



100 Pine Street • PO Box 1166 • Harrisburg, PA 17108-1166
Tel: 717.232.8000 • Fax: 717.237.5300

Adeolu A. Bakare
Direct Dial: 717.237.5290
abakare@mcneeslaw.com

November 29, 2016

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street, 2nd Floor
Harrisburg, PA 17120

VIA ELECTRONIC FILING

**RE: Pennsylvania Public Utility Commission, *et al.* v. City of DuBois – Bureau of Water;
Docket No. R-2016-2554150**

Dear Secretary Chiavetta:

Enclosed for filing with the Pennsylvania Public Utility Commission is the Main Brief of the City of DuBois – Bureau of Water, in the above-referenced docket.

As shown by the attached Certificate of Service, all parties to this proceeding are being duly served with a copy of this document. Thank you.

Sincerely,

McNEES WALLACE & NURICK LLC

By

A handwritten signature in black ink, appearing to read 'A. Bakare', is written over a horizontal line.

Adeolu A. Bakare

Counsel to the City of DuBois – Bureau of Water

Enclosure

c: Deputy Chief Administrative Law Judge Mark A. Hoyer (via E-Mail and First-Class Mail)
Certificate of Service

www.mwn.com

HARRISBURG, PA • LANCASTER, PA • SCRANTON, PA • STATE COLLEGE, PA • COLUMBUS, OH • WASHINGTON, DC

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a true copy of the foregoing document upon the participants listed below in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant).

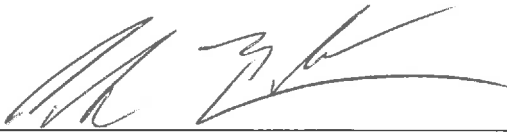
VIA E-MAIL AND FIRST CLASS MAIL

Steven C. Gray, Esq.
Office of Small Business Advocate
Suite 202, Commerce Building
300 North Second Street
Harrisburg, PA 17101
sgray@pa.gov

Phillip C. Kirchner, Esq.
Pennsylvania Public Utility Commission
Bureau of Investigation & Enforcement
P.O. Box 3265
Harrisburg, PA 17105-3265
phikirchne@pa.gov

Christine M. Hoover, Esq.
Harrison W. Breitman, Esq.
Office of Consumer Advocate
555 Walnut Street
Forum Place – 5th Floor
Harrisburg, PA 17101-1921
choover@paoca.org
HBreitman@paoca.org

Thomas T. Niesen, Esq.
Charles Thomas, III, Esq.
Thomas, Niesen & Thomas, LLC
212 Locust Street, Suite 600
Harrisburg, PA 17101
tniesen@tntlawfirm.com
cet3@tntlawfirm.com



Adeolu A. Bakare

Counsel to the City of DuBois – Bureau of Water

Dated this 29th day of November, 2016, at Harrisburg, Pennsylvania.

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Pennsylvania Public Utility Commission, et al. :
: **R-2016-2554150**
v. :
:
City of Dubois – Bureau of Water :

**MAIN BRIEF OF THE
CITY OF DUBOIS – BUREAU OF WATER**

James P. Dougherty (Pa. I.D. No. 59454)
Adeolu A. Bakare (Pa. I.D. No. 208541)
Alessandra L. Hylander (Pa. I.D. No. 320967)
McNees Wallace & Nurick LLC
100 Pine Street
P.O. Box 1166
Harrisburg, PA 17108-1166
Phone: (717) 232-8000
Fax: (717) 237-5300
jdougherty@mcneeslaw.com
abakare@mcneeslaw.com
ahylander@mcneeslaw.com

