive rate-making is forbidden under Maryland law. (See pages 61-65, inclusive, of the County's Brief).

The fallacy of this argument is that this is not a rate-making procedure. Rates for customers of the City's water system in the Metropolitan District are set by the County. This is a proceeding to determine the costs of the City's supplying water to those customers. What rates are to be charged to individual customers for that is a matter for the parties to decide, not the Board.

Since this is not a rate-making procedure, the Maryland cases cited by the County at page 63 of its Brief have no application here. They stand for the proposition that rate-making is a legislative function establishing a rule for the future. Rather than a rate case, this is, in essence, a contractual dispute, wherein the City contends that the agreement which was reached by

the parties many years ago does not accurately fix the actual cost to the City of providing water service to the County. This is an arbitration proceeding which the Maryland courts have held to be a quasi-judicial function. See 2 M.L.E. Arbitration and Award, Sec. 5 at p. 477; Litman v. Holtzman 219 Md. 353, 149 A 2d 385 (1959). In that case, the Court of Appeals stated (219 Md. at 359):

> "Where the agreement is to arbitrate differences or disputes, those who are to decide act quasi-judicially and may receive the evidence or views of a party to the dispute only in the presence of, or upon notice to, the other side, and may adjudge the matters to be decided essentially only on what is presented to them in the course of an adversary proceeding."

See also Chillum v. Button & Goode 242 Md. 509, 219 A. 2d 801 (1966) declaring that "An arbitration award is the decision of an extra judicial Tribunal which the parties themselves have created, and by whose judgment they have mutually agreed to abide."

In the court proceedings that preceded this arbitration, Judge Fader found this to be common law arbitration so that the arbitrators make findings of fact and give reasons for their opinion, citing Board of Education of P.G. County v. Prince George's County Educators Association 309 Md. 85, 522 A.2d 931 (1987). The latter decision quotes an old decision of the United States Supreme Court declaring : "Arbitrators are judges chosen by the parties to decide the matters submitted to them." (Note:

The Court of Appeals of Maryland affirmed Judge Fader by a per curiam opinion for the reasons set forth in his order dated December 2, 1987. See paragraphs 4 and 5 of his order as to this.)

Hence, we can and shall make the award herein retroactive.

Contrary to the County's allegation of a "windfall" to the City if there be a retroactive award herein, it is the County and its rate payers in the Metropolitan District who have had the "windfall" of underpaying the "actual costs" of the City in supplying their water for many years. Further, as testified by the City's witness, Jerry Silhan, the monies to be awarded as the result of this proceeding have been and are needed to rehabilitate and upgrade the existing water system. Such monies are required by the Enterprise Fund Amendment to the City's Charter to remain in that system. The Metropolitan District water customers will share pro rata in the expenditure of these monies for betterment of the system.

I. The Effective Date for Implementation Of The Utility Basis Methodology For Determining The Cost to Baltimore City Of Furnishing Water To Consumers In The Metropolitan District

The Board has concluded that the effective date for implementing the utility basis, as well as the functional cost basis for allocating O&M expenses, is the fiscal year beginning July 1, 1983. Unless the utility basis method and the functional cost allocation are implemented retroactively to that date, the

result ultimately would be to penalize the City unjustly while rewarding the County for the County's delay in proceeding to arbitration, as required by the Metropolitan District Act. Such an outcome truly would be inequitable to both the City and to all consumers dependent upon the City's water system when the City has had the financial responsibility of maintaining and operating the system during the period of the County's delay and when the funds are needed to rehabilitate the system.

In 1978, a City-County study determined that improvements costing $100 million were needed for the water utility (City Ex. No. 6, p. 27). The City believed that proposed methods of cost allocation were inequitable because of the "continual decline in the City's population and water consumption" and because the proposed methods of cost allocation "would require the City to pay about 12% of total construction costs whereas without any additional County demands for water, the City would not have to expend any significant sums for capital improvements: (City Ex. No. 6, Schedule JS-8, p.2); see also city Ex. No. 6, p. 27). Accordingly, on August 10, 1979, Governor Schaefer, then Mayor of the City, wrote to the Executives of Baltimore County, Anne Arundel County, and Howard County, notifying them of the City's views (id.).

The response of the Baltimore County Executive, dated June 16, 1981, recognized that the Counties' future demands required expansion of the water system and admitted that the City had a right to be compensated for its expenses (City Ex. No. 6, Schedule JS-9). Nevertheless, he rejected the City's proposed

utility accounting method because, in his opinion, it "would tie the County inextricably to the City's financial position" and because the County "interpret[s] as profit any rate-of-return earned in excess of actual interest paid out by the City for County-used facilities" (id.).

Mayor Schaefer's September 9, 1982 letter to the Baltimore County Executive (City Ex. No. 6, Schedule JS-10), indicated that the 1978 Study had been "the subject of numerous meetings and correspondence between the City and Baltimore County" (id.). Although the County had agreed to the allocation of O&M costs on a functional cost basis, no agreement had been reached on the proposed utility accounting method (id.). Accordingly, the Mayor requested initiation of arbitration proceedings (id.). One month later, by letter dated October 8, 1982, the Baltimore County Executive agreed that arbitration "appear[ed] to be the only remaining course to resolve our substantial differences on what will constitute a proper way of setting a cost on water utility operations and improvements benefiting Baltimore County" (City Ex. No. 6, Schedule JS-11). Mr. Hutchinson also stated the County's belief "that the proper scope is the costing of future water utility operations and improvements and that <u>any change in the 1972 Water Agreement should cover events from this time forward</u>" (id.) (emphasis added). This acceptance of arbitration by the County Executive in 1982 presents a strong basis for making the Award retroactive to that time. As Mr. Silhan's testimony showed, without any contradictory testimony by any County witness, from 1982 until the Court signed its Order in November 1988, the County refused to appoint its arbitrator.

