COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA PUBLIC UTILITY COMMISSION
P.O. BOX 3265, HARRISBURG, PA 17105-3265

IN REPLY PLEASE
REFER TO OUR FILE

October 7, 2013

Secretary Rosemary Chiavetta
Pennsylvania Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105-3265

Re: Pennsylvania Public Utility Commission v.
The Columbia Water Company
Docket No. R-2013-2360798

Dear Secretary Chiavetta:

Enclosed please find an original copy of the Bureau of Investigation and Enforcement's (I&E) **Reply Brief** in the above-captioned proceeding.

Copies are being served on all active parties of record, as reflected in the attached Certificate of Service. If you have any questions, please contact me at (717) 783-6151.

Sincerely,

Charles Daniel Shields
Senior Prosecutor
Bureau of Investigation and Enforcement
PA Attorney I.D. No. 29363

CDS/sea
Enclosure

cc: Parties of Record
Hon. Dennis J. Buckley

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	Docket No. R-2013-2360798
v.	:	
	:	
The Columbia Water Company	:	

REPLY BRIEF
OF THE
BUREAU OF INVESTIGATION
AND ENFORCEMENT

Charles Daniel Shields
Senior Prosecutor
PA Attorney I.D. No. 29363

Richard A. Kanaskie
Deputy Chief Prosecutor
PA Attorney I.D. No. 80409

Johnnie E. Simms
Chief Prosecutor
PA Attorney I.D. No. 33911

Bureau of Investigation and Enforcement
Pennsylvania Public Utility Commission
P.O. Box 3265
Harrisburg, Pennsylvania 17105-3265
(717) 787-1976

Dated: October 7, 2013

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

Rules and Regulations

I. INTRODUCTION

A. Status of the Proceeding

On September 26, 2013, the Bureau of Investigation and Enforcement ("I&E") filed its Main Brief in this proceeding setting forth the argument, evidence and law in support of its recommendations to the Pennsylvania Public Utility Commission ("Commission") that The Columbia Water Company ("Columbia" or "Company") be disallowed any rate increase whatsoever and instead be directed to file a tariff that provides for $3,983,663 in allowable annual revenues, a reduction of $243,609 from the Company's $4,227,272 pro forma adjusted revenues at present rates.

I&E has received timely service of the Company's Main Brief and the Main Brief submitted by the Office of Consumer Advocate ("OCA"). The Office of Small Business Advocate ("OSBA") submitted a letter indicating that they would not be filing a Main Brief.

This Reply Brief provides focused I&E responses and comments to individual arguments in the Company's Main Brief. The respective I&E testimonies and exhibits entered into the record will be further referenced here, particularly where any of the three I&E witnesses' criticisms and adjustments to the Company's claims are relevant. A review of the OCA Main Brief will disclose that a number of their adjustments are precisely consistent with or consistent in principle with the adjustments and positions set forth in the I&E Main Brief and this I&E Reply Brief.

The tables attached to the I&E Main Brief, Tables I, II, and III, provide the figures and revenue effect for each recommended I&E adjustment and the computations supporting the I&E's overall recommended $243,609 decrease in present base rates. This I&E Reply Brief therefore includes every topic section heading found in the I&E Main Brief but only addresses in detail those issues that require responsive discussion. As such, the Revenues, Taxes, Rate Structure and Cost of Service headings found in the I&E Main Brief are included here (with a brief notation in each) to maintain the structural consistency of this I&E Reply Brief with the I&E Main Brief.

This instant Reply Brief incorporates by reference all argument and analysis contained in the I&E Main Brief, and the fact that such arguments are not fully repeated here do not represent, in any way, a waiver of those arguments.

B. Burden of Proof and Evidentiary Standard

As discussed in detail in the I&E Main Brief, the Company retains the burden of proving the reasonableness of each and every element of its claim throughout the entire proceeding. This standard is well-established and recognized by the Commission and courts. In the present proceeding, it is Columbia's obligation to affirmatively prove the reasonableness of each and every element of its claim with substantial evidence. A review of the evidence and arguments presented by the opposing parties in this proceeding demonstrates that the Company has failed to meet its burden, as both present and proposed annual revenue levels fail to produce just and reasonable rates.

II. SUMMARY OF ARGUMENT

I&E reaffirms each and every argument raised in the I&E Main Brief and respectfully submits that they should be adopted by ALJ Buckley and the Commission as being in the public interest. As noted, the arguments made in this I&E Reply Brief augment the recommendations and conclusions presented in the I&E Main Brief and respond to a number of the assertions and contentions contained in Columbia's Main Brief.

The first full section of this I&E Reply Brief addresses Rate Base and contains five (5) subheadings covering different aspects of the I&E recommendation to reduce the Company's measure of value claim by $3,048,292 to remove any rate base recognition of PennVest financed plant included in that claim.

The I&E recommended reductions to several of the Company's claims for Expenses remain valid. In this Reply Brief, I&E further addresses the various contentions in the Company's Main Brief that relate to the I&E expense adjustments. As noted in the I&E Main Brief and in the Company's Main Brief, a number of expense adjustments advocated by I&E during the case were conceded by the Company and reflected in their subsequent adjustments to those claims.

Regarding the Company's claimed overall rate of return, this I&E Reply Brief responds to the Company's discussions and points out the flaws in the Company's position that fail to support their claim and further support the validity of the I&E recommended overall weighted cost of capital of 7.07%, based upon an appropriate 9.15% cost rate of common equity, a debt cost rate of 5.00% and the I&E recommended 50/50 capital structure.

The I&E recommendations for Rate Structure relate to the appropriate scale-back of rates if the Commission either orders a rate rollback or reduces the requested increase sought by the Company. The parties agree that any revenue change allocation should be "across-the-board" for the customer classes.

In conclusion then and for the reasons presented in both the I&E Main and this Reply Brief, I&E respectfully requests that the ALJ issue a Recommended Decision and the Commission issue an Opinion and Order directing Columbia to file a tariff designed to produce $3,983,663 in allowable annual revenues, a reduction of $243,609 from the present annual revenue level of $4,227,272.

III. ARGUMENT

A. RATE BASE

The I&E Main Brief at pages 18 through 28 references the testimonies and exhibit of I&E Witness Ethan Cline and presents the I&E position on the appropriate valuation of the Company's rate base. I&E MB, pp. 18-28. The I&E Main Brief specifically presents and discusses its recommendation that the Company's measure of value claim be reduced by $3,048,292 to remove the depreciated value of PennVest financed plant. I&E MB, pp. 18-28. *See:* Table II, Measure of Value.[1]

I&E hereby responds to a number of the Company's assertions and arguments attempting to support their measure of value, i.e. rate base, claim, as found at pages 9 through 16 of the Columbia Main Brief. Columbia MB, pp. 9-16. As discussed below, Columbia's arguments are directly contrary to Commission precedent and sound ratemaking principles and cannot successfully justify their attempt to include the subject PennVest plant in rate base.

1 I&E Witness Cline states that the $4,902,136 associated with plant funded by PennVest loans should not be included as any part of the Company's rate base for ratemaking purposes. He also recommended that the amounts of $1,853,844 in accrued depreciation be excluded from rate base and $115,913 in annual depreciation expense associated with the PennVest plant be excluded from the Company's expense claim. I&E St. No. 3-SR, p. 8.

1. The Company's Argument That The PennVest Plant Is Used and Useful Is Irrelevant To The Valid Reasons For Properly Excluding The Plant From The Measure of Value Claim.

At the beginning of their argument seeking to support the inclusion of the PennVest financed plant in rate base, the Company states, "I&E and OCA both recommend ignoring this plant, which they concede is used and useful, …." Columbia MB, p. 9. I&E would respond that the fact that the subject plant is still currently operational has nothing whatsoever to do with the resolution of the instant question of whether the Company supplied the funding for the plant and would therefore be entitled to have it made part of their recognized measure of value for ratemaking purposes. As stated by I&E Witness Cline in his Direct Testimony:

> The recovery of plant and the return on any utility plant related to the provision of service should only apply to plant funded by the utility's owners/shareholders. Then, any recovery of or return on plant can be provided by the customers through rates. Such is not the case with this plant financed by a PennVest loan. Therefore, any reflection of the PennVest-financed plant in the ratemaking equation is improper.

I&E St. No. 3, p. 8.

