**BEFORE THE**

**PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Pennsylvania Public Utility Commission :

:

v. : R-2014-2402324

:

Emporium Water Company :

Pennsylvania Office of Consumer Advocate :

:

v. : C-2014-2422783

:

Emporium Water Company :

**RECOMMENDED DECISION**

Before

Dennis J. Buckley

Administrative Law Judge

TABLE OF CONTENTS

[I. INTRODUCTION 1](#_Toc404064200)

[II. HISTORY OF THE PROCEEDINGS 3](#_Toc404064201)

[III. FINDINGS OF FACT 5](#_Toc404064202)

[IV. PUBLIC INPUT TESTIMONY 13](#_Toc404064203)

[V. DISCUSSION 17](#_Toc404064204)

[A. The Public Input Hearing of August 18, 2014 19](#_Toc404064205)

[B. Recommendations of the OCA and I&E 20](#_Toc404064206)

[1. Rate Base 21](#_Toc404064207)

[a. Proposed Deductions from Rate Base 21](#_Toc404064208)

[(1). Cash Working Capital 21](#_Toc404064209)

[(2). New $2,500,000 PennVest Plant 22](#_Toc404064210)

[2. Revenues 23](#_Toc404064211)

[a. Sale of Raw Bulk Water 23](#_Toc404064212)

[3. Expenses 24](#_Toc404064213)

[a. Rate Case Expenses 24](#_Toc404064214)

[4. Professional Services 25](#_Toc404064215)

[5. Unaccounted for Water 25](#_Toc404064216)

[6. Purification and Laboratory Supplies and Expenses 2](#_Toc404064217)6

[7. Maintenance of Structures and Improvements 26](#_Toc404064218)

[8. Lease Administrative Fee 27](#_Toc404064219)

[9. Distribution System Upgrade Recommendations 27](#_Toc404064220)

[10. Customer Complaint Log 30](#_Toc404064221)

[C. Rate of Return 30](#_Toc404064222)

[D. Capital Structure 31](#_Toc404064223)

[E. The Suggested Use of Depreciation Funds to Cover Debt 34](#_Toc404064224)

[F. Rate of Return on Common Equity 35](#_Toc404064225)

[G. Rate Structure and Rate Design 36](#_Toc404064226)

[1. Rate Structure 36](#_Toc404064227)

[2. Rate Design 36](#_Toc404064228)

[VI. CONCLUSION 37](#_Toc404064229)

[VII. CONCLUSIONS OF LAW 38](#_Toc404064230)

[VIII. ORDER 39](#_Toc404064231)

I. INTRODUCTION

This Recommended Decision considers the outstanding issues in a base rate case filed by Emporium Water Company (Emporium or Company). This Decision recommends that the Commission approve Emporium’s Supplement No. 25 to Tariff Water – Pa. PUC No. 5, and its proposed changes in rates, rules, and regulations that would produce $387,903 in additional annual operating revenues as filed. A Commission decision in this matter is due no later than January 29, 2015.

Emporium provides water service in a rural and mountainous area in north central Pennsylvania to a largely residential population of approximately 5,000 in the Borough of Emporium and portions of Shippen Township, Cameron County, Pennsylvania. (Emporium Statement No. 1 at 4:15-17)[[1]](#footnote-1) Both the local population in the geographic area and the Company’s customer base have been steadily declining. Currently, the Company serves less than 1,500 customers, mostly residential. (Emporium Statement No. 1 at 4:17-19) The Company’s service territory is surrounded by mountains, so the territory is isolated and not capable of interconnection with any other public water supply systems. The nearest system is located in St. Marys, PA, which is approximately 18 miles from Emporium. (Emporium Statement No. 1 at 4:19-22)

Originally, the Company operated a surface supply, gravity system with limited treatment and storage capacity. In 1996, the Company undertook a facilities project that included constructing a filtration plant, establishing a secondary source of supply (the Driftwood Sinnemahoning intake and transmission line), new controls, and additional storage facilities. That project represents approximately 45% of the Company’s rate base and was built using funds provided by a low interest $2,104,100.00 Pennsylvania Infrastructure Investment Authority loan. (Emporium Statement No. 1 at 5:3 – 5:8) Under that project, water from the Salt Run Dam and Reservoir and from the Driftwood Branch of the Sinnemahoning Creek was to be the primary and secondary source for the filtration plant for treatment and then introduction of "finished" or "filtered" water into the distribution system. Storage for the Company’s system was comprised of the Salt Run Dam and Reservoir and two (2) storage tanks, which also provided pressure stabilization.

The filtration plant and related facilities allow the Company to provide its customers with fully treated water and have improved the quality, quantity and pressure in the Company’s water supply system. (Emporium Statement No. 1 at 5:8 – 5:13)

The Company’s parent company (Deer Park Lumber) and its President Ronald Andrews have loaned Emporium approximately $589,071 for capital plant improvement purposes since acquiring Emporium.

In 2005 Emporium took a second loan from PennVest in the amount of $305,780 for numerous system improvements including Salt Run Reservoir intake rehabilitation and silt cleaning, emergency backup generator for Driftwood raw water intake, new water storage tank, general maintenance to the Wheaton Hollow tank, emergency generator for Salt Run water treatment plant, replacing 30 fire hydrants, buying spare high service pump, and furnishing and installing remote read meters.

In 2014, the Company undertook and is in the process of completing a $2,500,000 project financed by PennVest to: (1) construct a Sylvan Heights 150,000 gallon water storage tank and appurtenances, duplex pump station, and piping plan project consisting of the construction of approximately 417 LF of 8" mains; (2) construct a Britton Road 500,000 gallon water storage tank project and appurtenances including 1270 LF of 10" transmission main. (Emporium Statement No. 1 at 5:16 – 6:5) and (3) install a supervisory control and data acquisition (SCADA) system. The construction of these facilities is well under way and these facilities are estimated to be completed by the end of 2014. (Emporium Statement No. 3R at 5:16-18) Emporium’s PennVest loans are the primary reason for Emporium’s 82% long term debt. (Emporium Exhibit No. 1 at 2‑12)

As a consequence of Emporium’s use of low-interest PennVest loans and other loans from its parent company, its capital structure has become atypical and is 82% debt and 18% equity.

II. HISTORY OF THE PROCEEDING

On April 30, 2014, Emporium filed Supplement No. 25 to Tariff Water – Pa. PUC No. 5, to become effective on June 29, 2014. The filing contained proposed changes in rates, rules, and regulations intended to produce $387,903 in additional annual operating revenues.

On May 22, 2014, the Office of Consumer Advocate (OCA) filed a formal complaint against the filing.

On May 28, 2014, the Pennsylvania Public Utility Commission’s Bureau of Investigation and Enforcement (I&E) entered an appearance in this proceeding.

By Order entered June 19, 2014, the Commission suspended the filing by operation of law until January 29, 2015, and instituted an investigation to determine the lawfulness, justness and reasonableness of the proposed rates, rules, and regulations.

On June 26, 2014, a hearing notice was issued setting July 7, 2014 as the date of the prehearing conference in this case.

On June 27, 2014, the First Prehearing Order was issued relative to the July 7, 2014 prehearing conference.

On July 7, 2014, a prehearing conference was held at the Commission’s office in Harrisburg, Pennsylvania. Emporium, the OCA and I&E were each represented at this conference, and on July 14, 2014, a Second Prehearing Order was issued setting the agreed upon litigation schedule, certain modifications to the Commission’s discovery rules, and addressing other preliminary matters.

On July 15, 2014, a Third Prehearing Order was issued granting in part a Motion to Compel previously filed by the OCA.

Also on July 15, 2014, an Order was issued consolidating this rate case with the Complaint of the OCA separately docketed at Docket No. C-2014-2422783, as well as a Protective Order limiting the disclosure of confidential information on the public record consistent with the provisions of 52 Pa.Code § 5.423(a)(1)-(5).

On July 25, 2014, a Hearing Notice was issued setting August 18, 2014 as the date for a public input hearing at the Cameron County VFW, 427 East 3rd Street, Emporium, Pennsylvania.

The public input hearing was held in the Borough of Emporium on August 18, 2014, which produced a transcript of 95 pages.

On August 24, 2014, a Hearing Notice was issued setting September 17-18, 2014 as the dates for an evidentiary hearing in this case.

Formal evidentiary hearings were held on September 17 and 18, 2014. At that hearing, Emporium was represented by Thomas J. Sniscak, Esquire, and William E. Lehman, Esquire. The OCA was represented by Christine Maloni Hoover, Esquire, and by Hobart J. Webb, Esquire. I&E was represented by Allison C. Kaster, Esquire. Testimony was received from Dylan W. D’Ascendis, Craig J. Bauer, P.E., and Gary D. Shambaugh for Emporium. Testimony was received from Ethan H. Cline, Emily Sears, and Christine Wilson on behalf of I&E. Testimony was provided by Glenn A. Watkins, Terry L. Fought, and Ashley E. Everette on behalf of the OCA. The hearing produced a transcript consisting of 288 pages, and 52 exhibits. The parties subsequently e‑filed their testimony with the Secretary of the Commission.