The evidence clearly shows that there were six years of delay from the time the County first agreed to an arbitration until the County finally proceeded to appoint its arbitrator. The County delayed the arbitration proceeding through failure to respond to the City's requests, retracting its earlier agreement to arbitrate and forcing the City to take legal action to have the court order the County to proceed to arbitration. During this time, in compliance with the provisions of the 1945 Act, the City met its obligations and continued to provide water service to the Metropolitan District without payment by the County of the full cost thereof.

In examining whether a judicial decision should be applied retroactively or non-retroactively, the Supreme Court considers three factors:

> First, the decision to be applied non-retroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression whose resolution was not clearly foreshadowed. . . .Second, it has been stressed that "we must . . .weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation.". . . .Finally, we have weighed the inequity imposed by retroactive application, for "where a decision of this Court could produce substantial inequitable results if applied retroactively, there is ample basis in our cases for avoiding the 'injustice or hardship' by a holding of non-retroactivity."

Chevron Oil Co. v. Huson, 404 U.S. 97, 106-07 (1971) (citations omitted). The facts in this protracted and lengthy proceeding clearly weigh in favor of applying the utility basis method retroactively.

The County cannot now argue that the concept of a utility basis method, even in this proceeding, is a new principle or that its resolution was not clearly foreshadowed. The disagreement between the parties actually arose in 1945 when the County attempted to lower its water costs through legislative action and the City argued that it was entitled to a return on its investment (Joint Ex. No. 4). Moreover, the County has been on notice since 1979 that the City desired to change the determination of cost to a utility basis method (City Ex. No. 6, Schedule JS-8). The County agreed to arbitrate the dispute in 1982 (id., Schedule JS-11), but the City had to seek mandamus to compel the County to begin the arbitration proceedings (City Ex. No. 6, pp. 34-35). That a judge of the Circuit Court for Baltimore County found the issue of return on investment was an arbitrable issue also should have put the County on notice that a decision might be applied retroactively if there were further delay in proceeding to arbitration. Moreover, as City Exhibit No. 12 clearly shows, by its delay, the County continued to receive millions of dollars of refunds from the City -- dollars which the City could, but to its credit, did not withhold during the pendency of this dispute. Unless the award is made retroactive, there will be no incentive for either party to proceed to arbitration without delay in the future.

The Supreme Court's third test, whether inequity would be imposed by retroactive application, must be answered in the negative. Rather, inequity would be imposed by a failure to apply the decision retroactively. As explained by Mr. Lobb and Mr. Silhan,

the valuation of the City's rate base has declined with each passing year. Although originally the City funded all investment in water facilities, as Mr. Silhan testified, the 1972 Agreement now requires the County to fund an allocated portion of the investment in facilities on which construction was begun after 1972 (City Ex. No. 6, pp. 14-15). Accordingly, these contributions are not included in the City's rate base (City Ex. No. 1, p. 24; Schedule HJL-3 Revised). Moreover, from 1984 through 1990, the net rate base allocated to Baltimore County "has been decreasing at an average annual rate of approximately $1,240,000 to a level where it is now less than it was in 1980. This decline will continue as long as Baltimore County continues to contribute its share of new system facilities as it has been doing since 1972" (City Ex. No. 1, p. 24' see also City Ex. No. 1, Schedule JHL-3 Revised, Column 3). As the City-financed facilities age, "the accumulated depreciation of these facilities increases, thereby reducing net allocated rate base" (City Ex. No. 1, p.24).

Even though the County first agreed to arbitration in 1982, it made no movement toward proceeding with that arbitration and eventually attempted to retract its agreement in 1987; meanwhile, the City's rate base and been decreasing for the preceding three years and has continued to decrease each year since 1984. Accordingly, to order the implementation of the City's proposal, but to make it prospective only, would be to reward the County's fiscal irresponsibility while penalizing the City for living up to its legal obligations and its good faith efforts to resolve the disagreement through arbitration.

The County cannot be heard to argue that a retroactive application of return on investment is prohibited by provisions of the U.S. Constitution. See, e.g., United States v. Johnson, 457 U.S. 537 (1982); Great Northern R.R. Co. v. Sunburst Oil & Refining Co., 287 U.S. 358 (1932); United States ex rel. Angeles v. Fay, 333 F.2d 12 (2d Cir. 1964), aff'd, 381 U.S. 654 (1965);' Sunray Oil Co. v. Commissioner, 147 F.2d 962 (10th Cir.), cert. denied, 325 U.S. 861 (1945). In a long line of cases stemming from 1895, it has been held that retroactive application of judicial decisions does not constitute an impairment of contracts. See, e.g. Fleming v. Fleming, 264 U.S. 29 (1924); Tidal Oil Co. v. Flanagan, 263 U.S. 444 (1924) (the Constitutional prohibition "protecting the obligation of contracts against state action, is directed only against impairment by legislation") Moore-Mansfield Construction Co. v. Electrical Installation Co., 234 U.S. 619 (1914); Central Land Co. v. Laidley, 159 U.S. 103 (1895). Nor is it a violation of constitutional prohibitions against ex post facto laws. See, e.g., Frank v. Mangum, 237 U.S. 309 (1915). Moreover, it is neither a denial of due process, nor a denial of equal protection of the laws. See, e.g., Tidal Oil Co. v. Flanagan, 263 U.S. 444 (1924); Central Land Co. v. Laidley, 159 U.S. 103 (1895); Sunray Oil Co. v, Commissioner, 147 F.2d 962 (10th Cir.), cert. denied, 325 U.S. 861 (1945); Morton v. Dardanelle Special School District, 121 F.2d 423 (8th Cir.), cert. denied, 314 U.S. 655 (1941).