Counsel to the City of DuBois – Bureau of Water

Dated: November 29, 2016

TABLE OF CONTENTS

I.	INTRODUCTION	1
A.	Background.....	1
B.	Burden of Proof.....	3
II.	SUMMARY OF ARGUMENT	4
III.	ARGUMENT	6
A.	Rate Base	6
1.	Plant in Service	6
2.	Additions to Rate Base.....	7
3.	Deductions from Rate Base	8
4.	Conclusion	8
B.	Revenues.....	9
1.	Falls Creek	9
a.	<i>Background</i>	9
b.	<i>Notifications to PUC Regarding Interconnection with Falls Creek</i>	9
c.	<i>Sandy Township Position on Falls Creek Borough</i>	10
2.	Union Township Contract Sales	13
3.	Borough of Sykesville Contract Sales	15
C.	Expenses.	15
1.	Unaccounted For Water	15
2.	Wages.....	17
3.	Overtime	18
4.	Payroll/FICA Taxes	19
5.	WTP Contractual	19
6.	Transmission & Distribution ("T&D") Contractual Services Expense.....	20
7.	Rate Case	21
8.	WTP Vacant Property	24
9.	General Administrative Expenses.....	25
10.	Allocation of City Manager Salary	26
11.	Allocation of Health Insurance and Other Benefits for Administrative Employees.....	29
12.	City Buildings/Computer Parts/Supplier Software.....	29
13.	Pension.....	30

D.	Taxes.....	32
E.	Rate of Return.....	32
	1. Introduction.....	32
	2. Legal Standard	33
	3. Capital Structure	34
	4. Risk Analysis	41
	5. Cost of Common Equity	43
F.	Miscellaneous Issue	55
	1. Motion to Strike Portions of OCA Statement No. 2S.....	55
G.	Rate Structure.....	57
	1. Cost of Service.....	57
	2. Revenue Allocation.....	57
	3. Tariff Structure.....	58
IV.	CONCLUSION.....	58

TABLE OF AUTHORITIES

Cases:

Bluefield Water Works & Improvement Company v. P.S.C. of West Virginia,
262 U.S. 679 (1923)

City of Lancaster – Bureau of Water v. Pennsylvania Public Utility Commission,
Docket No. R-2010-2179103 (Order entered July 14, 2011)

Consolidated Edison Co. v. NLRB, 305 U.S. 197 (1938)

Helwig v. DOT, Bureau of Driver Licensing, 99 A.3d 153 (Pa. Commw. 2014)

Hurley v. Hurley, 754 A.2d 1283 (Pa. Super. Ct. 2000)

Pa. Pub. Util. Comm'n. v. Lemont Water Co., 1994 Pa. P.U.C. LEXIS 44, (1994)

Mill v. Pa. P. U. C., 447 A.2d 1100 (Pa. Cmwlth. 1982)

Murphy v. Commonwealth, Dept. of Public Welfare, White Haven Center,
480 A.2d 382 (Pa. Cmwlth. 1984)

Norfolk & Western Ry. v. Pa. P. U. C., 413 A.2d 1037 (Pa. 1980)

Pa. Pub. Util. Comm'n. v. PPL Gas Utils. Corp. 102 Pa. P.U.C. 325 (2007)

Pa. PUC v. Borough of Media, 77 Pa. PUC 481 (1992)

Pennsylvania Public Utility Comm'n v. Emporium Water Company, PUC Docket No.
R-2014-2402324 (Order entered Jan. 28, 2015)

Pennsylvania Public Utility Comm'n v. City of Lancaster - Sewer Fund, Docket No. R-
00049862 (Pa. PUC 2005)

Riverton Consolidated Water Company v. Pennsylvania Public Utility Commission,
140 A.2d 114 (Pa. Super. 1958)

Samuel J. Lansberry, Inc. v. Pa. P. U. C., 578 A.2d 600 (Pa. Cmwlth. 1990)

Se-Ling Hosiery, Inc. v. Margulies, 70 A.2d 854 (Pa. 1950)

Statutes:

2 Pa. C.S. §704

Pennsylvania Public Utility Code,
66 Pa. C.S. § 332(a)

66 Pa. C.S. § 1102(a)(5)

Other Authorities:

Joint Petition of Metropolitan Edison and Pennsylvania Power Co. for Approval of Smart Meter Technology Procurement and Installation Plan, Docket No. R-2009-2123950 (Initial Decision of ALJ Colwell, issued Jan. 28, 2010)