On September 30, 2014, an Order was issued admitting Emporium Rejoinder Exhibit GDS-RJ-11 and I&E Cross Examination Exhibit No. 8 to the record of this proceeding.

Main Briefs were filed on September 30, 2014, and Reply Briefs were filed on October 14, 2014. The record closed on October 7, 2014.

This case is now ready for decision.

III. FINDINGS OF FACT

1. On April 30, 2014, Emporium Water Company filed Supplement No. 25 to Tariff Water – Pa. PUC No. 5, to become effective on June 29, 2014. The filing contained proposed changes in rates, rules, and regulations intended to produce $387,903 in additional annual operating revenues.

2. Emporium began to provide water service to the public in 1886. The current owner, Mr. Ronald Andrews, acquired the Company in 1990. At that time the system was not filtered. Shortly after such acquisition, Mr. Andrews led an initiative that resulted in obtaining financing and construction and putting into operation a new filtration plant and additional supply facility upgrades. (Emporium Statement No. 1 at 4:2-6)

3. Emporium provides water service in a rural and mountainous area in north central Pennsylvania to a largely residential population of approximately 5,000 in the Borough of Emporium and portions of Shippen Township, Cameron County, Pennsylvania. (Emporium Statement No. 1 at 4:15-17)

4. Both the local population in the geographic area and the Company’s customer base have been steadily declining. Currently, the Company serves less than 1,500 customers, mostly residential. (Emporium Statement No. 1 at 4:17-19)

5. Because the Company’s service territory is surrounded by mountains, the territory is isolated and not capable of interconnection with any other public water supply systems. In fact, the nearest system is located in St. Marys, Pennsylvania, which is approximately 18 miles from Emporium. (Emporium Statement No. 1 at 4:19-22)

6. Originally, the Company operated a surface supply, gravity system with limited treatment and storage capacity. In 1996, the Company undertook a facilities project that included constructing a filtration plant, establishing a secondary source of supply (the Driftwood Sinnemahoning intake and transmission line), new controls, and additional storage facilities. That project represents approximately 45% of the Company’s rate base and was built using funds provided by a low interest $2,104,100.00 Pennsylvania Infrastructure Investment Authority loan. (Emporium Statement No. 1 at 5:3 – 5:8)

7. At that time, raw water from the Salt Run Dam and Reservoir and from the Driftwood Branch of the Sinnemahoning Creek was pumped to the filtration plant for treatment. Storage for the Company’s system was comprised of the Salt Run Dam and Reservoir and two (2) storage tanks. The filtration plant and related facilities allow the Company to now provide its customers with fully treated water and have improved the quality, quantity and pressure in the Company’s water supply system. (Emporium Statement No. 1 at 5:8 – 5:13)

8. The Company’s parent company (Deer Park Lumber) and its President Ronald Andrews also loaned Emporium approximately $589,071 for capital plant improvement purposes. (Emporium Statement No. 1 at 4:6-10)

9. In 2005 Emporium took a second loan from PennVest in the amount of $305,780 for numerous system improvements including Salt Run Reservoir intake rehabilitation and silt cleaning, emergency backup generator for Driftwood raw water intake, new water storage tank, general maintenance to the Wheaton Hollow tank, emergency generator for Salt Run water treatment plant, replacing 30 fire hydrants, buying spare high service pump, and furnishing and installing remote read meters.

10. Presently, the Company has undertaken and is in the process of completing a $2,500,000 project financed by PennVest to: (1) construct a Sylvan Heights 150,000 gallon water storage tank and appurtenances, duplex pump station, and piping plan project consisting of the construction of approximately 417 LF of 8" mains; (2) construct a Britton Road 500,000 gallon water storage tank project and appurtenances including 1270 LF of 10" transmission main (Emporium Statement No. 1 at 5:16 – 6:5) and (3) install a supervisory control and data acquisition (SCADA) system. The construction of these facilities is under way and are estimated to be completed by the end of 2014. (Emporium Statement No. 3R at 5:16-18) Emporium’s PennVest loans are the primary reason for Emporium’s 82% long term debt. (Emporium Exhibit No. 1 at 2‑12)

11. Emporium’s original claim for rate base in its filing, as of September 30, 2014 is $4,495,588. (Emporium Statement No. 1 at 11:22-23; EMPORIUM Exhibit No.1 at 1-18) During the course of the proceeding, the Company discovered an error and its correction increased its rate base claim to $4,553,201. (GDS RJ-7 Revised) The individual adjustments to the rate base claim resulting in the revised rate base claim are as follows:

(1) The accumulated amount of federal deferred taxes was corrected to $308,000.00, which has the effect of increasing the Company's rate base by $55,000.00. (Emporium Rejoinder Exhibit GDS-RJ-7)

(2) The accumulated depreciation reserve was increased by $787.00 to $1,830,486.00.

12. The $2,500,000 PennVest project is ahead of schedule and is positioned to be completed by the end of 2014 and in service during January of 2015. (Emporium Statement No. 3R at 5:16-18)

13. The Company in the past has sold, pursuant to its tariffed rate based upon meter size, bulk water from its limited withdrawal permit from DEP for the Sinnemahoning Creek to only one customer, Cameron Resources. (Tr. 296)

14. There is no known and measurable dollar amount that would be realized from the sale of raw bulk water for fracking or other Marcellus Shale purposes over the next six or seven years. (Tr. at 293)

15. In September of 2014, Cameron Resources notified the Company that it would no longer obtain water supply from it. (Emporium Water Company Exhibit GDS-RJ-3)

16. Emporium has a direct competitor, Keystone Clearwater Solutions (Keystone), which now provides raw fracking water at a takepoint on the Driftwood Branch of the Sinnemahoning Creek about a mile upstream from Emporium’s takepoint on that same creek. (Tr. at 293)

17. Keystone can withdraw 1 million gallons per day compared to Emporium’s 275,000 gallons per day and can undercut Emporium’s rate. (Tr. at 293; Emporium Exhibit GDS-RJ-2; Emporium Rejoinder Exhibit GDS-RJ-8)

18. Raw water bulk sales are also highly dependent on the state of the fracking industry in north central Pennsylvania. (Emporium Statement No. 1R at 9:13)

19. Emporium’s estimated total rate case expense is $371,469. (Emporium Rejoinder Exhibit GDS-RJ-10)

20. The Company, in its filing requests a three-year normalization period. (Emporium Statement No. 1 at 10:9-12; Emporium Exhibit No. 1 at 1-15)

21. Emporium would likely be denied for a commercial loan based upon its future financial position resulting from inadequate revenues and rates, so essentially it could not even borrow money to pay rate case costs. (Tr. at 301)

22. The inability to recover unamortized balances of rate case costs would further erode Emporium’s financial viability. (Tr. at 301)

23. Should the Commission grant a three-year normalization period, Emporium will file a rate case within the next three years. (Tr. at 302)

24. Emporium has claimed $10,374 for Professional Services. (Emporium Exhibit No. 1 at 1-15)

25. The Company will incur additional professional services (legal and consulting) on an annual basis to address the general contract requirements of the PennVest loan.

26. Emporium accepts the OCA’s unaccounted for water numbers. (Tr. at 195) Therefore, the Company accepts the negative adjustment of $8,574 to the Company’s treating and pumping expenses. (Tr. at 304)

27. Emporium claimed $32,743 for Supplies and Expenses under the "Purification & Laboratory Expenses" category. (Emporium Exhibit No. 1 at 1-15) Chemical costs, like any supply cost, will likely increase in the future. Attempting to normalize these costs with stale or outdated costs from prior years is essentially imputing a decrease in the cost of chemicals in the future, which will not be the case. (Emporium Statement No. 1R at 15:3-14)

28. The Company claimed an expense of $10,420 for Maintenance of Structures and Improvements. (Emporium Exhibit No. 1 at 1-15)

29. With over $40,000 of needed repairs the next few years, the Company’s expenses claim of $10,420 for Maintenance of Structures and Improvements is prudent and reasonable.