In Sunray Oil Co. v. Commissioner, supra, the Court upheld a deficiency assessment on income derived from oil and gas

leases even though the income was derived at a time when such income was immune from taxation under a decision of the U. S. Supreme Court. 147 F.2d 962, 963. Subsequently, the Supreme Court overruled that decision and held that income from oil and gas leases was taxable. Id. Even though the outcome was detrimental to Sunray, the Tenth Circuit held that Sunray had no vested right in the Supreme Court's earlier decision and rejected Sunray's arguments that the income derived prior to the overruling decision remained exempt from taxation. Id. at 963-64. See also Massaglia v. Commissioner, 286 F.2d 258 (20th Cir. 1961).

Likewise, in People ex rel Rice v. Graves, supra, was held that a retroactive assessment of income taxes could be made even though the income had been exempt from taxation in prior years. Rice, 242 A.D. 128, 273 N.Y.S. 582 (1934), aff'd, 270 N.Y. 498, 200 N.E. 288, cert. denied, 298 U.S. 683 (1936). In 1928, the U.S. Supreme Court held that a state could not impose state income taxes on income derived from copyrights. For the years 1929, 1930, and 1931, Mr. Graves' income tax returns showed income derived from copyrights as non-taxable and he was advised expressly by the state that such income was tax exempt. 242 A.D. at 129. The U.S. Supreme Court overruled its earlier decision in 1932 and held that such income was taxable by the states. The state of New York then attempted to collect an income tax assessment against Mr. Graves' income for the years 1929, 1930, and 1931. Id. at 130. The Court upheld the assessment on the ground that income derived from a copyright was, and always had been, subject to state income tax. Id. at 134. Reasoning that Mr.

Graves had not entered into any contract nor acquired any vested right in reliance on the Supreme Court's earlier decision, there was nothing to prevent a retroactive assessment of income tax. Id. at 132-35. Although the Court recognized that the tax assessment might create a hardship for Mr. Graves, the Court reasoned that the hardship was no greater than that suffered previously by the state. Id. at 136.

In the instant proceeding, the County acquired no vested rights and has no substantial reliance interests that would be defeated by retroactive application of the Board's decision. Any harm to the County has been of the County's own making through its repeated failures to proceed to arbitration. As explained previously, the County sets the rates to be paid by residents of the Metropolitan District (City Ex. No. 6, p. 19) and those rates are billed and collected by the City; if those rates result in higher revenues than what is determined to be the cost of service for that year, the difference is refunded by the City to the County (City Ex. No. 6, p.19). City Exhibit No. 12 shows that for all but two of the last ten years the City has refunded substantial amounts of money to the County:

BALTIMORE CITY-COUNTY SETTLEMENT

| | Revenue | Expenses | Over/(Under) |
|---|---|---|---|
| 1980 | $10,552,229.00 | $ 9,368,634.40 | $1,183,594.60 |
| 1981 | 11,964,517.94 | 10,187,936/68 | 1,776,581.26 |
| 1982 | 11,863,241.33 | 11,022,585.44 | 840,655.89 |
| 1983 | 11,504,497.11 | 11,841,123.12 | ( 336,626.01) |
| 1984 | 12,531,153.34 | 12,288,838.70 | 242,314.64 |
| 1985 | 11,968,852.06 | 13,423,209.77 | (1,454,357.71) |
| 1986 | 16,606,319.41 | 15,078,692.26 | 1,527,627.15 |
| 1987 | 18,629,773.30 | 15,157,212.86 | 3,472,560.44 |
| 1988 | 18,488,378.71 | 15,382,186.93 | 3,106,191.78 |
| 1989 | 18,630,714.51 | 16,747,000.64 | 1,883,713.87 |
| 1990 | 23,002,670.79 | 18,001,670.79 | 5,000,000.00 EST |

(City Ex. No. 12). Any hardship to the County is no greater than the hardship under which the City has been operating.

The impact of the retroactive application of this decision, in reality, will benefit the County and its residents in the long run. As Mr. Silhan testified, the County benefits from mains that are 12-inch or larger diameter, whether those mains are located in the City or in the County (Tr. 456). Many of those mains are constructed of unlined cast iron and there is a natural tendency toward a buildup of corrosion, thereby decreasing the capacity of the mains (Tr. 453). As Mr. Silhan explained:

> The average age of our system is probably in excess of 50 years, and in fact, we have got some cast iron mains which are as much as 125 years old. At the rate of $4 million per year, which is indicated as our spending level in 1991 [see County Ex. No. 2, p. B-2], we will be able to rehabilitate our system in approximately 75 years. Considering that some of the mains are already 125 years old, it looks as though we are a bit behind in trying to keep our system in good order . . . .
>
> * * * * * *
>
> I, as Chief of the Utility Engineering Division, recommended to the Director of Public Works that we increase this program to at least $6 million a year. Six million

> dollars a year would have gotten our cycle time down probably lower than 50 years, which I deem still not to be acceptable, but realistically with the availability of funds we gave it a shot for $6 million. We were turned down. (Tr. 453-55) (emphasis added).

An additional two million dollars a year from the County would enable the City to complete its mains cleaning program twenty-five years sooner than it otherwise will be able to do, thereby benefiting Metropolitan District consumers as well as consumers in the City. Mr. Silhan also testified to other necessary projects for which additional capital is necessary (Tr. 457-62). The Sedimentation Basins Replacement Program for Montebello Plant No. 1 requires a total cost of $10 million (Tr. 459; County Ex. No. 2, p. B-21). The Ashburton treatment plant, the City's newest plant, was built in 1956 and is now almost forty years old (Tr. 460). The City Water Utility submitted a budget request for approximately $15 million to upgrade the plant, but because of the amount of funds available, the project was downgraded to approximately $500,000 a year for the next six years (id.). The projects are necessary to maintain the "basic functions of the plant, structural, chemical feed systems, instrumentation" (Tr. 461). Additional funding would be required if the plants do not meet the new more stringent requirements of the Safe Drinking water Act (id.). As Mr. Silhan explained, the costs of improvements to treatment plants are allocated on a volumetric basis in the year of construction (id.). Based on the current volumetric allocation, Baltimore County would pay approximately 36 to 37 percent of the total cost of the improvements in the year construction was begun, but this allocation does not account for any future change in usage.