The Company's reference to and attempted misuse of the "used and useful" ratemaking standard in furtherance of the argument for rate base treatment of a certain portion of plant - for which they provided no dollars whatsoever - needs to be rejected. Such a "used and useful" standard is certainly to be applied to determine whether certain capital assets should be recognized in the measure of value, but it is not the only applicable and conclusive standard. Rather, whether a particular plant is "used and useful" is a threshold standard to be satisfied when evaluating a proposal to include a capital item in a rate base claim. And in fact, it would be highly unusual if plant financed by PennVest didn't continue to be useful after the monies to provide the loan repayments were collected from ratepayers and the term of the loan had expired. The plant certainly should be in use, given that the Company's own witness identified that the average remaining life of the PennVest plant was 46.5 years as of 1993. CWC St. 2R, pp. 12-13.

As noted by I&E Witness Cline in both his Direct and Surrebuttal Testimony, in Columbia's prior base rate cases at Docket Nos. R-2008-2045157, R-00061496, R-00049409, and R-00016423, during which the PennVest surcharge was being assessed, the Company excluded the PennVest-financed plant from its rate base claim. I&E St. No. 3, p. 9. I&E St. No. 3-SR, p. 3. OCA MB, pp. 13-17. Presumably, the plant was also "used and useful" at that time.

As such, the solitary fact that the plant financed by a PennVest loan continues to be in use after the loan has been repaid and the charge removed from rates does nothing to advance the conclusion that it can now properly be made part of the Company's measure of value claim. The ALJ and the Commission should properly disregard the Company's argument as having no bearing on the resolution of the instant issue.

2. The Company's Reference To A Joint Stipulation As Supporting Their Present Inclusion of PennVest Plant In Rate Base Is Both Misleading And, Given Subsequent Company Action, Rendered Inapplicable.

At page 11 of the Columbia Main Brief, the Company seeks to argue that I&E Witness Cline has somehow capitulated to the PennVest financed plant now being included in rate base by stating, "[D]espite acknowledging in their Surrebuttal Testimony that the volumetric PennVest rate set in 1993 'clearly intended to have the plant included in rate base instead of instituting a surcharge,' (I&E Statement No. 3-SR at 7:16-18) (emphasis in original) …." This reference has been taken out of context and misrepresents the import of the subject I&E testimony. Only a reading of the entire paragraph at I&E Statement No. 3-SR, page 7, will disclose whether I&E Witness Cline acknowledged anything that would support the Company's argument. As he stated there:

> Q. HOW DID THE COMPANY JUSTIFY INCLUDING PENNVEST PLANT IN BOTH A SURCHARGE AND RATE BASE?
>
> A. Mr. Lewis contends that the Commission had previously approved the inclusion of these assets in rate base via a Joint Stipulation between the OCA and the Company (CWC St. No. 1R, p. 24). This referenced Joint Stipulation is simply not relevant to the resolution of the present issue because, contrary to the provision of that Joint Stipulation that clearly intended to have the plant included in rate base instead of instituting a surcharge, Columbia Water, instead,

> did institute a surcharge and has collected every dollar of the PennVest loan and related interest from ratepayers.

Clearly, I&E Witness Cline was making no "acknowledgement" that would stand for the proposition put forth the Company. Rather, in referencing the Company's subsequent actions to avail itself of the benefits of a surcharge, he was providing his conclusion that the Company deviated from the terms of the Joint Stipulation and that therefore the terms provided for by the Joint Stipulation were no longer applicable.

In the same paragraph above, I&E Witness Cline points out the fundamental fact that the Company collected the monies to repay the PennVest loan and related interest and have therefore contributed no monies to the financing of the plant.[2] This is indeed the crux of the matter.

And in full support of I&E Witness Cline's observation that the Company's subsequent actions equated with the imposition of a surcharge, OCA Witness Everette states in her Surrebuttal Testimony that "Contrary to the 1993 Stipulation with the OCA, CWC appears to have implemented the surcharge method, but used the rate base/rate of return calculation. In the rate cases that followed the implementation of this surcharge, the Company removed the PennVest-funded plant from rate base, removed the surcharge revenues and excluded the PennVest

---

2 Columbia ended the surcharge in 2011, having the opportunity to reconcile it at that point if they believed that not all monies were collected to repay the PennVest loan.

loan form capital structure in calculating its base rate revenue requirement." OCA St. No. 1S, pp. 39-40.

As such, not only does the Company's narrow and skewed reference to I&E Witness Cline's testimony not support the Company's argument, it undermines it by focusing attention on I&E's emphasis of the fact that the Company deviated from the terms of the Joint Stipulation through subsequent manipulations of its volumetric rates. I&E St No. 3-SR, p. 7.

Simply put, the Company deviated from the terms of the Joint Stipulation and cannot now rely on its provisions to support its argument for inclusion of the PennVest plant in rate base.

3. The Company's Argument Seeking To Dismiss A Relevant Commission Policy Statement Should Be Disregarded.

The I&E Main Brief references that I&E Witness Cline in his surrebuttal testimony included the Commission's policy statement at 52 Pa. Code § 69.361, that states:

> PENNVEST loans were established to provide funding to water and wastewater companies for improvements of drinking water and wastewater treatment facilities in this Commonwealth. The Commission is required to establish expedited practices, procedures and policies to facilitate and accomplish repayment of the loan obligations. See section 14 of the PENNVEST Act (35 P. S. § 751.14). Companies with outstanding PENNVEST loans not currently reflected in rates and companies that will receive PENNVEST loans in the future are encouraged to establish under 66 Pa.C.S. § 1307(a) (relating to sliding scale of rates; adjustments) and subject to

> Commission approval, an automatic adjustment by means of a sliding scale of rates limited solely to the recovery of PENNVEST principal and interest obligations, **instead of seeking recovery of these amounts under 66 Pa.C.S. § 1308 (relating to voluntary changes in rates) base rate filing.**

I&E MB, p. 22-23; I&E St. No. 3-SR, p. 4. [Emphasis Added]

In citing this Commission policy statement, I&E Witness Cline makes the point that, in this proceeding, the Company attempts double recovery of the financing of the plant through both the complete recovery of the PennVest loan with interest and then the inclusion in rate base of the undepreciated value of the PennVest plant. I&E St. No. 3-SR, p. 4. In response, the Columbia Main Brief apparently attempts to lessen the impact of the policy statement by noting that I&E Witness Cline responded in the affirmative when asked whether the Commission's policy statement was issued the year after Columbia's "election in 1993." Columbia MB, pp. 13-14.

First, as reiterated earlier in this I&E Reply Brief, said, "election" was a methodology that was subsequently altered by the Company and the changes to the charge ensured repayment of the PennVest loan through subsequent reconciliations and finally the elimination of the charge following full repayment – all the characteristics of a surcharge. As such, any reference to the timing of the Commission's policy statement as it relates to the initiation of the charge, created under terms and conditions that were unilaterally abandoned while the charge structure was being inexorably altered by the Company during the repayment of the PennVest loan, is a "red herring" of the highest order. By the Company's own actions that occurred after the issuance of the policy statement, the cited timing difference is rendered completely and totally irrelevant to the resolution of the instant issue.

As noted in the instant record, the Commission has historically allowed a utility a choice of two methods to recover the costs of plant financed by PennVest loans, either place the plant in rate base and recover the associated costs through depreciation expense and the opportunity to earn a return on the undepreciated plant over the useful life of the plant or implement a surcharge to recover the loan principle and interest during the loan repayment period. OCA St. 1S, p. 38 & MB, p. 10.

Further, the I&E Main Brief specifically referred to the "development" of the policy statement. I&E MB, p. 23. Consistent with that characterization in the I&E Main Brief, it can be elaborated upon here that Commission policy statements are often issued to clarify and essentially codify a Commission's position that existed and had been exercised for a number of years. That situation is indeed what arose here.

As such, the Company's attempt to limit the applicable of the policy statement to the instant situation should be given no credence whatsoever.

4. The Company's Argument That They Assumed A Substantial Level Of Risk Regarding The Repayment Of The PennVest Loan Should Be Rejected.

In its Main Brief, the Company also seeks to undermine the I&E position on this issue by stating that "First of all, on cross-examination, Mr. Cline admitted that the ratepayers did not sign for the loan, promissory note or the pledge of accounts nor do they own the PennVest plant. (Tr. at 177)." The Company's Main Brief goes on to attempt to further inflate the level of "risk" related to the plant financed by the PennVest loan. Company MB, pp. 14-15.