30. The Company claimed an expense for a lease administrative fee of $2,744. The lease administrative fee is part and parcel of the costs associated with the leases in total. This is an appropriate expense that should be recovered by Emporium. (Tr. at 306–307)

31. Each year since the last rates were adopted in 2006, Emporium has had negative or minimal income available after debt service payments, including bulk water sales to the fracking industry. Instead of building up retained earnings for capital replacements, repairs or maintenance, Emporium has been building up tax loss carry-forwards. (Tr. at 322)

32. Deer Park Lumber is financially supporting the activities of Emporium Water. (Tr. at 319)

33. Emporium’s system is not extraordinarily old when compared to those throughout Pennsylvania, but Emporium does have certain circumstances that many other systems do not encounter. The very steep terrain causes pressure fluctuations throughout their system due to elevational changes in the water lines, as well as very cold climate in north central Pennsylvania, frost being driven deeper into the ground, causing movement of soils which potentially can cause lines to break. (Tr. at 196)

34. A review of the break history for Emporium Water Company reveals their line breaks are not excessive. Over the last three years they average just about 15 line breaks a year, which is reasonable. (Tr. at 196) The longest outage over the past three years was a 14 hour outage. Most repairs were taken care of within four to five hours, people were back in service, so it was a very short period of interruption. (Tr. at 198)

35. The Company’s Wheaton Hollow Tank and the Towner Run tank are currently furnishing adequate service to the customers of Emporium Water Company, both domestic and fire service, so there are no known problems with either of those facilities. No problems were found by DEP during a recent inspection. There were no issues presented to the staff of the Emporium Water Company for those two facilities. (Tr. at 204) The Wheaton Hollow Tank is in need of some cleaning, repair and recoating. Mr. Bauer estimates a cost of about $344,000 for that work. (Tr. at 204)

36. The Towner Run Tank is a much newer facility. It is a glass fused to steel bolted tank which does not need to be painted for the life of that facility though there might be a minor amount of silt that has been accumulated on the tank. (Tr. at 204–205) Every five to ten years the tank should be drained and power washed and then put back into service, and the Emporium Water Company has committed to doing that, funds permitting, by the end of 2015. (Tr. at 205)

37. Emporium Water Company’s valves should be exercised on a three to five year cycle. In 2012, Emporium exercised 46 of the 140 valves in their system and 48 of the 140 valves in 2011. They are currently on a three to four year cycle of exercising valves, so that falls within the three to five year recommended valve exercising cycle. (Tr. at 214) There are no valves that cannot be exercised. Every valve in the Emporium Water Company is currently operable. (Tr. at 214)

38. Emporium has replaced 37 of the 140 valves on their system, so in excess of 26 percent of the valves have been replaced in the last 20 years. (Tr. at 214)

39. The Company is in compliance with the PUC regulations for meter testing and beyond that, it has replaced 1,243 meters since 1997, which is 80 percent of the meters in the system. (Tr. at 214–215)

40. If Emporium were to replace the remaining 134 meters it would cost approximately $47,000. (Tr. at 215)

41. An appropriate, authorized overall rate of return is 7.17% based upon a comparative industry group "hypothetical" capital structure which consists of 46.29% long-term debt and 53.71% common equity at an embedded or actual debt cost rate of 2.68%. The recommended common equity cost rate is 11.05%. (Emporium Statement No. 2 at 2:2-16)

42. The hypothetical capital structure of 46.29% long-term debt and 53.71% common equity, is based on the average capital structure of a proxy group with an embedded long-term cost rate of 2.68%. This is Emporium’s pro forma embedded debt cost rate as of September 30, 2014. (Emporium Statement No. 2R at 9:9-13)

43. An actual capital structure as approved by the Commission in Emporium’s last rate case in 2006 is not workable as each year since the last rates were adopted, Emporium has had negative or minimal income available after debt service payments despite bulk water sales to the fracking industry which were additional revenues not contemplated at the time the 2006 rates were set. Instead of building up retained earnings for capital replacements, repairs or maintenance, Emporium’s rates have been building up tax loss carry-forwards. (Tr. at 322)

44. After principal repayments of $935,086 on PennVest loans between 2007 through 2013, Emporium had income available after total debt service payments of a negative $713,148. (Emporium Rebuttal Exhibit GDS-RJ-5; Tr. at 316–317)

45. Mr. Andrew’s and Deer Park’s infusion of money into Emporium Water has resulted in well maintained facilities, (Emporium Rejoinder Exhibit CB-RJ1), and there were no quality of service issues raised by any party in this proceeding.

46. Emporium’s requested relief will produce $33,932 in net income in the first year and $105,411 of net income for the remaining years the rates are in place. The rates proposed by Emporium are in line with other providers of filtered water service in the state. (Emporium Statement No. 2R at 4:1-2; GDS Rebuttal Exhibit No 1 Revised; Schedule DWD-R1; Tr. at 314‑316)

47. The ratemaking formula [RR = D + T + O&M + R(RB)] is clear that an annual depreciation expense is cost recoverable through rates and is distinct from the cost of capital, which provides revenues to cover profit and debt service. Depreciation is a separate and distinct element not related to the return on rate base, operating expenses and taxes. (Tr. at 283:9-14) The ratemaking formula is exact. The revenue requirement equals depreciation, taxes, operating and maintenance expenses and return on rate base. (Tr. at 283:15-20)

48. The recommended return on equity is 11.05%, based on an assessment of market-based cost of common equity models using a proxy group of water companies based on the results of an analysis of a group of nine water companies comparable (but not identical) in risk to Emporium, using three market-based cost of equity models; i.e., the Discounted Cash Flow, the Risk Premium Model and the Capital Asset Pricing Model (CAPM), including the empirical CAPM ("ECAPM"). (Emporium Statement No. 2 at 2:28-3:17; Schedule DWD-1)

49. Because the Company must compete with non-price regulated firms for capital, a selected group of seventeen domestic, non-price regulated companies comparable in total risk to a proxy group of nine water companies with the application of three market-based costs of equity models allows the determination of an appropriate cost of equity for Emporium. (Emporium Statement No. 2 at 34–38) (Emporium Statement No. 2R at 20– 22)

50. A Discounted Cash Flow analysis based on a proxy group of nine water companies comparable in risk to Emporium produces an equity cost rate of 8.75%. (Emporium Statement No. 2 at 11:19–12:18; Emporium Statement No. 2 at 4:7; Emporium Appendix B at Schedules DWD-1 and DWD-3)

51. A risk premium model analysis produces an equity cost rate of 10.99% for the proxy group. (Emporium Statement No. 2 at 4:8; Appendix B at Schedule DWD-5)

52. The indicated common equity cost rate for Emporium before adjustments to reflect certain differences in risk between Emporium and the proxy group of water companies is 10.30%. (Emporium Statement No. 2 at 4; Appendix B at Schedule DWD-1) With one adjustment to the common equity cost rate to account for the difference in business risk attributable to the smaller size of Emporium’s jurisdictional rate base compared to the proxy group of water companies, the indicated common equity cost rate for Emporium is 11.05%. (Emporium Statement No. 2 at 39–41)

53. Customer billing analysis at present rates (Supporting Schedule No. 1) includes all bills rendered including those bills for customers lost. Therefore, the bills and water use associated with the customers lost at present rates must be removed from the billing determinants to accurately establish the revenues to be billed from the proposed rate design. Supporting Schedule No. 10 includes the adjustments for the loss of customers, their water use and the re-blocking of the billed water use resulting from the elimination of the water allowance. (Emporium Statement No. 1R at 10:14-23)

IV. PUBLIC INPUT TESTIMONY

On August 18, 2014, a public input hearing was held in Emporium, Pennsylvania, which produced a transcript consisting of 68 pages. The following are summaries of the testimony presented at that hearing.

Samuel A. Smith

Samuel A. Smith is a member of the council at the Senior Citizens Center in Emporium. He characterized the requested increase as “ridiculous,” and questioned the ability of residents to pay it. He also opined that such an increase would adversely impact schools and drive out businesses.

Alvin D. Lyon

Alvin D. Lyon is a resident of Emporium. While he is concerned with the size of the requested increase and the ability of senior citizens to pay it, he is most concerned about aging infrastructure and 80-90 year old distribution lines. He feels that any increase should be directed to the replacement of those lines. He did state that a business had recently closed in Emporium (Graf Tech) with the loss of many jobs.

Tina J. Solak

Tina J. Solak is a resident of Emporium. She is also the Executive Director of the Chamber of Commerce. She testified that the Emporium Water Company is a very responsible utility, but she did complain about one specific leak that is taking a long time to correct. She opined that the requested increase is excessive with the rate almost doubling for commercial customers. She asked that the rate increase be considerably lowered from the amount requested.

Joann Park

Joann Park is a resident of Emporium. She testified that she and her family obtain drinking water from a spring and complained about the quality of her tap water, stating that in the summer the water stinks and has a bad taste. She also agreed that the rate increase would be a burden on seniors (those over 65 years old).

Joseph Desio

Joseph Desio is a resident of Emporium. He stated that he had read that one reason for the increase was to build two new holding tanks, but he does not see the need for the tanks, nor does he understand why the Company did not budget the cost so as not to need such a large rate increase. He also testified that a volumetric declining cost change to the metering system will only encourage people to waste water.

John Kautz

John Kautz is a resident of Emporium. He was formerly in the plumbing business and had an ongoing business relationship with the Company. He testified that about eight years ago a fire occurred at his business which resulted in the total loss of the business, but that the Company provided in excess of 100,000 gallons of water to fight the fire, saving the building that he currently resides in. He suspects that the hydrant service provided by Emporium results in lower insurance rates and cited the Company’s water storage capacity as essential for public safety. He suggested that although the requested rate increase is high, an increased cost of $0.70 per day is about what people pay for a cup of coffee. He commended the Company for its repair of a water line break the previous winter. With respect to the issue of taste, he opined that DEP requires chlorination, but he uses a charcoal filter in his home and drinks city water.