Under common-law rules of arbitration, any dispute may be submitted to arbitration whether or not it constitutes a cause of action cognizable by the courts. See, e.g., Deshon v. Scott, 202 Ky. 575, 260 S.W. 355 (1924); Continental Bank Supply Co. v. International Bhd. of Bookbinders, 239 Mo. App. 1247, 201 S.W.2d 531 (1947). Moreover, an arbitration award must be made on all matters which are included within the agreement for arbitration. Washington Homes, Inc. v. Interstate Land Dev. Co., Inc., 281 Md. 712, 382 A.2d 555 (1978). See also Gold Coast Mall Inc. v. Larmar Corp., 298 Md. 96, 468 A.2d 91, 104 (1983) ("Where there is a broad arbitration clause, calling for the arbitration of any and all disputes arising out of the contract, all issues are arbitrable unless expressly and specifically excluded."); Chillum-Adelphi Volunteer Fire Dep't., Inc. v. Button & Goode, Inc., 242 Md. 509, 219 A.2d 801 (1966); Niles-Bement-Pond Co. v. Amalgamated Local 405, 140 Conn. 32, 97 A.2d 898 (1953); Thatcher Implement & Mercantile Co. v. Brubaker, 193 Mo. App. 627, 187 S.W. 117 (1916); Staklinski v. Pyramid Electric Co., 6 N.Y.2d 159, 160 N.E.2d 78, 188 N.Y.S.2d 541 (1959); Ruppert v. Egelhofer, 3 N.Y.2d 576, 148 N.E.2d 129, 170 N.Y.S.2d 785, (1958); Freydberg Bros., Inc. v. Corey, 177 Misc. 560, 31 N.Y.S.2d 10, aff'd mem., 263 A.D. 805, 32 N.Y.S. 2d 129, reh'g denied, 263 A.D. 858, 32 N.Y.S.2d 783 (1941) ("There is no rule of law limiting the relief which an arbitrator may award to money judgments, even in cases where no equitable decree would be proper if the controversy between the parties were

being determined by a court rather than by arbitrators"); Houston Saengerbund v. Dunn, 41 Tex. Civ. App. 376, 92 S.W. 429 (1906). One of the issues submitted by the parties for arbitration was the effective date for implementation of the City's proposed methodology (Joint Ex. No. 1, Exhibit A). Therefore, the Board has been called upon to decide this issue, and it hereby decides that the effective date should be July 1, 1983, (beginning of fiscal year).

While the City has proposed that the award be made retroactive to 1982, it is to be noted that the City's Water Division operates on a fiscal year beginning July 1st of each calendar year. Then, the City's demand for arbitration was by letter dated September 9, 1982 and the County's letter of response agreeing to arbitration was dated October 9, 1982. A fair assumption is that ensuing arbitration proceedings would have pre-empted the time until July 1, 1983 and, also, that a prompt award then would not have been retroactive, but prospective.

As a matter of convenience to both parties, the award should be made effective at the beginning of a fiscal year, not during a fiscal year, and July 1, 1983 is the reasonable date established by the record herein.

J. INTEREST ON THE ARBITRATION AWARD

The last issue stipulated for the Board to decide is: "What is the appropriate rate of interest applicable to amounts due the City from the date of the decision of the Board to the date of payment?"

Hence, it is within the Board's authority to award interest to accrue from the date of its decision until the date of payment of the award (plus accrued interest) to the City by the County.

An arbitration panel may, without specific statutory or contractual authority, award post-decision interest. Maryland Port Administration v. C. J. Langenfelder & Son, Inc., 50 Md. App. 525, 438 A 2d 1374 (1982) with the footnote (50 Md. App. at 546): "with regard to the implied authority of arbitrators to provide for interest on monetary awards, see Harson v. Board of Education 333 A. 2d 580 (N.J. Super. 1975) . . .".

Harson involved an arbitration award which the defendant had not paid. The court concluded that interest was justified from the date of the arbitration award saying: "The general rule is that an arbitration award for a sum of money carried interest from the time it is due and payable", citing 6 C.J.S. Arbitration and Award, Sec. 80 b(3)(j) at 224.

While it is clear that there may be interest on the arbitration award herein, the question remains as to the rate of interest. The City of Baltimore has requested 10%

In Federal Savings and Loan Insurance Corporation v. Quality Inns, Inc. 876 F.2d 353 (CCA4, 1989), the appellate court found that the lower court was bound by Maryland's legal rate of interest, which is six per cent rather than the ten per cent legal rate of interest on judgments. It noted that the Maryland courts have interpreted the statutory rate of ten per cent to apply only to judgments.

Since this is an arbitration award, not a judgment, we believe that the rate of interest on that award must be six per cent (6%) and so provide herewith.

Although the Board might award interest from the date of its decision, such an award seems less than just when the decision does not calculate the actual damages, but leaves the parties to work out the number. The parties should have a time, albeit short, to reach the number before interest starts to run. Therefore, interest will begin sixty (60) days from the date of this decision on whatever amount is ultimately determined.

The total amount due and payable by and from Baltimore County to Baltimore City applying the utility basis of cost determination (without return on equity) and the functional cost allocation method from fiscal year 1982, to date through fiscal 1990 has been approximated by the Board to be some 10.3 million dollars as shown by Appendix A to this decision. As previously stated, the Board has used the evidence of record, which does <u>not</u> include actual numbers for each fiscal year. Moreover, the figures used in Appendix A are taken from the exhibits of the City's Witness, Howard Lobb, and have not been agreed to by the County. The County's witness , Paul Moul, testified that if ordered by the Board to adopt the utility method and the functional cost allocation procedures, the County and the City could reach agreement on the relevant figures. The Board expects that the parties will be able to reach such agreement within sixty (60) days from the date of this decision.