And on this issue, the Company in its Main Brief states that "I&E witness Cline also attempts to divert attention from the fact that the PennVest charge was not a debt-based surcharge by arguing that by implementing the charge, the Company bore no risk by taking out the PennVest loan (I&E Statement No. 3-SR at 2:21-3:9)." Columbia MB, p. 14. In fact, what I&E Witness Cline did state in his I&E Statement No. 3-SR at page 2 was that, "[B]y implementing the PennVest surcharge and collecting the entire original cost of the subject plant, the Company bore virtually no risk." I&E St. No. 3-SR, p. 2, lines 21-22. The second Company reference to I&E Witness Cline's Surrebuttal Testimony is also a misrepresentation, as the this actual language from his Surrebuttal Testimony provides, "[T]he simple fact remains that the Company did institute a surcharge – which included recovery of both principle and interest on the loan – and as such was ultimately at virtually no risk." I&E St. No. 3-SR, p. 3, lines 5-7. The Company's mischaracterization of I&E Witness Cline's reference as "no risk" rather than what he actually said, "virtually no risk" is no minor matter. I&E Witness Cline rightly acknowledged a small element of risk and the Company portrayed him as completely oblivious to that fact by misrepresenting his statement not once, but twice. Further on this point, it should be made clear that I&E Witness Cline was accurately describing the circumstances here by recognizing that that the charge had been reconciled several times during the period of loan repayment. As opposed to a charge that cannot be reconciled, the reconciled charge here had the firm security of those reconciliations - presumably if done correctly - would reach up to the point that dollars collected met dollars to be repaid to PennVest. That situation represents "virtually no risk" to the Company. Again, there is a massive difference between "no risk" and "virtually no risk," and the Company's actions to misstate I&E Witness Cline' characterizations in such a manner cannot easily be excused or dismissed.

During the course of this proceeding, I&E Witness Cline also responded to the Company witnesses attempts to defend their "substantial risk" contention. I&E Witness Cline provided extensive analysis and discussion on this issue in his Surrebuttal Testimony, where he states, "[C]ompany Witnesses Lewis and Shambaugh advance the tenuous argument that, because the Company signed the

PennVest loan documents, they assumed all of the risk (CWC St. No. 1R, p. 23, CWC St. No. 2R, p. 7)." I&E St. 3-SR, p. 2.

I&E submits that the controlling case here is *Pa. P.U.C. v. National Utilities, Inc.*, at Docket No. R-00932828. 1994 PUC LEXIS 55, 1994 WL 932284. In that case, specifically referenced in detail in I&E Witness Cline's Surrebuttal Testimony, the Commission addressed essentially the same utility proposal as pursued here by Columbia. There, NUI sought rate base treatment of plant financed by PennVest loans, some of which were still being repaid thorough surcharges implemented by utilities acquired by NUI. In its Order there, the Commission denied the request and allowed only the amount of unpaid loan balances to be included in rate base. Interestingly, one of NUI witnesses was Mr. Shambaugh, the witness here for Columbia. In the NUI case, Mr. Shambaugh advanced this precise same "risk" argument in support of NUI's proposal to suspend the surcharges and place the undepreciated value of the PennVest financed plant in rate base (1994 WL 932284)." I&E St. No. 3-SR, p. 5.

In its NUI Order entered some twenty years ago, the Commission referenced the submitted testimony of Mr. Shambaugh, and stated:

> In further describing the Company's position, the ALJ pointed out that NUI's witness Shambaugh testified that the responsibility for the Pennvest loans rests with NUI, since the loans are secured by NUI, and not its ratepayers. Furthermore, since NUI secured the loans, built the plant and placed the plant into service, Mr. Shambaugh contended that NUI is entitled to earn a reasonable

> return on its investment. The ALJ observed that all parties agree that NUI is obligated to pay back the Pennvest/WFLB loans. (R.D., pp. 24-25).

1994 WL 932284, p. 8; I&E St. No. 3-SR, p. 6.

Despite this argument by Mr. Shambaugh in the NUI case, the Commission there, as noted by I&E Witness Cline in his Surrebuttal Testimony, allowed the value of the PennVest plant to be based upon the existing loan balances from PennVest loans and did not allow the plant in question to be included in rate base at its depreciated value, where the Commission stated:

> In considering this matter, we find, as the ALJ did, that the value of the Pennvest financed plant should be based upon the principal balance of the Pennvest/WFLB loans. We, therefore, conclude that the sum representing the difference between the loan balances and the original cost of the plant has in fact been provided by the customers. Therefore, NUI's proposal to include Pennvest financed plant in its rate base at original cost less book depreciation would result in double recovery from the ratepayers. (Order entered September 1, 1994).

[(1994 WL 932284, page 8); I&E St. No. 3-SR, p. 6.

Further in his Surrebuttal Testimony at pages 5 and 6, I&E Witness Cline points out the Commission's characterization of the OTS (now "I&E") position in the NUI case, as follows:

> In its Reply Exceptions, the OTS argues that ALJ Kashi arrived at the proper findings regarding the method of valuation of the Pennvest financed plant, and that there is ample evidence in the record in this proceeding to support the recommended findings. The OTS contends that: While the surcharges were in place, the assets purchased with PennVEST loans were not included in the

> Company's plant in service measure of value. The return of investment (depreciation) experienced by NUI through surcharge recovery occurred at a faster rate than the rate that NUI would have experienced had the plant been included in rate base and depreciated over its useful life. OTS St. 1, p. 7-8; Tr. 103. The dollar-for-dollar recovery of PennVEST debt service through the surcharge allowed the NUI companies to collect for and pay off their PennVEST loans on a direct basis. This treatment provided a return of capital in the form of the repayment of the principal amount of the loan. As such, the ratepayers are entitled to be credited as having already paid for the portion of the PennVEST loan which has already been surcharged.

I&E submits that there is no substantial difference between the facts of the NUI case and this present utility's attempt to place such plant in rate base. The only difference is that NUI sought to include a portion of the plant in rate base while the surcharges were still being assessed and the total loan and interest amounts had yet to be completely recovered.

Directly relevant here is the fact that the Commission in the NUI case denied the precise treatment sought by Columbia here – the inclusion of the PennVest plant in rate base at its depreciated value. Instead, the Commission authorized in rates only the loan balances from PennVest loans. Following his repeated references to the NUI decision in his Surrebuttal Testimony, I&E Witness Cline states definitively that, as to this present Columbia case, "there is no remaining 'loan balance,' so there is nothing about the PennVest plant that remains to even be considered to be included in rate base." I&E St. No. 3-SR, p. 7.

The reasoning and rationale used by the Commission when deciding the NUI case is indeed relevant and controlling here and fully supports Commission adoption of the I&E position in this proceeding to deny Columbia's attempt to include the depreciated value of the subject PennVest plant into its measure of value claim.

5. The Company's Contention That The I&E and OCA Arguments Rely Upon A "Debt-Service Only Surcharge" Is Patently Inaccurate.

The concluding paragraph of the Company's Main Brief on this issue provides the following statement, "In sum, OCA and I&E's arguments are flawed from the beginning as they rely on the false premise that the PennVest rate was a debt-service only surcharge, which it was not, and that now precludes the Company from earning a return on the PennVest plant." Company MB, p. 16. And in fact, the Company's Main Brief is peppered with the term "debt-service only surcharge," while repeatedly alleging that it was the basis for the I&E and OCA positions. Company MB, pp. 8-16.

Without giving any credence to the Company's skewed argument here, an effort will now be made to present it in all its inaccuracy and illogic, and ultimately its irrelevance. The argument appears to first rely upon the fact that the vast majority of PennVest surcharges are exclusively computed using the loan repayment schedule (including interest) as the determinant for the rate to be charged. The Company's argument then appears to leap from there to a conclusion that any charge that uses any other computational methodology, even if it serves to collect the PennVest loan repayment amounts, cannot by definition be a surcharge. Then, continuing the apparent Company argument, when I&E refers to the Company's charge to their rates as a surcharge, I&E (and notably also OCA) must be contending that the charge was a "debt-service only" surcharge, because that's the only kind of surcharge that can exist. Therefore, as the Company's fractured logic continues, since the charge imposed by the Company wasn't based exclusively upon the PennVest loan repayment schedule, it couldn't possibly be a surcharge. In mangled conclusion then, there is no need to determine whether the Company's charge and the result it brought about had any of the characteristics and the many benefits of a surcharge to the utility, because it couldn't possibly be a surcharge.

The Company's argument can be exposed as mere semantics and one that sets up the classic logical fallacy of the "straw man," i.e. if the I&E/OCA erroneous insistence upon declaring the Company's charge to be a "debt-service only" surcharge can be knocked down, the only argument left standing is the Company's argument.

In reality, it is simply untrue that I&E is either insisting that the Company's surcharge methodology was "debt-service only" or that such a characterization was relied upon by I&E in support of its recommended exclusion of the PennVest plant from the Company's measure of value claim.