Deborah Hathaway

Deborah Hathaway is a resident of Emporium. While she considers a rate hike inevitable, she thinks that the Company’s request is unrealistic given what people can afford. She lives with her mother and splits bills with her, but her mother is on a fixed income, and her own income is small. She hopes that the Commission will take the economic cost of an increase to the ratepayers into account.

Bruno Carnovale

Bruno Carnovale is a resident of Emporium. He testified that Emporium has a high unemployment rate, is losing industry, and is losing population. While he understands the Company’s position, he feels the requested increase is too high. He agreed with Mr. Kautz that the Company provides good service. He expressed concern not only for the senior citizens but for younger people and young unmarried people in paying a substantial rate increase.

Donna Holly

Donna Holly is a resident of Emporium. She is a senior citizen on a fixed income, and she agrees with those who testified expressing concern at the size of the requested rate increase. She expressed concern that all costs continue to go up while Social Security does not keep pace.

Don Olivett

Don Olivett is a resident of Emporium and a businessman. He owns three businesses and five rental properties. He testified that the Company is responsive and does a very professional job. His concern is the ability of people to pay the requested increase in rates. He stated that the demographics of the area are 35 percent-plus retirees with a 10 percent unemployment rate. School enrollment has declined approximately 40 percent in the past 20 years. While he agreed that the water system requires upgrades, he feels that it is poor management not to pass through costs gradually with a 10 year capitalization. He stated that an increase of $90 per quarter is more than the people of Emporium can bear. He also stated that asking for a 50 percent increase but settling for a 15-20 percent increase may get people to accept the increase, but it is still not the right thing for the people of Emporium.

Ruth Metcalf

Ruth Metcalf is a resident of Emporium. She testified that she agrees with the testimony offered and understands the need for infrastructure improvement, but she questioned the current quarterly billing system because most people budget on a monthly basis. From her perspective, the high amount of quarterly bills is an issue.

Geraldine Smith

Geraldine Smith is a resident of Emporium. She expressed the concern that the local school uses a lot of water, and that any rate increase that results in higher water bills for the school will ultimately be passed on to the residents of Emporium as well.

Robert Hostler

Robert Hostler is a resident of Emporium. While he agreed with the potential negative impact of a rate increase on older citizens, he testified with respect to how he believes the increase would affect younger citizens. He opined that a retiree actually makes more money than younger people, and that a young family of four will not be able to sustain a budget if the increase is granted. He believes that there are people living in Emporium without water service because they cannot afford it. He questioned why the rate increase was not planned for years ago and argued that the proposed increase will adversely affect the entire town and that people will simply stop paying their bills.

Kelli Farabaugh

Kelli Farabaugh is a resident of Emporium. There are six people living in her home, but only one has an income. She testified that she suffers from acid reflux and that the water makes her sick. She stated that she travels to a spring 10 miles away for drinking water. All of the residents in her home drink the spring water. She also testified that the water in her bathtub is sometimes yellow. She asked who would bear the rate increase with the population of the area declining. She is concerned that the location of the Company’s storage tanks may lead to flooding if something would ever happen to the tanks.

V. DISCUSSION

A public utility has the burden of proof to establish the justness and reasonableness of every element of its rate increase request in all proceedings under 66 Pa.C.S. § 1308(d). The standard to be met by the public utility is set forth at 66 Pa.C.S. § 315(a):

**Reasonableness of rates.** –In any proceeding upon the motion of the Commission, involving any proposed or existing rate of any public utility, or in any proceeding upon complaint involving any proposed increase in rates, the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility.

66 Pa.C.S. § 315(a)

The Commonwealth Court of Pennsylvania set forth the utility’s burden of proof in a rate proceeding pursuant to 66 Pa.C.S. § 315(a) as follows:

Section 315(a) of the Public Utility Code, 66 Pa.C.S. Section 315(a), places the burden of proving the justness and reasonableness of a proposed rate hike squarely on the public utility. *It is well-established that the evidence adduced by a utility to meet this burden must be substantial*.

*Lower Frederick Twp. Water Co. v. Pa. Pub. Util. Comm’n*., 48 Pa. Cmwlth. 222, 226-227, 409 A.2d 505, 507 (1980) (emphasis added). *See also*, *Brockway Glass Co. v. Pa. Pub. Util. Comm’n*., 63 Pa. Cmwlth. 238, 437 A.2d 1067 (1981).

In general rate increase proceedings, the burden of proof does not shift to parties challenging a requested rate increase. Rather, the utility’s burden of proof to establish the justness and reasonableness of every component of its rate request is an affirmative one and that burden of proof remains with the public utility throughout the course of the rate proceeding. There is no similar burden placed on other parties to justify a proposed adjustment to the public utility’s filing. The Pennsylvania Supreme Court has held:

[T]he appellants did not have the burden of proving that the plant additions were improper, unnecessary or too costly; on the contrary, that burden is, by statute, on the utility to demonstrate the reasonable necessity and cost of the installations, and that is the burden which the utility patently failed to carry.

*Berner v. Pa. Pub. Util. Comm’n*., 382 Pa. 622, 631, 116 A.2d 738, 744 (1955).

However, a public utility does not need to affirmatively defend every claim it has made in its filing, even those which no other party has questioned, in proving that its proposed rates are just and reasonable. The Pennsylvania Commonwealth Court has held:

While it is axiomatic that a utility has the burden of proving the justness and reasonableness of its proposed rates, it cannot be called upon to account for every action absent prior notice that such action is to be challenged.

*Allegheny Center Assocs. v. Pa. Pub. Util. Comm’n.*, 131 Pa. Cmwlth. 352, 359, 570 A.2d 149, 153 (1990) (citation omitted). See also*, Pa. Pub. Util. Comm’n. v. Equitable Gas Co.*, 73 Pa. PUC 310, 359 – 360 (1990).

Additionally, 66 Pa.C.S. § 315(a) does not place the burden of proof on the utility with respect to an issue the utility did not include in its general rate case filing and which, frequently, the utility would oppose. The burden of proof must be on a party to a general rate increase case who proposes a rate increase beyond that sought by the utility.

This case presents two distinct choices with virtually no middle ground, nor do I think it appropriate or possible on the basis of this record for me to try to craft a middle-ground “solution.” Simply put, one can choose the actual capital structure and the adjustments thereto recommended by the public advocates, or one can adopt the Company’s hypothetical structure and the requests based on it. I understand that in the 2006 rate case, the ALJ recommended, and the Commission adopted, a decision based on the actual capital structure. Having heard this case and reviewed the evidence, I agree with the Company. That approach did not work. Emporium is effectively being subsidized by its Deer Park parent because the Company’s financial posture makes it so unattractive in constrained capital markets. Deer Park management has made it clear that this will not continue. Further, the picture painted in this case is of an efficient, well-run company that must function as a stand-alone entity. While I understand the concern of the public advocates about the potential appearance of “unjust enrichment” related to the PennVest loans taken by the Company, I find no evidence to suggest that the management of the Company has engaged in or has shown a propensity to engage in using the Company as some sort of cash cow. To the contrary, the principal’s (Ronald Anderson) other business interest (Deer Park Lumber) is keeping the Company afloat with loans. That cannot continue.

A. The Public Input Hearing of August 18, 2014

Compelling testimony was presented by Emporium’s ratepayers at the August 18, 2014 public input hearing, and their comments need to be considered. The generally expressed concern is that the rate increase is too high and will not be affordable for young adults struggling in a recessionary job market or seniors who rely primarily on Social Security. The majority of those who testified either raised no quality of service issues or commended the Company for its service and responsiveness.

I do understand that rate increases during hard economic times are unwelcome. However, water is an essential commodity, and the Company must remain economically viable. As will be explained throughout this Recommended Decision, Emporium faces many of the dilemmas that confront other small water companies, and it cannot continue to rely on subsidization from other businesses in the form of cash transfusions. At least one individual complained about a perceived lack of foresight on the part of the Company. While I do not accept that characterization, the Company *would* be failing to exercise foresight if it did not present an aggressive strategy such as that put forward in this case.

Any rate increase will be a burden for these ratepayers. What the Company should do to help mitigate that effect is to transition to monthly billing.

B. Recommendations of the OCA and I&E

As active parties in this case, both the OCA and I&E have recommended multiple adjustments that would result in substantial reduction of Emporium’s requested rate increases. I&E maintains that the Company is entitled to an increase in revenue of no more than $129,112. I&E Main Brief at 5. The OCA recommends a revenue requirement of no more than $139,928. OCA Main Brief at 3.

Both parties presented the testimony of qualified witnesses in support of their recommendations. However, the public advocates’ view of the Company’s request paints a picture of an entity that is seeking to foist debt onto its ratepayers without justification. That is not so. While this Recommended Decision will address the separate issues in this case, the dichotomy between the Company’s approach and that of the public advocates is stark, and can be highlighted with an example.