Of the approximate 10.3 million dollars awarded to the City by this decision over 6 million dollars represents additional dollars which would have been paid by the County to the City in operation and maintenance expenses on a functional cost allocation basis. The record clearly shows that the County has been willing to bear this expense from the very outset of this dispute.

## CONCLUSION

The 1945 Act clearly provides that "cost, however determined, shall be subject to revision from time to time . . ." 1945 Act, Section 332 (c). The appropriate interpretation is that cost should be determined in light of today's circumstances. The evidence presented in this proceeding clearly demonstrated that the 1972 Agreement between the City and the County does not comply with the 1945 Act's requirement that the City provide water to the County at cost and without loss. Due to shifts in the population since the 1950's, the justification for the original determination of cost is no longer valid. Accordingly, the appropriate determination of cost in light of today's circumstances is the utility basis methodology and functional cost allocation, but without any return on equity because that would be "profit" prohibited by the 1945 Act. (Note: Arbitrator Charles E. Woods dissents, finding that a return on equity would be a proper "cost" within the meaning of the statute. His written dissent as to that and other issues is appended to this decision).

In 1982, the County agreed that arbitration was necessary to resolve the dispute and agreed that any change to the existing

determination of cost should be from 1982 forward. Therefore, and for the reasons previously set forth, it is appropriate, and within the Board's authority in ruling on one of the issues which the parties submitted to the Board, to order that implementation of the City's proposal be made retroactive.

Since the City's Water Utility operates on a fiscal year beginning July 1st, it is not feasible to make the award retroactive to July 1, 1982 where the parties did not agree to arbitrate until later that year. However, when the County agreed that any change determined by arbitration would be from that time forward, the Board's decision is that the award be made retroactive to the fiscal year beginning July 1, 1983 and continuing through the fiscal year ending June 30, 1990, with the total award for that period to be determined by the parties in accordance with this decision.

In addition, the Board awards interest at the rate of six per cent (6%) per annum beginning sixty (60) days from the date of this decision until the date of payment.

Harrison M. Robertson, Jr.

Harrison M. Robertson, Jr.

Charles E. Woods

Charles E. Woods

Richard B. McGlynn

Date: August 22 1991

## Appendix A

The schedules on the pages of this Appendix show the approximate total amounts of additional cost due to the City from the County for the fiscal years ended June 30, 1984 through 1990. The amount to which the full Board agrees is $10,273,869. and reflects the use of the Utility Basis and the functional cost allocation/base-extra capacity methods for cost allocation. It represents added cost because of use of depreciation rather than repayment of principal, added operation and maintenance expenses, and interest.

For the minority, there is an added line showing the amount of return on the City's equity investment at a rate of return equal to the inflation rate as measured by the consumers price index (CPI) for urban areas.

With this return on equity in the amount of $5,468,200, the total increases to $15,742,069. As is emphasized throughout this analysis, these amounts are only approximations in that all data necessary to make accurate cost calculations are not in the record.

The County, subject to its right to participate in the final determination of cost, has agreed that the use of the functional cost allocation/base-extra capacity methods should be used for determining amounts of O&M expenses applicable to County consumer uses. These methods are equally applicable to determining rate base, and related annual capital expenses, e.g., depreciation and interest.

Also, the County as is shown in their Exhibit 6 agree that the City is entitled to a return on its inventory which is applicable to County consumer uses. Thus, this cost is included in the calculation.

## APPENDIX A

Gross Revenues from Customers after adjustments for refunds - Compared to revised Cost using Utility Basis with Functional Cost Allocation Procedures and Base-Extra Capacity Method - and Additional Amounts of Cost due City of Baltimore - with and without return on equity.

| | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|
| Gross Revenues..... | $12,531,153 | $11,968,852 | $16,606,319 | $18,629,773 |
| Less: Adjustments... | ( 242,315) | 1,454,358 | (1,527,627) | ( 3,472,560) |
| Net Revenues..... | $12,288,838 | $13,423,210 | $15,078,692 | $15,157,213 |
| Costs: | | | | |
| O & M Expenses.... | $11,530,600 | $12,958,600 | $14,386,700 | $14,591,400 |
| Depreciation..... | 1,571,200 | 1,595,500 | 1,619,800 | 1,697,600 |
| Interest Expense.. | 580,000 | 624,800 | 530,500 | 332,300 |
| Int. on Inventory. | 49,732 | 23,693 | 40,378 | 33,503 |
| Sub-total..... | $13,731,532 | $15,202,593 | $16,577,378 | $16,654,803 |
| Return on Equity.... | 847,900 | 772,200 | 780,000 | 730,700 |
| Total Costs..... | $14,579,432 | $15,974,793 | $17,357,378 | $17,385,503 |
| Additional Amounts Due City of Baltimore | | | | |
| Without Equity..... | $ 1,442,694 | $ 1,779,383 | $ 1,498,686 | $ 1,497,590 |
| With Equity Return.. | $ 2,290,594 | $ 2,551,583 | $ 2,278,686 | $ 2,228,290 |

Data Sources:

| | |
|---|---|
| Gross Revenues | - Baltimore City Exhibit 12 - It is noted that there are adjustments between years for City and County figures. These must be reconciled in actual calculations. See City Exhibit 13. |
| Adjustments: | - Baltimore City Exhibit 12. |
| Net Revenues | - Gross less adjustments |
| O&M Expenses | - From City Exhibit 2, HJL-7, Column 1 and 2 for both O&M and Depreciation. |
| Interest | - Estimated based upon use of functional cost allocation procedures. |
| Int.Inventory | - From Moul's Schedule 2, County Ex. 6. |
| Sub-total | - Addition of above items. |
| Equity Return | - See Appendix C. |
| Added Amounts due City | - Subtract actual revenues (net) from costs. |

Note: All years are fiscal year ended June 30.