The salient point at risk to be lost in confronting the Company's misrepresentations and illogic is that the record reflects that the Company instituted a charge, then changed and reconciled that charge several times over the term of the PennVest loan repayment schedule to ensure that adequate monies were collected from ratepayers, and then subsequently extinguished that charge when the loan was repaid.[3] By doing so, the Company invested zero dollars in the PennVest plant. And yet, the Company now seeks to place that this fully-paid-for plant into rate base to earn a return of and on the depreciated value, an amount of $3,048,292, plus an annual depreciation expense associated with the PennVest plant in the amount of $115,913. I&E St. No. 3-SR, p. 8.

The Company has instituted a rate charge to customers that, over the course of the PennVest loan repayments, had virtually all the characteristics and advantages of a surcharge. And presently in this proceeding, the Company has the

---

3 The evidence of record shows that Columbia changed its method of recovery from rate base/rate of return treatment with depreciation to a reconcilable surcharge. In the rate cases that followed the implementation of this surcharge, the Company removed the PennVest-funded plant from rate base, removed the surcharge revenues and excluded the PennVest loan form capital structure in calculating its base rate revenue requirement." OCA St. No. 1S, pp. 39-42.

audacity to claim that they are now entitled earn a "return of and return on" the depreciated value of that plant, despite the undisputed fact that they contributed no monies whatsoever to the original cost of the plant.

Again, the Company's argument consists of mere semantics that seek to obscure the actual results of the Company's use of its imposed and repeatedly reconciled charge on ratepayers and should be given no credence by the Commission.

For the foregoing reasons, the ALJ and the Commission should adopt the I&E recommendation and reduce the Company's measure of value claim by $3,048,292 to remove the depreciated value of PennVest financed plant.[4]

B. REVENUES

As stated in the I&E Main Brief, both the Company and I&E have resolved some initial revenue issues and have incorporated them into our respective positions. I&E MB, pp. 28-29. Therefore, no present rate revenue adjustment issues initially raised by I&E in this proceeding remain to be pursued in this I&E Reply Brief. I&E MB, p. 29.

4 As discussed in the I&E Main Brief, in determining the appropriate value for rate base to reflect the removal of the PennVest-financed plant, an amount of $1,853,844 representing accumulated depreciation related to the PennVest-financed plant must be netted against the $4,902,136 plant in service figure to arrive at the net decrease amount of $3,048,295. I&E MB, pp. 25-26. There is also a resultant and appropriate I&E recommended reduction in the Company's annual depreciation expense claim in the amount of $115,913. I&E MB, p. 26.

C. EXPENSES

I&E hereby responds to a number of the Company's discussions regarding their expense claims found at pages 18 through 45 of the Columbia Main Brief. As pointed out herein and as outlined in the I&E Main Brief, I&E has three (3) recommended adjustments to the Company's various expense claims. I&E MB, pp. 29-35.

Those three adjustments are (1) a reduction of $115,913 to the Company's Annual Depreciation expense claim consistent with and related to the I&E recommended removal of the PennVest plant from the Measure of Value claim [also presented in the I&E Main Brief at the Rate Base section]; (2) a reduction of $5,512 to the Company's updated expense claim of $66,144 for Officers, Directors, & Majority Stockholders salaries; and (3) the denial of the Company's "Employee Recognition" expense claim of $6,051. I&E MB, pp. 29-35. I&E reiterates that these adjustments are more consistent with established ratemaking principles and should be adopted.

As to the Company's attempted inclusion of $115,913 in its Annual Depreciation claim, the I&E Main Brief makes it clear that the issue rises or falls according to the resolution of the issue of the Company's attempt to claim the depreciated value of PennVest plant as part of its rate base. I&E MB, pp. 26-28 & 32-33.

As to the I&E recommended reduction of $5,512 to the Company's updated expense claim of $66,144 for Officers, Directors, & Majority Stockholders salaries, the Company's Main Brief discusses the adjustments made by both I&E and OCA at pages 33 through 45. Columbia MB, pp. 33-45. Regarding their claimed level for officers' salaries, the Company states in their Main Brief that they are currently seeking "substantially less" than the amount approved by the Commission in Columbia's last rate case. Columbia MB, p. 33. This representation should not be considered relevant to the I&E adjustment because it is based upon an allocation of a portion of the claimed level of expense to the Marietta Division, rather than an assertion that the amount of the claim is too high. I&E MB, pp. 33-35. Of further note, and as referenced in the I&E MB, the Company itself has already recognized the need for an allocation of this expense to the Marietta Division, although doing so at a lower percentage than recommended by I&E. I&E MB, p. 35. As such, the reference to the level of this expense granted in the Company's last rate case is immaterial to the continuing validity of the I&E adjustment that uses a 12% allocation factor. I&E MB, pp. 33-35.

As to the Company's attempt to support their $6,051 expense claim styled as Employee Recognition, the Company's Main Brief places its discussion of the issue under the subheading "Pensions and Benefits," presumably as if placing it there would clarify its status as a benefit. Company MB, p. 28. As noted in the

I&E Main Brief, the Company may indeed make such expenditures, but should not be authorized to recoup such expenditures from ratepayers as a legitimate ratemaking expense. I&E MB, pp. 35-36.

In its Main Brief, the Company seeks to support this claim by pointing out that Hershey Park tickets are distributed to employees for their use during the year and are not related to one particular trip. Company MB, p. 28. I&E would respond that such distribution of tickets rather than as a single trip renders the expense claim even less supportable then it already was. This is particularly notable given that the Company's citation to Commission case related to the authorization to recoup expenditures for an awards banquet, where individual employees are recognized at a formal utility function. Columbia MB, p. 29. Again, as pointed out in the I&E Main Brief, a similar entertainment expense was disallowed as a legitimate recoverable expense by the Commission in Columbia's last base rate case, docketed at R-2008-2045157. I&E MB, p. 36. In that Order, the Commission adopted the ALJ's recommendation to disallow the expense, agreeing that the expense claimed by Columbia did not directly relate to the provision of water service. Order at R-2008-2045157, p. 28.

For the reasons stated here and in the I&E Main Brief, the I&E recommended expense adjustments remain valid and should be adopted by the ALJ and the Commission.

D. TAXES

The I&E Main Brief identified the sole tax adjustment advocated by I&E. I&E MB, p. 36. As such, no additional discussions is required in this section of the I&E Reply Brief.

E. RATE OF RETURN

1. Introduction

As presented in detail in the I&E Main Brief, I&E recommends a 7.07% overall rate of return derived from the use of the I&E recommended debt cost rate of 5.00%, the I&E recommended 50/50 capital structure, and the I&E-recommended 9.15% cost of common equity. I&E MB, pp. 37-54; I&E St. No. 1, pp. 7, 24, 35 & 45; I&E Ex. No. 1, Sch. 1. See also: I&E MB, Appendix A, Table III.

Based on the credible evidence in this proceeding and consistent with this recommended 7.07% overall weighted cost of capital, I&E asserts that the ALJ and the Commission should disallow the Company's overall return because it is based upon an inappropriate capital structure and overstated faulty return on common equity calculation. In this proceeding, I&E presented the testimony and exhibits of its rate of return expert witness, Rachel Maurer, who provided the I&E recommendation for an appropriate overall fair rate of return. I&E Stmt. No. 1; I&E Ex. No. 1; I&E Stmt. No. 1-SR. The I&E Main Brief provided a full description of Ms. Maurer's cost of capital conclusions and their well-reasoned and factually supported rationale. I&E MB, pp. 37-54.

In the Columbia Main Brief, the Company references the testimony of its rate of return witness Mr. D'Ascendis and attempts to support his recommended 11.35% cost rate of common equity, the use of the Company's actual pro forma capital structure consisting of 35.60% debt and 64.40% equity at December 31, 2013, and an updated debt cost rate of 5.00%. Columbia MB, pp. 45-59. The Company's proposed overall rate of return of 9.18% is shown in Table 1 attached to the Columbia Main Brief.

This section of the I&E Reply Brief will point out the flaws in the analyses and methodology used by Company Witness D'Ascendis and will respond to his attempts to criticize the analyses presented by I&E Witness Maurer. Specifically, the Company's Main Brief addresses I&E Witness Maurer's rate of return testimony and exhibits at pages 49 and 50. Columbia MB, pp. 49-50.

2. The Company's Criticism of I&E's Recommended Capital Structure And Support For Its Capital Structure And Should Be Discounted.