At the most basic level, I&E states that “The fundamental building block in determining Emporium’s overall cost of capital hinges upon a determination of the appropriate capital structure to be utilized.” I agree. Where I part ways with I&E and the OCA is when they contend that the Commission must adopt the Company’s actual capital structure in this proceeding. I&E Main Brief at 27. I do not agree with the OCA contention that the use of the Company’s proposed hypothetical capital structure would result “in windfall profits to Emporium.” OCA Main Brief at 35. In listening to and later reviewing the testimony of the witnesses in this case, I found that presented by the public advocates’ witnesses so inflexible as to allow no cognizance to be taken of the unique circumstances facing the Company. Even beyond that, I agree with the Company when it states:

At its core, OCA and I&E punish Emporium financially for using low interest PennVest loans, and that is a bad thing. Revenues after debt service will not be used by Emporium for dividends and, instead, it has on the record committed to using those monies for system betterment and to allow it to be able to obtain loans to do projects it would like to do.

Emporium Main Brief at 9.

While the “safe” course in this proceeding might be to adopt the public advocates’ positions, in the long and perhaps even in the mid-term to do so will serve only to deny the Company access to the capital it needs.

1. Rate Base

a. Proposed Deductions from Rate Base

(1). Cash Working Capital

I&E proposes a negative adjustment of $3,100 for uncollectibles (bad debt expense) asserting that uncollectibles should be treated as a non-cash item. Wilson Surrebuttal 16-19. Emporium’s witness Shambaugh countered that there is no ratemaking basis for the exclusion of this item from the cash working capital calculation. Tr. at 292. Cash working capital is an investment made by the stockholders to provide funds for operations until the customers pay their bills and funds are available to pay operating expenses. Until the recovery of the expense through customer rates, Emporium has to provide capital to recover the costs incurred in serving non-paying customers and has a right to earn a return on this investment. Tr. at 292. I agree. I&E’s removal of the uncollectible expense resulting in a negative adjustment of $3,100 to the cash working capital claim should be rejected.

(2). New $2,500,000 PennVest Plant

The parties argue extensively with respect to the appropriate treatment of the Company’s new debt as the result of a $2,500,000 PennVest loan that will expire in 2015. No one challenged the Company’s prudence in taking this loan. I note that the PennVest loan is guaranteed by Deer Park and Ronald Andrews personally. Emporium Statement No. 2R at 9. I&E acknowledges that "PennVest provides low cost financing of water projects at affordable cost that are not currently available through other sources." I&E Statement No. 1 at 15. The new $2,500,000 PennVest project makes up the bulk of the Company's debt and includes: (1) constructing a Sylvan Heights 150,000 gallon water storage tank and appurtenances, duplex pump station, and piping plan project consisting of the construction of approximately 417 LF of 8" mains; (2) constructing a Britton Road 500,000 gallon water storage tank project and appurtenances including 1270 LF of 10" transmission main (Emporium Statement No. 1 at 5–6); and (3) installing a supervisory control and data acquisition (SCADA) system. This new plant will provide additional fire protection for the town of Emporium by providing additional water storage. Emporium Reply Brief at 49, 52. The low PennVest loan interest rate also benefits customers through lower rates by passing through the resultant embedded debt cost rate (another of the inputs of the rate of return formula). However, the acquisition of that debt has changed the Company’s financial posture since the 2006 rate case. The use of the actual embedded long-term debt cost rate of the Company which includes the PennVest loan, results in a very low debt rate compared to a typical water company, but it does not result in a “windfall” for the Company. Emporium Reply Brief at 50-51 citing Emporium Statement No. 2R at 6. I agree with the Company that a hypothetical capital structure will promote, as opposed to punish, the Company’s PennVest borrowing with its low interest rates which Emporium has reflected in the rate of return/ratemaking process.

2. Revenues

a. Sale of Raw Bulk Water

The sale of raw bulk water was an issue that evolved even as the evidentiary hearing in this case neared. Emporium believes, based upon updated record evidence, that no revenue for the sale of bulk water should be imputed on a going forward basis. I agree.

In its rebuttal testimony, which was done before additional information was supplied by Cameron Resources, the Company believed that an entity called Cameron Resources would remain a customer. In September of 2014, Cameron Resources notified the Company that it would no longer obtain supply from it. Emporium Water Company Exhibit GDS-RJ-3, is a letter from Cameron Resources, who is the only customer of Emporium for raw bulk water. That letter unequivocally states that Cameron will not remain a customer.

The Company also agreed, and in view of declining Marcellus Shale activity driven largely by plummeting gas prices and over supply, that it would accept $14,000 of revenue imputation, which is approximately 50% of the $28,883 generated in 2013 that I&E witness Cline used as his imputation basis. Emporium Statement No. 1R at 9 However, that was before the notification by Cameron. The Company’s final position on this issue is more accurately stated in its Main Brief:

Given that during the test year, Emporium’s only bulk water customer has indicated that it will no longer be taking water from Emporium and there is now a formidable competitor for the sale of bulk water within a mile of Emporium that can undercut their rates, there is no known and measureable amount of bulk water that can be attributed to Emporium during the period when the new rates will be in effect. OCA and I&E’s bulk water revenue addition should be rejected.

Emporium Main Brief at 16.

The Company also argues that:

Both OCA and I&E's positions, however, are based solely on past sales and the pure speculation that there might be additional sales in the future, despite OCA's recognition that only "known and measurable changes should be reflected for ratemaking purposes." (OCA MB at 11) Company witness Shambaugh testified that there is no known and measurable dollar amount that would be realized over the next six or seven years that I&E and OCA, respectively, contend rates set here will be in effect.

Emporium Reply Brief at 11 citing Tr. at 293.

Finally, in Main Brief I&E suggests that, Emporium might be selling bulk water in the future to EQT Corporation (EQT). I&E Main Brief at 11. As the Company points out, this assertion, which is based on a newspaper article (I&E Cross-Examination Exhibit 7), is not correct. EQT is not a bulk customer of Emporium.

I agree. The OCA and I&E positions are not only speculative, there is no evidentiary basis for the Company having a bulk water revenue addition going forward.[[2]](#footnote-2)

3. Expenses

a. Rate Case Expenses

The issue here is the normalization period to be used to recover Rate Case Expenses. The Company requests a three-year normalization period. Emporium Statement No. 1 at 10; Emporium Exhibit No. 1 at 1-15. The OCA recommends a 6-year normalization period based on the Company’s past three rate case filing intervals. OCA Statement 1S at 13-15. I&E recommends a five-year normalization period based on the Company’s past four rate case filing intervals. I&E Statement No. 2-SR at 7-11. While there is nothing unreasonable, per se, with the public advocates’ recommendations, Emporium has a sound basis for its proposed three year normalization period.

Emporium’s witness, Mr. Shambaugh testified that considering current information and the challenges the Company will be facing, a three-year normalization period for the recovery of rate case costs is reasonable and fair. Further, should the Commission grant the three-year period, Emporium stipulated that it will file a rate case within the next three years. Tr. at 302.

I agree with the proposition that Emporium is obligated to pay rate case costs now, not in five or six years. Emporium Main Brief at 19. Emporium cannot afford to lose the ability to recover prudently expended rate case costs for regulation, thus, effectively preventing Emporium from filing a rate case sooner than the normalization period that’s approved by the Commission because they lose the ability to recover those costs. Emporium Main Brief at 17-18; Reply Brief at 17-18.

4. Professional Services

Emporium claimed $10,374 for Professional Services (Emporium Exhibit No. 1 at 1‑15). OCA witness Everette recommended a negative adjustment of $1,022 based on two invoices, one from AUS Consultants for $680.75 and one from Hawke, McKeon and Sniscak LLP for $341.15. Ms. Everette believes these amounts should be moved to rate case expense. The Company disagrees with Ms. Everette, contending that these costs were not rate case specific, but were related to services provided to the Company on an ongoing basis. In other words, the costs were to monitor the financial viability of Emporium and essentially provide advice to them for a number of different issues. Emporium Main Brief at 20; Emporium Reply Brief at 19-20. The explanation is reasonable, no evidence to the contrary was presented, and the proposed adjustment of $1,022 should be rejected.

5. Unaccounted for Water

The Company accepts the OCA’s negative adjustment of $8,574 to the Company’s treating and pumping expenses. Tr. at 304 Therefore, this is no longer an issue.

6. Purification and Laboratory Supplies and Expenses

The OCA recommended a negative adjustment of $2,482 for non-chemical Supplies and Expenses based on a two-year normalization. OCA Statement No. 1S at 3-5. I&E recommended a negative adjustment of $2,835 for Supplies and Expenses. I&E statement No. 2-SR at 18. The Company disagrees with these proposed adjustments, stating:

[C]hemical costs like any supply cost will increase in the future, not go down. Attempting to normalize these costs with stale or outdated costs from prior years, is, essentially imputing a decrease in the cost of chemicals in the future, which will not be the case. Furthermore, neither witness explains a correlation between their suggested rate case recovery period of six (6) years and their hope or guess that the cost of chemicals will remain at a two (2) or three (3) year historical average for the next 6 years. They are wrong, and the result is to short the Company of expenses that are necessary to provide service.