## APPENDIX A

Gross Revenues from Customers after adjustments for refunds - Compared to revised Cost using Utility Basis with Functional Cost Allocation Procedures and Base-Extra Capacity Method - and Additional Amounts of Cost due City of Baltimore - with and without return on equity.

| | 1988 | 1989 | 1990 | Totals |
|---|---|---|---|---|
| Gross Revenues..... | $18,488,379 | $18,630,715 | $23,002,671 | 119,857,862 |
| Less: Adjustments.... | (3,106,192) | (1,883,714) | (5,000,000) | (13,778,050) |
| Net Revenues..... | $15,382,187 | $16,747,001 | $18,002,671 | 106,079,812 |
| Costs: | | | | |
| O & M Expenses.... | $14,796,100 | $15,894,100 | $16,992,200 | 101,149,700 |
| Depreciation..... | 1,775,300 | 1,768,700 | 1,762,000 | 11,790,100 |
| Interest Expense.. | 341,700 | 381,400 | 350,000 | 3,140,700 |
| Int. on Inventory. | 41,624 | 42,751 | 41,500 | 273,181 |
| Sub-total..... | $16,954,724 | $18,086,951 | $19,145,700 | 116,353,681 |
| Return on Equity.... | 713,700 | 899,400 | 724,300 | 5,468,200 |
| Total Costs..... | $17,668,424 | $18,986,351 | $19,870,000 | 121,821,881 |
| Additional Amounts Due City of Baltimore | | | | |
| Without Equity..... | $ 1,572,537 | $ 1,339,950 | $ 1,143,029 | $10,273,869 |
| With Equity Return.. | $ 2,286,237 | $ 2,239,350 | $ 1,867,329 | $15,742,069 |

Data Sources:

| | |
|---|---|
| Gross Revenues | - Baltimore City Exhibit 12 - It is noted that there are adjustments between years for City and County figures. These must be reconciled in actual calculations. See City Exhibit 13. |
| Adjustments: | - Baltimore City Exhibit 12. |
| Net Revenues | - Gross less adjustments |
| O&M Expenses | - From City Exhibit 2, HJL-7, Column 1 and 2 for both O&M and Depreciation. |
| Interest | - Estimated based upon use of functional cost allocation procedures. |
| Int.Inventory | - From Moul's Schedule 2, County Ex. 6. |
| Sub-total | - Addition of above items. |
| Equity Return | - See Appendix C. |
| Added Amounts due City | - Subtract actual revenues (net) from costs. |

Note: All years are fiscal year ended June 30
Total Column represents sum of the amounts in each year from June 30, 1984 through June 30, 1990.

| | | |
|---|---|---|
| MAYOR AND CITY COUNCIL OF BALTIMORE, | * | IN THE |
| | * | CIRCUIT COURT |
| Petitioners | * | FOR BALTIMORE |
| v. | * | COUNTY |
| BALTIMORE COUNTY, MARYLAND, et al., | * | CASE NO.: 87-CSP-2636 |
| Respondents | * | |

* * * * * * * * * * * * *

PETITION FOR STAY OF ARBITRATION
AND REQUEST FOR DAMAGES

The Mayor and City Council of Baltimore ("City" or "Petitioners"), by its attorneys, Neal M. Janey, City Solicitor, Otho M. Thompson, Deputy City Solicitor, William R. Phelan, Jr., Special Solicitor, Valentine A. Kogler, Jr., Assistant City Solicitor, Edward F. Shea, Jr. and Jeral A. Milton, respectfully request that this Court issue an order: (1) staying further arbitration proceedings, (2) entering judgment in the amount of $13,017,308 in favor of Petitioners, (3) directing Baltimore County, Maryland ("County" or "Respondents") to cease further delay in concluding this proceeding, and (4) awarding damages, in the form of attorneys' fees and other costs, to Petitioners. In support thereof, Petitioners respectfully state as follows:

COUNT I

1. As will be discussed further in the accompanying Memorandum, this proceeding first was brought before this Court on July 31, 1987, by Petitioners', Mayor and City Council of Baltimore, Complaint for Injunctive Relief or for Writ of Mandamus.

2. By Order dated December 2, 1987, this Court granted summary judgment in favor of Petitioners and ordered the County to proceed with arbitration.

3. On appeal by the County, the Court of Appeals, by per curiam order filed September 15, 1988, affirmed the order of this Court.

4. After selection of a three-member Board of Arbitration ("Board"), the City and County jointly submitted the issues for arbitration by letter dated March 7, 1990.

5. The parties submitted the prepared written testimony and exhibits of their respective witnesses prior to hearings held in December, 1990. Both parties filed briefs and oral argument was heard by the Board on May 7, 1991.

6. The Board's Decision ("Decision") was issued on August 22, 1991. A copy of the Decision is attached as Exhibit A. The unanimous decision of the Board found, inter alia, that the "utility basis method is the proper method of determining the costs of the City's Water Division" (Decision, p. 49) and that the "effective date for implementing the utility basis, as well as the functional cost basis for allocating [operations and maintenance] expenses, is the fiscal year beginning July 1, 1983" (Exhibit A, p. 53).

7. The Board's Decision further held:

> "The total amount due and payable by and from Baltimore County to Baltimore City applying the utility basis of cost determination (without return on equity) and the functional cost allocation method from fiscal year 1982, to date through fiscal 1990 has been approximated by the Board to

> be some 10.3 million dollars as shown by Appendix A to this Decision. As previously stated, the Board has used the evidence of record, which does not include actual numbers for each fiscal year. . . . The County's witness, Paul Moul, testified that if ordered by the Board to adopt the utility method and the functional cost allocation procedures, the County and the City could reach agreement on the relevant figures. The Board expects that the parties will be able to reach such agreement within sixty (60) days from the date of this decision." (Exhibit A, p. 67) (emphasis in original).

8. On September 20, 1991, the County filed a Motion to Vacate Arbitration Award (Docket Entry No. 25.) A Motion to Confirm Arbitration Award was filed by the City on October 24, 1991 (Docket Entry No. 26).