The Company's Main Brief mentions their proposed capital structure in only three sentences: (1) a sentence at page 45 noting that it's "not entirely different" from the ratio approved by the Commission in Columbia's 2008 base rate case; (1) a sentence at page 49 stating that I&E Witness Maurer recommended hypothetical capital structure ignores the determination in the 2008 case; and (3) a sentence at page 50 stating that the OCA witness similarly "ignores the regulatory precedent of allowing the use of pro forma capital structures for ratemaking purposes in CWC's most recent rate case." Columbia MB, pp. 45, 49 & 50.

In repeating that solitary refrain, the Company conveniently ignores the several valid reasons set forth by I&E Witness Maurer that explain why the use of their capital structure is inappropriate. As to any comparison between the capital structure approved in Columbia's last base rate case and the current claim, I&E Witness Maurer investigated the Company's capital structure in the five intervening years between the two cases and revealed that the average for that period was 42.45% debt and 57.55% equity. I&E MB, pp. 42-43; I&E St. No. 1, p. 14.

As such, Columbia's utilized capital structure is not in line with their historical capital structure but is in fact more heavily weighted toward equity than the Company has been in any of the past five years. I&E MB, pp. 43-43; I&E St. No. 1, p. 14. Coincidentally then, the Company's capital structure is more heavily skewed towards the higher priced equity around the time of the rate cases. The fact that the Company's capital structure from 2008 to 2012 is more in line with I&E Witness Maurer's barometer group's indicates that a capital structure of 50% long-term debt and 50% common equity is a more accurate representation of the capital structure that the Company normally holds and is more representative of the industry norm than the Company's current claim of 35.60% long-term debt and 64.40% common equity. I&E St. No. 1-SR, p. 7.

As noted above, the Company's criticism of the I&E recommended 50/50 capital structure relies solely upon their reference to the acceptance of the actual capital structure in their last base rate case. Columbia MB, p. 49. This response leaves unaddressed the valid and applicable I&E contentions that the use of Columbia's actual capital structure is (1) not in line with the industry average and (2) places an unfair and unnecessary financial burden upon customers when compared to the I&E recommended 50/50 capital structure. I&E MB, pp. 41-43.

For the foregoing reasons and particularly those presented in the I&E Main Brief, the Commission should adopt the I&E recommended capital structure of 50% debt and 50% equity, one that is fundamentally more fair and better representative of Columbia.

3. Company Witness D'Ascendis' Choice of Proxy Groups Is Unjustified And Undermines The Claimed Validity And Relevance Of His Various Analyses.

The Company based its proposed cost of equity on the results of Mr. D'Ascendis' analysis of two proxy groups that he selected, a water company group and group of domestic, non-price regulated companies. Columbia MB, p. 46. I&E St. No. 1, pp. 8-13; I&E St. No. 1-SR, pp. 4-5. For his first proxy group, Mr.

D'Ascendis selected American States Water Company, American Water Works Company, Inc., Aqua America, Inc., Artesian Resources Corporation, California Water Services Group, Connecticut Water Service, Inc., Middlesex Water Co, and SJW Corp., and The York Water Company. I&E St. No. 1, p. 9.

For her single proxy group, I&E Witness Maurer selected six (6) water companies, representing the remainder following her exclusion of three of the water companies in Company Witness D'Ascendis' first proxy group of nine (9) water companies. Specifically, she excluded three: American Water Works Company, Inc., Artesian Resources Corporation and The York Water Company stating initially that they were removed because each failed to meet her criteria that investment information for the water company must be available from more than one source. I&E MB, pp. 45-46. I&E St. No. 1, pp. 9-10. In her Surrebuttal Testimony, she clarified that the reason she excluded American Water Works Company, Inc. from her barometer group was because that company was not fully divested of its owner, RWE, until November 2009, and therefore does not contain enough public information to be useful. I&E St. No. 1-SR, p. 4.[5]

I&E Witness Maurer categorically opposes Company Witness D'Ascendis' use of a second proxy group (consisting of twenty nine companies in industries ranging from medical services to retail building supplies), where she opines that its use in any fashion as a proxy for Columbia is unwarranted and undermines the results of each and every one of Mr. D'Ascendis' methods he used to calculate his recommended cost of equity. I&E St. No. 1, pp. 10-11. I&E Ex. No. 1, Sch. 2.

As pointed out by I&E Witness Maurer, although Mr. D'Ascendis' second barometer group of unregulated companies may have betas that are similar to his water group, it remains an unacceptable proxy for Columbia as the companies are from different industries, face different risks, and are significantly more

---

5 As referenced at page 45 and 46 in the I&E Main Brief, I&E Witness Maurer initially selected her proxy group consisting of American States Water Company, Aqua America, Inc., California Water Services Group, Connecticut Water Service, Inc., Middlesex Water Co, and SJW Corp. using the following criteria:

1. 50% or more of the company's revenues must be generated from the water industry;
2. The company's stock must be publicly traded;
3. Investment information for the company must be available from more than one source;
4. The company must not be currently involved/targeted in an announced merger or acquisition; and
5. The company must have five years of historic earnings data. I&E St. No. 1, p. 7; I&E Ex. No. 1, Sch. No. 1, p. 2.

profitable.[6] I&E St. No. 1, p. 11.

As explained by I&E Witness Maurer, the purpose of a barometer group is to provide market data for a company that is not publicly traded. Each industry faces different types of risk. A barometer group must contain companies in the same industry as the company they are a substitute for if the return that is being estimated is to be accurate. I&E St. No. 1, pp. 10-11.

I&E emphasizes that the claimed legitimacy of Mr. D'Ascendis' cost of common equity results is undermined by his selection of proxy groups not as representative of Columbia as the proxy group utilized by I&E. The unrepresentative nature of Mr. D'Ascendis' proxy groups, when applied to his

6 I&E Witness Maurer also rejects the notion that the fact that Mr. D'Ascendis' unregulated barometer group has a beta similar to that of his water group would indicate that those companies face the same risks as Columbia. She points out that each different industry faces different risks which dramatically affect the growth or decline of the companies within that industry. Although beta can indicate risk two companies with similar betas do not always face the same type or level of risk. Beta is an indicator of volatility or how each company responds when compared with the market as a whole. A beta of less than one indicates that the price movement of the stock is less than that of the market as a whole. I&E St. No. 1, p. 11.

In her Surrebuttal Testimony, I&E Witness Maurer also disagrees with Company Witness D'Ascendis' claim that he has proven that the companies contained in his non-regulated proxy group have a similar risk to those in his water utility proxy group based on the unadjusted beta and standard error of the regression being inside that of the range of the water utility proxy group. I&E St. No. 1-SR, pp. 4-5. She adds that the risks faced in each industry for the companies used in Mr. D'Ascendis' unregulated group differ from the risk faced by his water utility group and that the recent outperformance of the water utility industry is not expected to continue while the drug industry has recently plummeted and is not in the bottom third of all sectors under Value Line coverage. I&E St. No. 1-SR, pp. 4-5. The assertion that risk between industries can be evaluated based on beta and standard error regression while ignoring current events leads to an incorrect assessment of risk.

Finally, I&E Witness Maurer emphasizes that, although at one particular point in time, each industry may have a similar degree of risk when compared to the market as a whole, Mr. D'Ascendis has ignored what the industry has faced in the past or is expected to face in the future. Mr. D'Ascendis' unregulated barometer group may have a beta similar to that of his water group, but that does not mean that the companies face the same risks. I&E St. No. 1-SR, pp. 4-5.

already suspect use of multiple methodologies, further erodes the legitimacy of his recommended cost of common equity.

Turning to the Company's Main Brief, the Company mistakenly includes a criticism of I&E Witnesses Maurer's reason for her exclusion of American Water Works Co., Inc. from her selected barometer group, citing CWC Statement No. 3R, p. 4. Columbia MB, p. 49. As explained above, I&E Witness Maurer had clarified the reason for her exclusion of American Water Works Company, Inc. in her Surrebuttal Testimony. I&E St. No. 1-SR, p. 4. The Company's criticism of Ms. Maurer's rationale is therefore outdated and inapplicable.

For the foregoing reasons, the ALJ and the Commission in this proceeding would be justified in giving substantially less weight to the results of Mr. D'Ascendis' utilized methodologies, solely on the basis that such results are not representative of an appropriate rate of return for Columbia due to the use of an unrepresentative proxy group non-price regulated companies.