Both OCA and I&E Witnesses employ mathematical calculations in an effort to support their proposed adjustments but do not explain how their adjustments would be relative to the future market for chemicals, six (6) or seven (7) years in the future. Both witnesses’ calculations are result-oriented and should be rejected by this Commission.

Emporium Main Brief at 22, citing Emporium Statement No. 1R at 15.

Emporium’s reasoning in this respect is sound and the negative adjustments proposed by the OCA and I&E should be rejected.

7. Maintenance of Structures and Improvements

Emporium claimed an expense of $10,420 for Maintenance of Structures and Improvements. Emporium Exhibit No. 1 at 1-15. OCA witness Everette recommended an allocation of $6,267 for Maintenance of Structures and Improvements, an adjustment of $4,153 (OCA statement No. 1 at 20), based on a two-year normalization of this expense. OCA Statement No. 1S at 25. Emporium provided information that the repairs needed over the next few years will amount to $41,019. Mr. Shambaugh testified that if witness Everette’s proposed adjustment is adopted, Emporium will only have $6,267 (her allowance) per year for maintenance of structures and improvements, and based upon the uncontested needed repairs of $41,019, it will take the Company over six and a half years to generate enough funds through rates to make those repairs. Tr. at 306.

The Company is correct that with over $40,000 of needed repairs over the next few years, the expenses claim of $10,420 for Maintenance of Structures and Improvements is prudent and reasonable. The OCA’s negative adjustment of $4,153 should be rejected.

8. Lease Administrative Fee

The Company claimed an expense for a lease Administrative Fee of $2,744. OCA witness Everette made a negative adjustment of the entire fee because she claims it is not a recurring expense, or in the alternative the amount should be amortized over a five-year period. OCA Statement No. 1S at 27. I&E witness Wilson accepted the $2,744 fee but recommended that it be amortized over a five-year period. I&E Statement No. 2-SR at 12. The Company disagreed with OCA’s proposal that this fee should be eliminated contending that the fee is an appropriate expense that is “part and parcel of the costs associated with the leases in total.” However, the Company’s witness, Mr. Shambaugh, agreed that the costs should not be recovered in one year. Tr. at 307.

Neither the OCA nor I&E has argued that the fee is unnecessary for administering the leases for the equipment. Neither party contested that the leased equipment is not necessary for the continuing operations and maintenance of Emporium's water system. This adjustment assumes the Company will not continue to face these fees and it would “short” the Company money. Emporium Reply Brief at 23.

The OCA’s negative adjustment of $2,744 should be rejected. A three-year amortization of this cost is reasonable and should be adopted.

9. Distribution System Upgrade Recommendations

In its Main Brief the Company understandably expresses concern about the testimony of I&E witness Ethan Cline and the OCA witness Terry Fought. Emporium Main Brief at 24-31. I share that concern because it was unclear and remains unclear whether these witnesses are advocating actions that must take place or are just offering recommendations. In an understandable act of caution, the Company has briefed the points raised by these witnesses.[[3]](#footnote-3) I am of the opinion that neither of the public advocates’ witnesses offered testimony supported by a preponderance of the evidence that would incline me to treat what they had to say as anything more than recommendations. Those recommendations should not be translated into ordering paragraphs both because they were more observational than evidentiary, and (more importantly) because the Company is doing a commendable job in maintain its facilities and serving the public.

Mr Cline made recommendations about the age of the Company’s distribution system and the line breaks that occurred and recommended that mains be replaced. OCA witness Fought, in his direct and surrebuttal testimony, made observations about certain Company facilities that in his estimation should be taken care of by the Company in the near future. Significantly, neither I&E nor the OCA provided any revenues or adjustments to implement their recommendations.

I agree with the Company when it argues:

To further illustrate the bad results occasioned by OCA’s and I&E’s capital structure recommendation and adjustments they would repeat here, Mr. Shambaugh explained that the rates they successfully advocated resulted not in the revenues they convinced the Commission would occur, but in accumulated tax loss carryforwards for Emporium available for fiscal year 2013 amounting to $670,478. Deer Park Lumber’s financial condition is supporting the activities of Emporium Water. (Tr. at 319:3-6)

As explained fully in the next section, both Mr. D’Ascendis, through Schedule DWD-R1, and Mr. Shambaugh, through GDS Rebuttal Exhibit No. 1 (updated) have both shown that under I&E’s and OCA’s positions in this case, Emporium will have Net Income after Total Debt Service in the red for the years the rates in this case will be in effect. Furthermore, neither Mr. Andrews nor Deer Park Lumber is willing to subsidize the operations of the Company in the future if OCA’s and I&E’s capital structure and inadequate rates are adopted. (Tr. at 309:18-24) That will make it next to impossible for the Company to borrow money to complete these tasks.

Emporium Main Brief at 26.

With respect to the inspection and painting of storage tanks proposed by the OCA, I was somewhat taken aback when the OCA, at hearing, introduced a highly prejudicial picture of the Wheaton Hollow Tank. While that tank needs external maintenance, that isolated picture is by no means a fair representation of the Emporium system in its entirety. See Emporium Rejoinder Exhibit CB-RJ1 for a much more comprehensive picture of the Company’s facilities. The introduction of the Wheaton Hollow Tank picture by the OCA and their strident objection to the introduction of Emporium Rejoinder Exhibit CB-RJ1 did little to enhance the credibility of the OCA’s presentation.

With respect to exercising isolation valves, the OCA asked that the Company’s isolation valves be exercised within three years, that the Company develop an exercising and replacement schedule and that the Company develop a replacement schedule for the valves that cannot be successfully exercised through a full cycle. OCA Statement 3S at 10. In response, the Company’s witness convincingly argued that valves should be exercised on a three to five year cycle. Tr. at 214. Most tellingly, the Company’s witness testified that "there are no valves that cannot be exercised. Every valve in the Emporium Water Company is currently operable." Tr. At 214.

With respect to meter age and testing, the OCA’s contention that the Company should replace all meters that have not been tested and move forward with testing any meters that are not replaced in accordance with the Commission’s regulations, is micro-managing. OCA Statement 3S at 11. If these along with the rest of the public advocates’ testimony are in the nature of recommendations, the Company may take them under advisement. If, however, the public advocates’ witnesses were obliquely implying that the Company is suffering from deficiencies that *must* be corrected, then they failed to make their case. Because the Company is in compliance with the Commission's regulations regarding meter testing and replacement, and there is no allegation that there is any problem with the remaining 134 meters, the Commission cannot require Emporium to replace the remaining 134 meters. *West Penn Power Company v. Pa. Pub. Util. Commn.*, 478 A.2d 947 (Pa. Cmwlth. 1984).

This entire area of contention may be summed up through the testimony of Company witness Craig J. Bauer:

There were several recommendations that focused on very finite and small components of the Emporium Water Company system -- the O&M of the bulk of the system costs money every single day. They are focusing on very minor things that have a capital cost.

I believe that it has to be looked at as a whole, O&M and capital needs going forward. Without including funding for the Wheaton Hollow Tank, which should have some attention to it – again, no one’s claiming that there’s any problem with the tank providing service, but at some point everything wears out. Everything needs to be replaced.

As Dylan was indicating, you know, the depreciation, you need to be able to acquire funds to replace components that wear out. And that doesn’t appear to be provided for in the rate structure that we’re currently seeing.

Tr. at 216; Emporium Main Brief at 30.

10. Customer Complaint Log

The OCA alleges in its Main Brief that the Company does not keep a log of customer complaints that tracks when the Company receives a complaint or what the nature of that complaint is and requests that the Commission's final order direct Emporium to do so. OCA Main Brief at 78. The Company has agreed to keep a customer complaint/compliment log on a going forward basis. Emporium Reply Brief at 28.

C. Rate of Return

The OCA has recommended an overall rate of return of 3.58% based on a capital structure of 81.88% long-term debt and 18.12% common equity. OCA Statement 2 at 2. I&E has recommended an overall rate of return of 2.50% based on a capital structure of 82.21% long-term debt and 17.79% common equity. I&E Statement No. 1 at 6. These extremely low rates of return reflect the unworkability of the public advocates’ approach to this case.

The Company witness, Dylan W. D’Ascendis, recommended that the Commission authorize Emporium the opportunity to earn an overall rate of return of 7.17% based upon a comparable industry group hypothetical capital structure which consists of 46.29% long-term debt and 53.71% common equity at an embedded or actual debt cost rate of 2.68%. He also recommended a common equity cost rate of 11.05%. Emporium Statement No. 2 at 2. While the Commission may see fit to adjust this, these recommendations are at least in the zone of reasonableness and fiscal reality.

I agree with Emporium when it states in its Main Brief:

Emporium is the only party in this proceeding that recommends a return on rate base sufficient enough to pay their debt service and to provide a meager return to equity investors which Emporium has committed not to use for dividends but for the benefit of the system. (Tr. at 62:15-17) Hopefully, all would agree that rates sufficient to allow a utility on its own to grow reserves for system repairs, maintenance and improvements, and which enable it to borrow money – are in the public interest.