I. INTRODUCTION

A. **Background**

On June 30, 2016, The City of DuBois – Bureau of Water ("City"), filed with the Pennsylvania Public Utility Commission ("PUC" or "Commission") Supplement No. 22 to Tariff Water Pa. P.U.C. No. 4 ("Supplement No. 22") proposing to increase jurisdictional revenues by \$257,604. *City of Dubois – Bureau of Water Request for Approval to Increase Water Rates*; Docket No. R-2016-2554150 (June 30, 2016). The supporting documentation in the filing included: City of DuBois Statement No. 1, the Direct Testimony of John "Herm" Suplizio ("City Statement No. 1"), City of DuBois Statement No. 2, the Direct Testimony of Constance Heppenstall ("City Statement No. 2"); City of DuBois Statement No. 3, the Direct Testimony of John J. Spanos ("City Statement No. 3"); and City of DuBois Statement No. 4, the Direct Testimony of Harold R. Walker ("City Statement No. 4").

On July 14, 2016, the Office of Consumer Advocate ("OCA") and the Office of Small Business Advocate ("OSBA") each filed a Complaint in this proceeding. A formal Complaint was also filed by Sandy Township on July 20, 2016. The Bureau of Investigation and Enforcement ("I&E") filed a Notice of Appearance on July 15, 2016. Other than Sandy Township, no end-use customers intervened in the rate proceeding and no customers requested public input hearings.

On August 11, 2016, the Commission suspended Supplement No. 22 for investigation. The filing was referred to the Office of Administrative Law Judge ("OALJ") for Alternative Dispute Resolution or hearings before Deputy Chief Administrative Law Judge ("ALJ") Mark A. Hoyer. A Prehearing Conference was held on September 9, 2016, before ALJ Hoyer, at which time the ALJ approved a procedural schedule establishing deadlines for testimony, hearings, and briefs.

On September 23, 2016, all parties convened for an Initial Settlement Conference. Subsequent settlement discussions continued amongst the parties through approximately October 14, 2016.

In accordance with the approved litigation schedule, the City received Direct Testimony from the following parties on October 5, 2016: OCA, OSBA, I&E, and Sandy Township. OCA submitted OCA Statement No. 1, the Direct Testimony of Ashley E. Everette ("OCA Statement No. 1"); and OCA Statement No. 2, the Direct Testimony of Terry L. Fought ("OCA Statement No. 2"). I&E submitted I&E Statement No. 1, the Direct Testimony of Rachel Maurer ("I&E Statement No. 1"); I&E Statement No. 2, the Direct Testimony of D.C. Patel ("I&E Statement No. 2"); and I&E Statement No. 3, the Direct Testimony of Ethan Cline ("I&E Statement No. 3").¹ OSBA submitted OSBA Statement No. 1, the Direct Testimony of Brian Kalcic ("OSBA Statement No. 1"). Finally, Sandy Township submitted OSBA Statement No. 1, the Direct Testimony of David Monella ("Sandy Township Statement No. 1").

The City submitted Rebuttal Testimony on October 20, 2016: City of DuBois Statement No. 1-R, the Rebuttal Testimony of John "Herm" Suplizio ("City Statement No. 1-R"); City of DuBois Statement No. 2-R, the Rebuttal Testimony of Constance Heppenstall ("City Statement No. 2-R"); City of DuBois Statement No. 3-R, the Rebuttal Testimony of John J. Spanos ("City Statement No. 3-R"); and City of DuBois Statement No. 4-R, the Rebuttal Testimony of Harold Walker III ("City Statement No. 4-R").

On November 3, 2016, the City received Surrebuttal Testimony from the following parties: OCA, I&E and Sandy Township. OCA submitted OCA Statement No. 1S, the Surrebuttal

¹ I&E Statement No. 3 was submitted in both Proprietary and Non-Proprietary versions.