9. After oral argument on the respective motions, this Court issued its Judgment Affirming Arbitration Award and Denying Motion to Vacate, dated May 16, 1992 (Docket Entry No. 28). This Court held that "the Arbitrators did not apply legally prohibited retroactive rate-making in making their award."

10. The County noted an appeal on June 15, 1992 (Docket Entry No. 24). The sole issue raised by the County in its appeal was:

> "Did the Arbitrators' decision to allow the City certain changes in the method it uses to calculate the cost of providing water service in the Metropolitan District impermissibly constitute retroactive rate-making to the extent that it was directed to be applied back to July 1, 1983 and resulted in a $10 million award against the County for service rendered prior to the date of the decision?" (County's Civil Appeal

Prehearing Information Report, Item No. 8, filed in Court of Special Appeals, dated June 24, 1992).

11. Before the appeal was heard by the Court of Special Appeals, the City's Petition for Writ of Certiorari, filed on July 30, 1992, was granted by the Court of Appeals by Order dated September 21, 1992.

12. Briefs were filed in the Court of Appeals on November 30, 1992, by the County and on December 30, 1992, by the City. Oral argument was heard by the Court of Appeals on January 12, 1993. The sole question presented by the County to the Court of Appeals was:

> "Did the arbitrators' decision to allow the City to put into effect certain changes in the method it uses to calculate the cost of providing water service in the Metropolitan District exceed the arbitrators' authority and violate the clear public policy prohibiting retroactive rate-making to the extent that it was directed to be applicable as of July 1, 1983, fixing an estimated $10 million award against the County for service rendered prior to the date of the decision?" (Brief of Appellant Baltimore County, Maryland, p. 2).

13. On March 25, 1993, the Court of Appeals issued its opinion rejecting the County's argument that the arbitrators' decision violated public policy and affirming the award of approximately $10.3 million to the City. See Baltimore County v. Mayor and City Council, 329 Md. 692 (1993).

14. On January 21 through January 23, 1992, while the County's appeal was pending before this Court, representatives of the City and County met to calculate the actual rate base

figures for the fiscal years 1982 through 1990 as directed by the Board (Exhibit A, pp. 50, 67). The City's consultant, Mr. R. Lewis Potter of Black & Veatch, was present at the meetings held January 21 through January 23, 1992, along with the County's consultants, Mr. Paul Moul and Mr. John R. Palko of AUS Consultants.

15. The aforementioned meetings resulted in agreement by the parties for fiscal years 1984 through 1990, as well as a model for developing future years' costs. In direct reliance on this agreement, the City commissioned Black & Veatch to "recalculate amounts owed by Baltimore County for the fiscal year 1984 through 1990 period reflecting mutually agreed to changes discussed in the joint meetings held on January 21 through January 23, 1992" (letter from R. Lewis Potter to Ambrose T. Hartman, Esq., dated February 6, 1992; a copy attached as Exhibit B). The cost to the City for this work was $39,500 (id.).

16. By letter dated February 24, 1992, pursuant to the statutory procedure, the County requested approval by the City's Board of Estimates for an increase in the County's Metered Water Rate Schedules to be applied to bills issued on and after April 1, 1992 (letter from Gene L. Neff to George G. Balog, dated February 24, 1992; copy attached as Exhibit C). This requested increase was approved by the Board of Estimates.

17. On or about March 25, 1992 Black & Veatch had completed recalculation of the amounts owed by Baltimore County for the fiscal year 1984 through 1990 period reflecting the mutually agreed to changes discussed in the January 21-23, 1992 meetings. The base amount calculated to be due to the City for the relevant period, excluding the interest awarded by the Board, was $12,038,032. The revisions incorporated by Black & Veatch included: (1) removal of properties not used and useful from the asset rate base; (2) revision of percentages used to allocate asset rate base and annual depreciation among jurisdictions; (3) revision of annual depreciation allocation methodology to parallel that used to allocate asset rate base; (4) revision of operation and maintenance expense allocations; (5) calculation of an annual depreciation and interest expense credit to the County to recognize that the County pays for certain vehicle and minor equipment charges in the year the cost is capitalized; and (6) other miscellaneous revisions and refinements (letter from R. Lewis Potter to Vincent L. DeFabio, dated March 25, 1992; copy attached as Exhibit D). The County was notified of the recalculated amount on March 31, 1992 (transmittal memo from Vincent L. DeFabio to Karen Miller dated March 31, 1992; copy attached as Exhibit E).

18. By letter dated February 12, 1993, the County requested approval by the City's Board of Estimates for a decrease in the County's Metered Water Rate Schedules to be applied to bills issued on and after April 1, 1993 (letter from

Gene L. Neff to George G. Balog, dated February 12, 1993; copy attached as Exhibit F). On February 19, 1993, the County issued a press release, copy attached as Exhibit G, in which it was stated that the reason for the decrease was "that the county has generated enough funds to pay off an $11.3 million arbitration award"; the press release further stated that "to pay this award within a reasonable time period, Baltimore County was forced to raise its water rates by 20 percent. As was projected by County Executive Hayden, sufficient funds have been generated in the past year to offset the award" (Exhibit G) (emphasis added). The requested decrease was approved by the Board of Estimates.

19. By letter dated August 2, 1993, approximately one and one-half years after the parties had reached agreement and after the County had raised water rates to pay the arbitration award, the County "identified four major issues . . . requir-[ing] further attention" (letter from Gene L. Neff to George G. Balog, dated August 2, 1993; copy attached as Exhibit H). According to the County's revisions, the County alleges that $10.857 million is owed by the City to the County for fiscal years 1984 through 1992 (Exhibit H, attachment).

20. The City, through its attorneys, responded by letter dated September 9, 1993, asserting that the four issues either were, or should have been, raised during the arbitration proceeding which concluded with the Board's Decision dated

August 22, 1991 and which was affirmed by the Circuit Court for Baltimore County and by the Court of Appeals. A copy of this letter is attached as Exhibit I.