4. Company Witness D'Ascendis' Criticism Of I&E's Sole Use And Application of the DCF Methodology Lacks Merit.

As stated in the I&E Main Brief, I&E Rate of Return Witness Rachel Maurer used the standard discrete Discounted Cash Flow ("DCF") method to determine her recommended 9.15% cost rate of common equity. I&E MB, pp. 46-47; I&E St. No. 1, pp. 24-30; I&E Ex. No. 1, Schs. 1 & 7-10. I&E Witness

Maurer used the CAPM method only as a comparison to her DCF results. I&E MB, pp. 46-47; I&E St. 1, p. 24.

At page 49 of their Main Brief, the Company seeks to criticize I&E Witness Maurer reliance "solely on the DCF methodology," while noting that she uses the CAPM as a check to her DCF results. The Company's Main Brief cites to Mr. D'Ascendis' Statement No. 3-R. Columbia MB, p. 49. In that referenced Rebuttal Testimony, Mr. D'Ascendis states that other methods in addition to DCF must be relied upon when recommending a cost of common equity. Columbia St. No. 3R, pp. 4-6.

In response, I&E first references that the I&E Main Brief provides the reason and rationale for I&E Witness Maurer's professional opinion that the results of the use of the DCF method are the most reliable. I&E MB, pp. 46-50. I&E St. No. 1, pp. 25-31. I&E St. No. 1-SR, p. 11. In her Surrebuttal Testimony, I&E Witness Maurer explains that since, "no method can perfectly predict the return on equity" she used the CAPM as a check on the validity of her DCF results. I&E St. No. 1-SR, p. 11. And in fact, her DCF analysis resulted in a cost of common equity of 9.15%, which she observed was above the results of her CAPM range of 5.14% to 9.02%. I&E St. No. 1-SR, p. 11.

Company Witness D'Ascendis also attempts to criticize I&E Witness Maurer's DCF analysis, claiming that she used an unadjusted dividend to calculate the indicated cost rate and attempts to "correct" the dividend yield. I&E St. No. 1-SR, pp. 7-8. Columbia St. No. 3R, pp. 11-12. This criticism is without merit. As explained by I&E Witness Maurer, "[W]hen a forecast of D_1 is not available, D_0…must be adjusted. As the dividend I chose was a forecast, Mr. D'Ascendis' "correction" of my DCF is inappropriate as he is adjusting a dividend that is already forward looking."[7] I&E St. No. 1, p. 25; I&E St. No. 1-SR, pp. 7-8.

For the foregoing reasons and those presented in the I&E Main Brief, the Commission should again recognize the superiority of using the primary use of the DCF method, with CAPM as a check, and reject the Company's criticisms of the I&E methodology.

5. Company Witness D'Ascendis' Criticism Of I&E's CAPM Methodology [Checking The DCF Results] Lacks Merit.

At page 49 of their Main Brief, the Company seeks to criticize I&E Witness Maurer's CAPM methodology, stating that "… even though Ms. Maurer only uses the CAPM as a check to her geometric mean equity risk premiums, 10-year Treasury bonds for her risk-free rate, and refuses to employ the empirical CAPM in spite of her own evidence. (CWC Statement No. 3R at 12:18-17:9)." Columbia MB, p. 49.

---

7 I&E Witness Maurer used the forecasted dividend available from Value Line for 2014 for each company in her water group. I&E St. No. 1-SR, pp. 7-8; I&E Ex. No. 1, Sch. 7.

In her Surrebuttal Testimony, I&E Witness Maurer provide a definitive response to this Company contention. I&E St. No. 1-SR, pp. 8-10. She first identifies that Mr. D'Ascendis' assertion that she has inappropriately used the 10-year Treasury Bond and has also erroneously used historical geometric returns for the market as a measure of the expected return is premised upon his claim that the use of a 30-year Treasury Bond and an arithmetic mean is more appropriate for cost of capital purposes. Mr. D'Ascendis also seeks to commend use of the ECAPM method of computing the cost of capital. I&E St. No. 1-SR, pp. 8-10.

As to her use of the 10-year Treasury Bond as opposed to the use of the 30-year Treasury Bond, I&E Witness Maurer explains that using the 10-year Treasury Bond balances the deficiencies of the short-term T-Bill and the 30-year Treasury Bond and that long-term Treasury Bonds have substantial maturity risk associated with the market risk and the risk of unexpected inflation. I&E St. No. 1-SR, pp. 8-9. Given that convincing explanation, I&E asserts that I&E Witness Maurer's choice of the 10-year Treasury Bill is both appropriate and superior to using the 30-year Treasury Bill.

As referenced above, Company Witness D'Ascendis also seeks to criticize I&E Witness Maurer's use of historical geometric returns for the market as a measure of the expected return. Columbia St. No. 3R, pp. 12-17. In response, I&E asserts that such use of the geometric mean is supported by the 2013 Ibbotson Valuation Yearbook which states on page 56,

> The arithmetic average equity risk premium can be demonstrated to be most appropriate when discounting future cash flows... The geometric average is more appropriate for reporting past performance, since it represents the compound average return. [8]

As such, Witness Maurer use of the geometric mean when calculating a historical return is valid and eminently appropriate. I&E St. No. 1-SR, p. 9.

As to the contention in the Columbia Main Brief that I&E Witness Maurer "... refuses to employ the empirical CAPM in spite of her own evidence," Ms. Maurer emphasized in her Surrebuttal testimony that she did not employ the ECAPM, i.e. empirical CAPM, as it has the same problems as the CAPM, as discussed in her Direct Testimony at pages 20 to 21. I&E St. No. 1, pp. 20-22; I&E St. No. 1-SR, pp. 9-10; Columbia St. 3R, p. 14. In his Rebuttal Testimony, Mr. D'Ascendis referenced an article provide by I&E Witness Maurer as her Exhibit No. 1, Schedule 5, claiming that it supported the ECAPM method.[9] Columbia St. No. 3R, p. 16. In her Surrebuttal Testimony, I&E Witness Maurer

---

8 Ibbotson SBBI 2013 Valuation Yearbook Market Results for Stocks, Bonds, Bills, and Inflation 1926-2012, Morningstar, Inc. Chicago, IL. page 56.

9 The article appeared in the New York Times on February 18, 1992, and summarized a CAPM study conducted by professors Eugene F. Fama and Kenneth R. French. Their study examined the importance of beta, CAPM's risk factor, in explaining returns on common stock. In CAPM theory, the higher a stock's beta, the higher the expected return on that stock. They found that the model did not do well in predicting actual returns, and suggest the use of more elaborate multi-factor models. I&E St. No. 1, p. 22.

responded that the article does not support the use of the ECAPM in the manner argued by Mr. D'Ascendis, and that he had taken certain language from the article out of its context. I&E Witness Maurer asserts that the referenced article does not conclude that the problems with the CAPM are resolved by the ECAPM but rather, quotes an excerpt from the article that states the contrary, as follows:

> The synthesis of the evidence on the empirical problems of the CAPM provided by Fama and French (1992) serves as a catalyst, marking the point when it is generally acknowledged that the CAPM has potentially fatal problems.

For the foregoing reasons and those presented in the I&E Main Brief, the Commission should reject Company Witness D'Ascendis' invalid criticism of I&E Witness Maurer's components to her CAPM analysis (again, used as a check on her DCF results).

6. Company Witness D'Ascendis' Rate of Return Methodology Contains Fundamental Flaws.

At page 46 through 49, the Company's Main Brief references Mr. D'Ascendis' testimony and exhibits in support of their claimed cost of common equity of 11.35%.[10] Columbia MB, pp. 46-49. I&E submits that Mr. D'Ascendis' cost of equity recommendation is biased due to several errors. I&E St. No. 1, pp. 36-37. As pointed out by I&E Witness Maurer, Mr. D'Ascendis has given undue weight to the Capital Asset Pricing and Risk Premium method. Further, he has used his own version of the Risk Premium method and has used a barometer group comprised of companies not in the water industry and therefore not comparable to Columbia or his water group.[11] Finally, Mr. D'Ascendis has made several unnecessary adjustments to his resulting cost of equity. I&E St. No. 1, pp. 36-37.

Specifically, Mr. D'Ascendis adjusted his indicated cost of common equity downward 16 basis points to reflect his position that Columbia has lower financial risk relative to the barometer group; adjusted upward 40 basis points due to position that it is appropriate to do so due to Columbia's small size relative to his proxy group. He then adjusted his indicated cost of common equity upward by 25 basis points to reflect Columbia's claim of exceptional managerial performance

---

10 In presenting his analysis of the cost rate of common equity, Mr. D'Ascendis relies on three methods: the DCF, the RP analysis, and the CAPM. As noted, he applies these methods using a barometer group of water utilities and a barometer group of domestic, non-price regulated companies. Based upon the results of his three methodologies, he selects10.60% as his common equity cost rate. He also recommends that his cost of equity be adjusted down 0.16% in recognition of Company financial risk that is lower than that of his barometer group, up 0.40% to recognize Columbia's smaller size, up 0.25%, claiming it's in recognition of Columbia's managerial performance, and up another 0.25%, claiming its in recognition of Columbia's history of acquiring other water systems. Mr. D'Ascendis' adjustments result in his final proposed cost of equity of 11.35%. I&E St. No. 1, p. 24.