Emporium Main Brief at 32.

D. Capital Structure

At the heart of this case—and illustrative of the widely diverging views of the parties—is the issue of which capital structure should be used: the actual capital structure of the Company or a hypothetical capital structure based on an industry average. The public advocates insist that the actual capital structure must be used, relying on “traditional” ratemaking theory and the underlying 2006 base rate case (in which actual capital structure was used). The Company convincingly argues that use of the actual capital structure in the 2006 rate case did not work and that the use of a hypothetical capital structure will bring financial stability to the Company whereas the use of actual capital structure will bankrupt it. Emporium Main Brief at 32-40.

I agree with the Company that Emporium’s actual capital structure of 82% debt and 18% equity is atypical and that this atypical debt laden basis causes the ratemaking formula not to work. Emporium Main Brief at 32. Emporium’s rate of return expert recommends a comparable industry average or hypothetical capital structure of 46.29% long-term debt and 53.71% common equity, which is based on the average capital structure of his proxy group at December 31, 2013 with an embedded long-term cost rate of 2.68%. This is Emporium’s pro forma embedded debt cost rate at September 30, 2014. Emporium Main Brief at 33; Emporium Statement No. 2R at 9. I take very seriously Mr. D’Ascendis’ statement that: “[I]f this order comes out and the actual capital structure is used, it’s going to bankrupt the company. They’re not going to be able to pay the debts. They’re not going to be able to pay." Tr. at 128. With respect to the OCA and I&E reliance on the use of the actual capital structure in the 2006 rate case, I would simply observe that that case is not binding precedent on the Commission. If, as it would appear, the continuation of the methodology used in that case would only aggravate the financial problems facing the Company, then it is time for a new approach.

The gradual financial deterioration of the Company is set forth candidly and in detail in the Company’s Main Brief. An extract from that Brief may demonstrate what is happening with the Company under its present structure, and what is likely to happen if that continues:

This approach [the 2006 Order based on actual capital structure] did not work, as each and every year since the last rates were adopted, Emporium has had negative or minimal income available after debt service payments despite bulk water sales to the fracking industry which were additional revenues not contemplated at the time 2006 rates were set. Instead of building up retained earnings for capital replacements, repairs or maintenance, Emporium’s rates have been building up tax loss carry-forwards. (Tr. at 322:2-9) Now the parties want to repeat those errors for the next six years, and, in addition, to require Emporium to spend monies while rates are in effect on a variety of things, for which, Mr. Shambaugh noted, those parties do not provide rate revenues. (Tr. at 322:10-14)

Mr. Bauer echoed those same sentiments at the hearing when he testified, regarding the recommendations/mandates proposed by OCA, that "Every capital improvement has a capital cost and without the funding being provided for in rates, the work can’t be done. It’s really simple." (Tr. At 216:3-5) Furthermore, he testified, "you need to be able to acquire funds to replace components that wear out. And that doesn’t appear to be provided for in the rate structure that we are currently seeing." (Tr. At 216:21-23)

\* \* \*

As Mr. Shambaugh testified, GDS-RJ-5 shows that after principal repayments of $935,086 on PENNVEST loans existing between 2007 through 2013, Emporium had income available after total debt service payments of a negative $713,148. (Tr. at 316:23 – 317:2) He further explained that the first two columns, net operating income and annual interest payments, come directly from page 35 of Emporium’s annual reports to this Commission. The net operating income of $221,938 basically is the net numbers from Ms. Everette’s testimony. The PENNVEST payments are the annual calendar year payments for the existing PENNVEST payments. (Tr. at 318:2-8) And it shows income available after total debt service of negative $713,148. (Tr. at 318:10-11)(emphasis added) Further, he testified, based upon the parties’ contention in this proceeding that the Company should use annual depreciation expense, which he thoroughly disagrees with, to pay debt service, even if the Company did that in those years from 2007 to 2013, they had annual depreciation expense totaling $581,095, which still would have provided the Company with a cash shortfall of $132,053. (Tr. At 318:12-18) Mr. Shambaugh testified that with the inadequate rates, Emporium had to use depreciation expense in order to pay current debt costs, and so they didn’t have those reserves available, and they should have those reserves available. (Tr. at 323:11-16) Further he testified, "It would have been really nice right now to have $581,000 for the year 2013 built up for annual depreciation expense maybe to fix the Wheaton Hollow Tank, or, you know, power wash the Towner Run Tank or be able to go out and exercise the valves, or, in the best case scenario, maybe the PENNVEST loan wouldn’t have been $2.5 million, maybe it would have only been $2 million." (Tr. at 323:16:22) He explained: "the problem is that, again, we’re trying to use revenue requirements for more than one purpose than what they’re designed, and the ratemaking methodology and the overall rates that are being deployed do not allow that to take place. That’s why we’re seeing the net operating losses for Emporium and we’re seeing insufficient rates and the inability to essentially attract capital." (Tr. at 323:22 – 324:4)

Emporium Main Brief at 34-35.

Emporium’s recommendation is to authorize a hypothetical capital structure based upon a comparable proxy group so Emporium can have a chance to attract capital, establish a representative capital structure, and limit subsidization of rates. Emporium’s recommendation balances both the interests of the ratepayers, who get the benefit of a low actual embedded debt rate, with that of the Company in having enough money to function and have earnings that the Company can use to build equity to move toward a more representative capital structure over time. See, Emporium Statement No. 2R at 11–12. Emporium argues (and I see no reason to doubt) that its position, if adopted, will produce $33,932 in net income (Emporium Statement No. 2R at 4; Schedule DWD-R1) in the first year and $105,411 of net income for the remaining years the rates are in place. GDS Rebuttal Exhibit No 1 Revised.

Emporium’s Reply Brief reprises the foregoing arguments and includes this interesting footnote in summary:

The insufficient rates caused the Company to utilize annual depreciation funds to meet annual debt service requirements taking away funds that are earmarked for capital renewals and replacements thus reducing the customer's rates. This caused the common stockholder (Deer Park Lumber) to provide cash to meet the revenue shortfall in customer rates. The insufficient customer rates resulted in annual operating losses and accumulated federal tax loss carry forwards of $690k available for 2014 and beyond. Since the Company will not have a federal income tax liability, resulting from the inadequate customers rates, the customers will experience reduced rates until the federal tax loss carry forwards are fully applied to the Company's future tax liabilities. The Commission's establishment of inadequate rates flows back all the benefits of Emporium's poor financial performance to the customers and rewards the ratepayers for paying low rates for the past seven years and this must be corrected to insure a financially viable water system in the future.

Emporium Reply Brief at 3, fn. 2.

While I would hesitate to term the ratepayers beneficiaries of poor financial performance, I do not question that they will bear the consequences if the financial issues of the Company are not adequately and appropriately addressed.

E. The Suggested Use of Depreciation Funds to Cover Debt

Depreciation expense cannot be used as a revenue stream to supplement shortfalls created by a lack of return on investment. As Emporium’s witness Shambaugh states: "the ratemaking formula [RR = D + T + O&M + R(RB)] is clear that an annual depreciation expense is cost recoverable through rates and is distinct from the cost of capital, which provides revenues to cover profit and debt service. Depreciation is a separate and distinct element not related to the return on rate base, operating expenses and taxes." Emporium Main Brief at 42 citing Tr. at 283. He further explained, "The ratemaking formula is exact. The revenue requirement equals depreciation, taxes, operating and maintenance expenses and return on rate base. Nowhere in the ratemaking formula does it say you depreciate or you basically subtract depreciation from your rate of return in order to arrive at a net income." Emporium Main Brief at 43 citing Tr. at 283. Again, I agree.

F. Rate of Return on Common Equity

Emporium requests a return on equity (ROE) of 11.05%, based on an assessment of market-based cost of common equity models using a proxy group of water companies. Emporium Statement No. 2 at 2-3; Schedule DWD-1. I&E recommends an ROE of 8.89%. I&E Statement No. 1 at 6. The OCA recommends an ROE of 9.10%. OCA Statement No. 2 at 2.

The relevant legal standard applicable to the authorized rate of return has been stated succinctly by the Commission, citing *Bluefield Water Works & Improvement Co. v. West Virginia Public Service Commission*[[4]](#footnote-4)and *Federal Power Commission v. Hope Natural Water Co.*[[5]](#footnote-5):

The authorized return must be commensurate with that which can be earned in an enterprise with comparable risk. Furthermore, the return must be reasonably sufficient to assure confidence in the financial integrity of the company. Finally, the return should permit the company to maintain its credit and attract capital.

I agree that the Company’s position allows it to pay its debt service (which includes principal payments and interest) and provides a modest return on equity ($34k). I&E’s and the OCA’s positions fail to meet the standards set by the *Hope* and *Bluefield* by not even allowing the Company to pay their debt service, which may lead to possible default on the loans and the bankruptcy of the Company.