Testimony of Ashley E. Everette ("OCA Statement No. 1S"); and OCA Statement No. 2S, the Surrebuttal Testimony of Terry L. Fought ("OCA Statement No. 2S"). I&E submitted I&E Statement No. 1-SR, the Surrebuttal of Rachel Maurer ("I&E Statement No. 1-SR"); I&E Statement No. 2-SR, the Surrebuttal Testimony of D.C. Patel ("I&E Statement No. 2-SR"); and I&E Statement No. 3-SR, the Surrebuttal Testimony of Ethan Cline ("I&E Statement No. 3-SR"). Finally, Sandy Township submitted Sandy Township Statement No. 1SR, the Surrebuttal Testimony of David Monella ("Sandy Township Statement No. 1SR"). An evidentiary hearing was held in this proceeding on November 10, 2016, for purposes of presenting oral rejoinder, admitting pre-served written testimony to the record, and performing cross-examination.² During this hearing, the City presented oral rejoinder testimony from Ms. Heppenstall and Mr. Walker. As part of her oral rejoinder testimony, Ms. Heppenstall introduced Exhibit_(CEH-3RJ), which reflected various adjustments reducing the City's proposed annual revenue increase from \$257,604 to \$229,551. The City also submitted a Joint Stipulation of the City of DuBois and the Office of Consumer Advocate ("City/OCA Stipulation") for admission to the record. Additionally, the ALJ confirmed the process for submitting Briefs. Pursuant to the procedural schedule, the City submits this Main Brief to address various issues raised in this proceeding.

B. Burden of Proof

Section 332(a) of the Pennsylvania Public Utility Code, 66 Pa. C.S. § 332(a), provides that "the proponent of a rule or order has the burden of proof." As the proponent of a rule or order, the City bears the burden of proof in this proceeding and, accordingly, must establish facts by a

² Upon request from the parties, the ALJ cancelled the initial day for evidentiary hearings previously scheduled for November 9, 2016.

"preponderance of the evidence." *Se-Ling Hosiery, Inc. v. Margulies*, 70 A.2d 854, 857 (Pa. 1950); *Samuel J. Lansberry, Inc. v. Pa. P. U. C.*, 578 A.2d 600, 602 (Pa. Cmwlth. 1990).

Any finding of fact necessary to support the PUC's decision must be based upon substantial evidence. 2 Pa. C.S. §704; *Mill v. Pa. P. U. C.*, 447 A.2d 1100, 1102 (Pa. Cmwlth. 1982). Substantial evidence is evidence that a "reasonable mind might accept as adequate to support a conclusion . . . [and it] requires more than a mere scintilla of evidence or a suspicion of the existence of a fact sought to be established." *Murphy v. Commonwealth, Dept. of Public Welfare, White Haven Center*, 480 A.2d 382, 386 (Pa. Cmwlth. 1984) (citing *Consolidated Edison Co. v. NLRB*, 305 U.S. 197 (1938); *Norfolk & Western Ry. v. Pa. P. U. C.*, 413 A.2d 1037 (Pa. 1980)).

The burden of proof is comprised of two responsibilities: the burden of persuasion and the burden of production. *Hurley v. Hurley*, 754 A.2d 1283, 1286 (Pa. Super. Ct. 2000). While the burden of persuasion remains with the party bearing the burden of proof, that party can shift the burden of production to another party upon production of prima facie evidence. *See Hurley v. Hurley*, 754 A.2d 1283, 1286 (Pa. Super. Ct. 2000); *Helwig v. DOT, Bureau of Driver Licensing*, 99 A.3d 153, 158 (Pa. Commw. 2014). *See also Joint Petition of Metropolitan Edison and Pennsylvania Power Co. for Approval of Smart Meter Technology Procurement and Installation Plan*, Docket No. R-2009-2123950 (Initial Decision of ALJ Colwell, issued Jan. 28, 2010).

II. SUMMARY OF ARGUMENT

The City operates a small, community-based water system serving customers within its municipal boundaries and in the surrounding Sandy Township. In total, the City provides water distribution service to 4,501 customers, including 3,338 customers inside of its municipal boundaries and 528 in Sandy Township. Furthermore, the City sells water to Sandy Township for resale to additional customers served directly through the Sandy Township's distribution system.

The City additionally provides jurisdictional bulk water service to Union Township and non-jurisdictional bulk water service to Sykesville Township, both through contract sales.