21. By letter dated October 5, 1993, the County unilaterally requested the Board of Arbitration to "reconvene for the purpose of reviewing and resolving differences that have arisen between the City and County over issues that were not directly addressed by the Board in the proceedings that led to its Decision of August 22, 1991" (letter from Roger D. Redden, Esq. to Board, dated October 5, 1993; copy attached as Exhibit J).

22. The four issues alleged by the County to require resolution are:

> (1) Given the Board's conclusion that a utility basis of accounting should replace the debt service basis of accounting provided for in the September 20, 1972 Agreement between them and should govern the annual determination of the cost to the City of providing water service in the Metropolitan District, beginning as of July 1, 1983, should the depreciation rates utilized by the City be those recommended for that purpose by the City's consultants, Black & Veatch, pursuant to that firm's "Report on Water Utility Annual Depreciation Expense Rates and Depreciation Reserve Adequacy for Baltimore, Maryland," dated November 1, 1977 and which the City is already utilizing at least for the limited purpose of determining the remaining lives of the depreciable plant balances among Baltimore County and the other jurisdictions to which the City supplies water, or should the City be allowed to use the arbitrary depreciation rates which it has used heretofor only for internal accounting purposes and without reference to utility accounting for the provision of service beyond the City's corporate limits?

(2) Again given the Board's conclusion that the utility basis of accounting be put into effect, is there any basis in that system of accounting for allowing the City to continue to impose and collect, pursuant to the terms of the September 20, 1972 Agreement, a 6% premium on its actual operations and maintenance expenses and its expenses for billing and for customer relations, considering that whatever unquantified costs that 6% premium was originally intended to cover 20-some years ago should presumably now be quantified and allocated the same as other operating expenses?

(3) May the City assign any interest expense on City water revenue bonds (as distinct from its general obligation bonds) to its calculation of the cost of providing water service in the Metropolitan District given the fact that the County is now paying from its own resources the cash necessary to cover its portion of the capital costs of new common use facilities by "fronting" its share of progress payments on construction activity and given, further, that revenue from Metropolitan District customers may not be pledged to the payment of debt service on the City's water revenue bonds?

(4) Was it appropriate, when Black & Veatch developed a model to implement the Board's Decision, for the County to receive credit for its cash contributions made to cover construction costs for common use facilities only upon completion of the project, even though the City has received and had the use of those funds on a progress payment basis throughout the construction period?

23. Furthermore, the County posits that:

"Because the Board there determined that the utility basis of accounting should be made effective as of July 1, 1983 and because each of these issues must be resolved in the context of proper application of the utility basis of accounting between the parties, the County believes that they are matters that need to be resolved as of July 1, 1983" (Exhibit J).

24. As will be discussed further in the accompanying memorandum, the Board's Decision is res judicata on all matters relating to the proper accounting and application of the utility basis methodology and functional cost allocation as they relate to fiscal years 1983 through 1994.

25. Accordingly, the base amount owing to the City for the relevant period is $12,038,032. With interest on the unpaid balance as awarded by the Board up through November 15, 1993, allowing appropriate credits, the total amount owed by the County is $13,017,308. A copy of the supporting calculation is attached as Exhibit K. Petitioners request judgment be entered in this amount.

COUNT II

26. Petitioners restate and reallege Paragraphs 1 through 25 as though set forth fully herein.

27. The County, having failed to present its case during the earlier arbitration proceeding, waived its right to raise accounting issues relating to fiscal years 1983 through 1994. Having waived its right to present its case during the earlier arbitration proceeding, the County is estopped from now raising issues which relate to the subject of the earlier arbitration proceeding.

28. The Board directed the parties to reach agreement on the relevant figures by November, 1991 (Exhibit A, p. 67). Even before the appeal from the Decision was ruled upon, the parties met and reached agreement in January, 1992. The County

was notified in March, 1992 of the actual amounts calculated according to the agreement reached in January, 1992. By waiting one and one-half years to notify the City of its disagreement with those calculations the County is guilty of laches.

29. Having reached an agreement in January, 1992, the County's attempt to renege on that agreement is in bad faith and the County's request to reconvene the Board for resolution of issues which relate directly to the subject of the earlier arbitration proceeding is frivolous and without merit.

30. Accordingly, Petitioners request this Court to enter an order staying further arbitration proceedings of any matter relating to the cost to the City of providing water service to the Metropolitan District of Baltimore County during fiscal years 1983 through 1994, entering judgment in the amount of $13,017,308, and directing Respondents to cease further delay in concluding this proceeding.

COUNT III

31. Petitioners restate and reallege Paragraphs 1 through 30 as though set forth fully herein.

32. Respondents' actions in refusing to abide by the agreement reached between the parties on January 21 through January 23, 1992 and in bringing a frivolous request to reconvene the Board of Arbitration has caused the City substantial expenditures, including but not limited to, outside consultants' costs in preparing the agreed-upon recalculations and attorneys fees.

33. Accordingly, Petitioners request this Court to award damages in the form of those costs and fees in the amount of $150,000 plus Court costs.

WHEREFORE, Petitioners urge this Court to enter an order:

1. Staying further arbitration of any matter relating to the cost to the City of providing water service to the Metropolitan District of Baltimore County during fiscal years 1983 through 1994;

2. Entering judgment in the amount of $13,017,308 in favor of Petitioners;

3. Directing Baltimore County to cease further delay in concluding the arbitration proceeding which was affirmed by the Court of Appeals on March 25, 1993; and

4. Awarding damages in the amount of $150,000, plus Court costs.

Respectfully submitted,

Otho M. Thompson /JAM

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 12th day of November, 1993, a copy of the foregoing Petition for Stay of Arbitration and Request for Damages was hand-delivered to Roger D. Redden, Esquire, Piper & Marbury, Charles Center South, 36 South Charles Street, Baltimore, Maryland 21201-3019, and to H. Emslie Parks, Esquire and Michael J. Moran, Esquire, Courthouse, Second Floor, Towson, Maryland 21204.

JERAL A. MILTON