11 The I&E criticisms of Mr. D'Ascendis' barometer group have been provided in an earlier section of this I&E Reply Brief.

and upward another 25 basis points to reflect his position that such an adjustment is necessary due to Columbia's history of acquiring and improving less viable systems. Mr. D'Ascendis' adjustments to his cost of common equity total an adjustment to common equity of 74 basis points. I&E St. No. 1, p. 37.

While I&E Witness Maurer is not opposed to using the CAPM results as a comparison to the results of the DCF calculation, she provides her opinion that it is inappropriate to give the CAPM and RP models comparable weight. I&E St. No. 1, p. 38-39. She explains the reason for this position, noting that the relevancy of the CAPM (and therefore, the RP method) does not carry over from the investment decision making process into the regulatory process and that the CAPM and RP method give results that indicate to an investor what the equity cost rate should be if current economic and regulatory conditions are the same as those present during the historical period in which the risk premiums were determined. I&E St. No. 1, p. 38-39. As she opines, by comparing CAPM and RP results with the current expected equity returns (DCF results), an investor can make rational buy and sell decisions within their portfolio. I&E St. No. 1, p. 38-39.

In comparison, I&E reiterates that the DCF method is the superior method for determining the rate of return for the current economic market and measuring the cost of equity directly. The CAPM and the RP method are less reliable indicators because they measure the cost of equity indirectly and risk premiums vary depending on the debt and equity being compared. Also, regulators can never be certain that economic and regulatory conditions underlying the historical period during which the risk premiums were calculated are the same today or in the future. I&E St. No. 1, p. 38-39.

In further criticism of Mr. D'Ascendis' Predicative Risk Premium Model (PRPM™),[12] I&E Witness Maurer observes that it is not used by investors and is based heavily on the recent performance of the industry, which is not expected to continue. I&E St. No. pp. 38-39. In support of that conclusion, she provides her observation and conclusion that the recent outperformance of the water industry is not expected to continue, citing an April 19, 2013, issue of Value Line, where that reputable report on the Water Utility Industry states:

> Equities in the Water Utility Industry may have finally peaked. Over the past nine months or so, investors have been pouring funds into this small industry and driving up prices. In our last report in January, the industry soared to a rank of 4 out of the 98 different stock groups in the Value Line Investment Survey. This outperformance was highly unusual, considering it was accomplished in a rising market. [13]

As the earnings of the Water Utility Industry is not expected to continue at recent levels, Mr. D'Ascendis' PRPM™™ weight given to recent time periods is inappropriate and serves to burden ratepayers with an inflated cost of equity that

---

12 The PRPM™™ is based on the theory that historical volatility can be used to predict future levels of risk and risk premiums. The PRPM™™ also gives greater weight to more recent time periods. Columbia St. No, p. 18.

13 I&E Exhibit No. 1, Schedule 3, page 1.

will not continue for the time Columbia's rates resulting from this proceeding will be in effect. I&E St. No. 1, p. 39.

For the foregoing reasons and those presented in the I&E Main Brief, the Commission should recognize the flaws in Company Witness D'Ascendis' methodologies and analyses and accordingly discount his rate of return recommendations.

7. Company Witness D'Ascendis' Size Adjustment To The Equity Cost Rate Is Unnecessary And Should Be Rejected.

Page 48 of the Company's Main Brief, contains a discussion of Mr. D'Ascendis' four adjustments to the common equity cost rate. Among those adjustments is a claim that relates to the size of Columbia's "jurisdictional rate base compared to the proxy group of water companies."[14]

I&E asserts that such a size adjustment is unnecessary because, while there is technical literature supporting adjustments relating to the size of a company, this literature is not specific to the utility industry. And importantly, as the Company bears the burden of proof of the components of each claim, Mr. D'Ascendis has not shown either that his barometer group is better able to absorb customer losses than Columbia <u>or</u> that Columbia has been significantly impacted by customer loss

---

14 Mr. D'Ascendis makes a 40 basis point adjustment because he believes that the Company has a greater relative risk than the average company in his barometer group due to its smaller size compared with the group.

in the past. I&E St. No. 1, p. 40. This lack of demonstrated proof for his adjustment alone justifies its rejection.

Mr. D'Ascendis claims that smaller companies are less able to cope with significant events which affect sales, revenues, and earnings and therefore investors expect to be compensated through greater returns. He also states that the loss of a few larger customers would have a greater effect on a small company than on a much larger, more diverse, customer base. Columbia St. No. 3, p. 34. In response, I&E Witness Maurer makes it clear that Mr. D'Ascendis has not shown that Columbia is less able to absorb loss than the water companies in his barometer group. Nor has Mr. D'Ascendis provided any evidence for the record that demonstrates that has in fact experienced the loss of any customer that has significantly impacted their revenue levels in the past. I&E St. No. 1, p. 40.

Further, there is academic evidence that supports the lack of validity for any such size risk adjustment for utilities. I&E St. No. 1, p. 40. I&E Witness Maurer has provided for the record her I&E Exhibit No. 1, Schedule No. 14, consisting of an article by Dr. Annie Wong, "Utility Stocks and the Size Effect: An Empirical Analysis," from the Journal of Midwest Finance Association in 1993, pp. 95-101, that concluded:

> The objective of this study is to examine if the size effect exists in the utility industry. After controlling for equity values, there is some weak evidence that firm size is a missing factor from the CAPM for the industrial but not

> for utility stocks. This implies that although the size phenomenon has been strongly documented for the industrials, the findings suggest that there is no need to adjust for the firm size in utility rate regulation.

Admittedly, this article is older, but remains credible unless a more current academic article is provided to refute these findings. I&E St. No. 1, p. 41.

Given the lack of evidence for the size adjustment as related to the utility industry and the lack of support for Mr. D'Ascendis' claim that Columbia may lose a large customer, Mr. D'Ascendis' size adjustment should be rejected.

8. Company Witness D'Ascendis' Management Efficiency Adjustment To The Equity Cost Rate Is Unnecessary And Should Be Rejected.

Among Mr. D'Ascendis' four adjustments to the common equity cost rate identified at page 48 of the Company's Main Brief, is a sought after premium for what the Company refers to as management efficiency. This adjustment by Mr. D'Ascendis relates to Company Witness Lewis' proposal to add 25 basis points to the recommended cost of equity in recognition of the Company's claimed outstanding service and commitment to the community. Mr. Lewis claims that the Company's lack of water quality issues, service to its customers and surrounding community, efforts to keep staffing levels low, and acquisitions of other water companies all demonstrate a level of management performance that should be rewarded with a 25 basis point increase to their cost of equity. Company St. No. 3, pp. 5-10.

In an effort to support such an adjustment, Mr. D'Ascendis cites to Aqua Pennsylvania's base rate case at Docket No. R-00072711 as a basis for the performance factor adjustment. Company St. No. 3, pp. 5-10. I&E St. No. 1, p. 42.

I&E submits that this claimed adjustment should be rejected. In response to the Company's claims, I&E Witness Maurer cited the 2011 Management Audit of the Company, where Columbia was found to be in need of minor improvement for all assessed areas except customer service, where they met expected performance levels.[15] I&E St. No. 1, p. 42. She also references that in the Aqua case cited by Mr. D'Ascendis, the Commission awarded Aqua 22 basis points based both on management performance and in recognition of Aqua's acquisition of troubled water systems. I&E St. No. 1-SR, p. 12.

Here, Columbia is requesting an additional 25 basis points for management performance alone. Importantly, the Commission rejected this type of claim in Columbia's last base rate proceeding, docketed at R-2008-2045157, determining that Columbia's management performance is adequate, but does not warrant a basis point adjustment to the return on equity. In that proceeding, the Commission addressed essentially the same arguments put forth here by Columbia and adopted the recommendation of the ALJ that rejected Columbia's request for a twenty-five basis point rate of return adjustment for management efficiency. Order at R-2008-2045157, p. 93. Referring to the Company arguments in the last case, the Commission stated there that, "[T]he ALJ pointed out that these all point to adequate, reasonable service, and this is not sufficient to warrant a rate of return premium of 0.25%. R.D. at 60-61." Order at R-2008-2045157, p. 91.