The Company maintains, and I agree, that both I&E and OCA's cost of capital positions of 2.50% and 3.58%, respectively, do not allow the Company the revenues to satisfy its debt service or to provide a fair return to equity investors. The Company characterizes this as an attempt by I&E and the OCA to “re-engineer the embedded long-term debt cost rate by eliminating certain debt from the capital structure or by readjusting the cost rates of debt because they do not comport with current market rates. Emporium Reply Brief at 6 citing OCA Main Brief at 56.

As Mr. D'Ascendis stated in his rebuttal and rejoinder testimonies, all of the affiliate debt is correctly categorized as debt, all of that debt finances rate base, and all of the debt was issued at or below market rates at the time of issue. Tr. at 380.

G. Rate Structure and Rate Design

1. Rate Structure

The proposed increase in revenues was allocated on an "across-the-board" basis to all customers. No party has opposed this structure.

2. Rate Design

The OCA recommended that Emporium change its billing analysis so the billing determinants are the same on both the present and proposed billing analysis. OCA Statement No. 1S at 32. The Company responded that the customer billing analysis at present rates (Supporting Schedule No. 1) includes all bills rendered including those bills for customers lost. Therefore, the bills and water use associated with the customers lost at present rates must be removed from the billing determinants to accurately establish the revenues to be billed from the proposed rate design. Emporium Statement No. 1R at 10. The Company stated that if it gained a customer for the partial year under present rates, the Customer Bill Frequency Analysis determinants at proposed rates would be increased to reflect those partial year billings to annualize for those customers gained. Tr. at 308.

I&E recommended a scale-back of all Company proposed rates to the level of approved revenues in this proceeding, proposing to reduce the 5/8" monthly customer charge, as an example, to $11.10 from the Company proposed $12.00 per month. All other customer charges by meter size would be reduced proportionately. I&E Statement No. 3 at 21. The Company disagrees, requesting that the customer charges be established as filed, regardless of the approved level of additional annual revenue for the purpose of revenue stabilization, as critical to the operation of the Company. I agree.

VI. CONCLUSION

As stated at the outset, this case presents us with two very distinct choices: find that the Company has met its burden and adopt its methodology, or accept the methodology and adjustments proposed by the public advocates. While I understand that the former will result in a significant rate increase, the Company’s approach makes sense. Sooner or later, the hard fact must be faced that the Company needs to alter its financial posture to continue operating. The approach recommended by the public advocates, that is, to continue the same course adopted in the 2006 rate case, has been shown by the Company to have failed. That approach has not resulted in stabilization of the Company’s finances.

The Company is being kept afloat with loans from PennVest and from its corporate parent, Deer Park Lumber, and that business’ principal, Ronald Andrews. Those capital sources have understandably stated that they will not continue loaning money to the Company. Further, such additional revenue as the Company might have realized from bulk water sales to drilling/fracking operations in the area has been shown by the Company as no longer viable for revenue production. This Company must have access to capital markets, and to do so, it must have a sounder financial picture than it does at present.

The fact that the Company is in its present condition is by no means an adverse reflection on the Company or its management. Public testimony and the record in this case established that the Company is well run and responsive to its customers. While I recognize the public testimony that a rate increase will be difficult for many, if the public is to continue to enjoy the services of the Company, a rate increase there must be.

The course proposed by the public advocates is not sound, nor was any of the evidence presented by the public advocates of such weight as to warrant the continuation of the methodology of the 2006 rate case. Even beyond the issue of basic methodology in determining rates, the multiple adjustments proposed by the public advocates are not justified. The Company has agreed to consider several recommendations made by the public advocates, and that is not only appropriate, it is all this record supports.

For all of the reasons stated above, it is recommended that the Emporium Water Company place into effect the rates, terms and conditions of service contained in Emporium’s Supplement No. 25 to Tariff Water – Pa. PUC No. 5 which are just and reasonable and therefore, lawful.

VII. CONCLUSIONS OF LAW

1. The Pennsylvania Public Utility Commission has jurisdiction over the Parties and subject matter of this proceeding. 66 Pa.C.S. §§ 701, 1308(d).

2. A public utility seeking a rate increase has the burden of proof to establish the justness and reasonableness of each element of its request. 66 Pa.C.S. § 315(a).

3. A public utility is entitled to rates that will allow it to recover its costs for expenses that are reasonably necessary to provide service to its customers. *Western Pa. Water Co. v. Pa. Pub. Util. Comm’n,* 422 A.2d 906 (Pa. Cmwlth. 1980).

4. The Commission must authorize a sufficient, or fair, rate of return to public utilities to ensure adequate revenues to cover operating expenses, debt serviced expenses and common and preferred (if necessary) dividends, as well as to maintain the financial integrity of the utility and enable the public utility to attract needed debt in equity capital in the marketplace or on reasonable terms, in competition with firms of similar risk. *Federal Power Commission v. Hope Natural Gas Co.,* 320 U.S. 591 (1944) and *Bluefield Water Works Improvement Co. v. Public Service Commission,* 262 U.S. 679 (1923).

5. It is important that there be enough revenues not only for operating expenses, but also for the capital costs of the business. These include service in the debt and dividends on the stock. By that standard, the return to the equity owner should be commensurate with returns on investment and other enterprises having corresponding risk. That return, moreover, should be sufficient to ensure confidence in the financial integrity of the enterprise, so as to maintain credit and to attract capital. *Federal Power Commission v. Hope Natural Gas Co.,* 320 U.S. 591, 603 (1944).

6. Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property, in violation of the Fourteenth Amendment. *Bluefield Water Works Improvement Co. v. Public Service Commission,* 262 U.S. 679, 690 (1923).

7. Pennsylvania Courts and the Pennsylvania Public Utility Commission have adopted the U.S. Supreme Court legal standards regarding the rate of return in *Hope* noting this case requires the Commission to balance utility company and ratepayer interests in setting rates. *Pennsylvania Electric Co. v. Pa. Pub. Util. Comm’n,* 509 Pa. 324, 502 A.2d 130 (1985).

VIII. ORDER

THEREFORE,

IT IS RECOMMENDED:

1. That Emporium Water Company place into effect the rates, terms and conditions of service contained in Emporium’s Supplement No. 25 to Tariff Water – Pa. PUC No. 5 which have been found to be just and reasonable and therefore, lawful.

2. That Emporium Water Company shall file tariffs, tariff supplements or tariff revisions containing proposed rates, rules and regulations, which are consistent with the Recommended Decision and which provide for an increase of $387,903 in additional annual operating revenues.

3. That Emporium Water Company’s tariffs, tariff supplements or tariff revisions may be filed upon one day’s notice, pursuant to the provisions of 52 Pa.Code §§ 53.31 and 53.101, and be effective for service rendered on and after the date of entry of the Final Order in this matter.

4. That Emporium Water Company shall comply with all directives, conclusions and recommendations in the Recommended Decision that are not the subject of individual ordering paragraphs as fully as if they were the subject of specific ordering paragraphs.

5 That Emporium Water Company shall allocate the authorized increase in operating revenues to each customer class and rate schedule within each class in the manner set forth in the Recommended Decision.

6. That the investigation at Docket No. R-2014-2402324 be terminated and marked closed.

7. That the Complaint filed by the Office of Consumer Advocate in this proceeding at Docket No. C-2014-2422783 be terminated and marked closed.

DATED: November 17, 2014 /s/

Dennis J. Buckley

Administrative Law Judge



|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| TABLE I(A) | | | | | |
| Emporium Water Company | | | | | |
| RATE OF RETURN | | | | | |
| R-2014-2402324 | | | | | |
|  |  |  |  |  |  |
|  |  |  |  |  | After-Tax |
|  |  |  |  |  | Weighted |
|  | Structure |  | Cost |  | Cost |
|  |  |  |  |  |  |
|  |  |  |  |  |  |
|  |  |  |  |  |  |
| Long-term Debt | 46.29% |  | 2.68% |  | 1.24% |
| Common Equity | 53.71% |  | 10.76% |  | 5.78% |
|  |  |  |  |  |  |
|  | 100.00% |  |  |  | 7.02% |
|  |  |  |  |  |  |
|  |  |  |  |  |  |
| Source - ALJ Recommended Decision page 11 item 47. | | | | |  |
|  |  |  |  |  |  |



1. I have adopted the citation form used by Emporium in its briefs as the most workable in accessing the testimony and exhibits that support Emporium’s case. [↑](#footnote-ref-1)
2. Alternatively, in its Reply Brief, Emporium submits no more than $14,000 of bulk water sale revenue should be imputed to Emporium based upon Mr. Shambaugh's adjustment (prior to knowing the only customer no longer will use Emporium). Emporium Reply Brief at 7, 15. It is clear to me that going forward, this potential source of revenue no longer exists. [↑](#footnote-ref-2)
3. The Company and I&E have indicated that they would be willing to discuss system improvements, an offer which the Company also extended to the OCA. Emporium Reply Brief at 26. [↑](#footnote-ref-3)
4. 262 U.S. 679 (1923). [↑](#footnote-ref-4)
5. 320 U.S. 591 (1944). [↑](#footnote-ref-5)