Given the lack of support and evidence for the management performance adjustment sought by the Company, it should be rejected as part of the proper determination of the cost of common equity.

9. Company Witness D'Ascendis' Acquisition Adjustment To The Equity Cost Rate Is Unnecessary And Should Be Rejected.

Among Mr. D'Ascendis' four adjustments to the common equity cost rate identified at page 48 of the Company's Main Brief, is a claimed acquisition adjustment. On that subject, Company Witness Lewis sought to advance the proposition that Columbia's acquisition of the Mountville municipal system in 1998 and the Marietta Grave Water Company (Marietta) in 2012 demonstrate that Columbia has a history of acquiring less viable water systems. Mr. Lewis also states that the Company has made improvements to both water systems. Columbia St. No. 1, pp. 10-11. Incorporating these contentions, Mr. D'Ascendis

---

15 Focused Management and Operations Audit of Columbia Water Company, Docket No. D-2011-2218445.

recommends an upward adjustment of 25 basis points based on Mr. Lewis' testimony of Columbia's acquisitions. Columbia St. No. 3, pp. 36-37.

I&E submits that this adjustment is without merit and should be rejected. The Company's alleged support is based on stale and insufficient data, as the 1998 acquisition of the Mountville Municipal System occurred 15 years ago. I&E St. No. 1, pp. 43-44. Also, the Company has filed at least four base rate cases (not including the instant proceeding) since that time and has more than sufficient opportunity to request an acquisition adjustment. As such, the request for an adjustment to the claimed return on equity based upon the acquisition of the Mountville Municipal System is no longer timely. I&E St. No. 1, pp. 43-44.

The Company also references the acquisition of Marietta Gravity in 2012 as a reason to be awarded an acquisition adjustment. As noted by I&E Witness Maurer in her Direct Testimony, although it can be noted that Marietta Gravity was a smaller company, Columbia failed to show that the system would not have been viable had Columbia not purchased it. I&E St. No. 1, pp. 43-44. She added that, although the acquisition of Marietta was found to be in the public interest and was beneficial to Marietta's customers, Columbia has failed to demonstrate that based on that one acquisition, they should be awarded an additional 25 basis points. I&E St. No. 1, pp. 43-44.

Given the lack of support and evidence for the acquisition adjustment sought by the Company, it should be rejected by the ALJ and the Commission.

For all the reasons cited above and in the I&E Main Brief, I&E respectfully asserts that the ALJ and the Commission should reject the Company's flawed arguments and analysis and instead adopted the I&E recommended overall weighted cost of capital of 7.07%, based upon a fully supported 9.15% cost rate of common equity.

F. RATE STRUCTURE

As recommended in the I&E Main Brief, customer charges and usage rates should be reduced proportionally to the percent decrease recommended by I&E in this proceeding. I&E MB, p. 55. Similarly, in the event the Commission were to grant some increase over present annual revenues, the same methodology should be applied and the revenue change allocated "across-the-board," as referenced in the Company Main Brief. Columbia MB, p. 61. As such, I&E recommends the proportional approach for either a rate increase or, as recommended by I&E in this case, for a rate rollback. I&E MB, p. 55.

G. COST OF SERVICE

As noted in the I&E Main Brief, I&E did not independently raise any cost of service issue that need be addressed by ALJ Buckley or the Commission in this proceeding.

IV. CONCLUSION

For the reasons set forth in this I&E Reply Brief, as well as those presented in the I&E Main Brief, the Bureau of Investigation and Enforcement respectfully requests that the Pennsylvania Public Utility Commission direct The Columbia Water Company to develop rates consistent with these instant I&E recommendations. Specifically, the Commission Order concluding this proceeding should provide that Columbia be directed to file tariffs, tariff supplements, or tariff revisions containing rates, provisions, rules and regulations, to produce $3,983,663 in allowable annual revenues, a reduction of $243,609 from the Company's present annual revenue level of $4,227,272.

Respectfully submitted,

Charles Daniel Shields
Senior Prosecutor
PA Attorney I.D. No. 29363

Richard A. Kanaskie
Deputy Chief Prosecutor
PA Attorney I.D. No. 80409

Johnnie E. Simms
Chief Prosecutor
PA Attorney I.D. No. 33911

Bureau of Investigation and Enforcement
Pennsylvania Public Utility Commission
P.O. Box 3265
Harrisburg, Pennsylvania 17105-3265
(717) 787-1976

Dated: October 7, 2013

Appendix A

Proposed Conclusions of Law

Proposed Conclusions Of Law

1. The Columbia Water Company has the burden of proof to establish the justness and reasonableness of every element of its rate increase request. 66 Pa.C.S.A. § 315(a) and 66 Pa.C.S.A. § 1308(d).

2. It is well-established that the evidence adduced by a utility to meet this burden must be substantial. *Lower Frederick Twp. v. Pa. P.U.C.*, 48 Pa. Cmwlth. 222, 226-227, 409 A.2d 505, 507 (1980); see also *Brockway Glass v. Pa. P.U.C.*, 63 Pa. Cmwlth. 238, 437 A.2d 1067 (1981).

3. In rate proceedings, it is well-established at the Commission and in the courts that the burden of proof does not shift to parties challenging a requested rate increase. Rather, the utility's burden of establishing the justness and reasonableness of every component of its rate request is an affirmative one and that burden remains with the public utility throughout the course of the rate proceeding. The courts have held that there is no similar burden placed on other parties to justify a proposed adjustment to the Company's filing. *Berner v. Pa. P.U.C.*, 382 Pa. 622, 631, 116 A.2d 738, 744 (1955); *Pa. P.U.C. v. Equitable Gas Co.*, 57 Pa PUC 423, 471 (1983); accord, *University of Pennsylvania v. Pa. P.U.C.*, 86 Pa. Cmwlth. 410, 485 A.2d 1217 (1984).

4. The Columbia Water Company's requested revenue increase request will result in an unjust and unreasonable level of rates, contrary to 66 Pa.C.S.A. § 1301.

5. The Bureau of Investigation and Enforcement's proposed annual revenue level will result in just and reasonable rates, consistent with 66 Pa. C.S.A. § 1301.

Appendix B

Proposed Ordering Paragraphs

THEREFORE,

IT IS RECOMMENDED:

1. The Columbia Water Company shall not place into effect the rates contained in Supplement No. 61 to Tariff Water - Pa. P.U.C. No.7, that have been found to be unjust, unreasonable, and therefore, unlawful.

2. The Columbia Water Company is hereby directed to file tariffs, tariff supplements, or tariff revisions containing rates, provisions, rules and regulations, consistent with the findings here, to produce revenues not in excess of $3,983,663, a reduction of $243,609 from the Company's present level of annual revenues of $4,227,272.

3. Tariffs, tariff supplements, or tariff revisions may be filed on less than statutory notice, and pursuant to the provisions of 52 Pa. Code § 53.31 and 52 Pa. Code § 53.101, and should be filed as soon as possible to become effective for service rendered on and after the date of entry of the Commission's Opinion and Order adopting this Recommended Decision.

4. The Columbia Water Company shall file detailed calculations with its tariff filing that shall demonstrate to the Commission's satisfaction that the filed rates comply with the proof of revenue, in the form and manner customarily filed in support of compliance tariffs.

5. The Columbia Water Company shall comply with all directives, conclusions and recommendations contained in this Recommended Decision that are not the subject of individual ordering paragraphs as fully as if they were the subject of specific ordering paragraphs.

6. The Columbia Water Company shall allocate the ordered decrease in annual operating revenues consistent to each customer class and rate schedule in the manner prescribed in this Recommended Decision.

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-2013-2360798
	:	
The Columbia Water Company	:	

CERTIFICATE OF SERVICE

I hereby certify that I am or will serve the foregoing **Reply Brief** on October 7, 2013, in the manner and upon the persons listed below, in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a party):

Served via electronic and first class mail or hand delivery

Thomas J. Sniscak, Esquire
William E. Lehman, Esquire
Hawke McKeon & Sniscak, LLP
100 North Tenth Street
Harrisburg, PA 17105

Daniel G. Asmus, Esquire
Office of Small Business Advocate
300 North Second Street
Suite 1102
Harrisburg, PA 17101

Christine M. Hoover, Esquire
Erin L. Gannon, Esquire
Office of Consumer Advocate
555 Walnut Street
5th Floor Forum Place
Harrisburg, PA 17101

Charles Daniel Shields
Senior Prosecutor
Bureau of Investigation and Enforcement
PA Attorney I.D. No.29363