Under current rates, the City cannot earn a reasonable rate of return on the water assets dedicated to serving its jurisdictional customers. Presently, the City earns an overall rate of return of 3.41% on its total water system. Inside-City customers generate a rate of return of 4.35%, while outside-City customers generate only a 1.08% rate of return. *See* City Statement No. 2-R, Exhibit_(CEH-1R), pp. 3-5. This disparity in rates of return presents a serious threat to the City's financial health and operational viability, and presents an unfair and inequitable cost recovery method. As a result, the City filed its request to increase rates by \$257,604 per year to support its ongoing efforts to provide safe, adequate, and reliable water service.

In support of this rate increase, the City provided direct, rebuttal, and rejoinder testimony on its revenue and expense claims. In addition, the City responded to over 300 discovery requests, not inclusive of multiple subparts included with many data requests and interrogatories. Following review of the testimony and discovery responses provided by the City, the OCA, I&E, and Sandy Township proposed adjustments to the City's rate base, revenues, expenses, and rate of return. Importantly, the City has already accepted certain recommendations proposed by the other parties, which collectively reduced the City's proposed revenue increase for the as-filed \$257,604 to \$229,551 (a 10 percent reduction). *See* Exhibit_(CEH-3RJ).

However, accepting the additional flawed recommendations proposed by I&E and OCA would reduce the City's proposed rate increase to \$51,429 or \$52,568, respectively. *See* I&E Statement No. 2-SR, p. 37, *see also* OCA Statement No. 1S, p. 29. This result would provide the City with insufficient revenue to meet its regulatory obligations to its outside customers, particularly after the City declined to increase rates for eight (8) years between 2006 and 2014. As

discussed in further detail below, the opposing parties' adjustments and proposals are misguided and meritless. Accordingly, the City's rate filing should be adopted, as modified by the City's rebuttal testimony, oral rejoinder, and any stipulations or concessions set forth below.

III. ARGUMENT

A. **Rate Base**

The City's rate base is the value of its property used in computing an authorized rate of return under the applicable laws of Pennsylvania and/or regulatory policies of the PUC. Under the City's current rates, it cannot earn a reasonable rate of return on its water utility assets. *See* City Statement No. 1, p. 5, lines 18-19. Accordingly, when the City initiated this proceeding, it provided a rate base claim of \$15,360,173 (\$20,982,073 plant in service less \$5,621,900 book reserve). City Statement No. 3-R, p. 2, lines 13 through 17. However, as discussed below, the City revised its calculations of rate base and depreciation expense on September 16, 2016, to reflect modifications to the future-test year additions. City Statement No. 3-R, p. 2, lines 1 through 11. Accordingly, the City developed a revised rate base of \$14,727,868 and a revised future test year depreciation expense of \$371,275. *See id.*

The City's adjustments to its rate base are appropriately calculated and should be accepted without modification. Certain components of the City's rate base claim are discussed in further detail below.

1. **Plant in Service**

Plant in service is the utility's investment in plant used and useful to provide service to the public. Using PUC-approved procedures, City witness John J. Spanos performed various depreciation studies regarding plant in service as of December 31, 2015 and December 31, 2016. *See* City Statement No. 3, p. 2, lines 6-7. Mr. Spanos also provided a breakdown of the City's plant in service by type and vintage as of December 31, 2016. City Statement No. 3, Exhibit JJS-2.

None of the parties appear to oppose the City's proposals regarding Plant in Service. Accordingly, the City requests that the PUC accept its claim in this category without modification.

2. Additions to Rate Base

Initially, Mr. Spanos estimated total rate base to be \$15,360,173 (excluding cash working capital). City Statement No. 3-R, p. 1, lines 15-17. During the rebuttal phase, Mr. Spanos revised his rate base expense calculation and depreciation expense calculation to develop a revised rate base of \$14,727,868 and a future test year depreciation expense of \$371,275. City Statement No. 3-R, p. 2, lines 1 through 11. This revision reflected reductions in total rate base of \$632,305 (excluding cash working capital) and reductions in depreciation expense of \$6,735. City Statement No. 3-R, p. 2, lines 9-10.

While I&E did not dispute the City's rate base adjustments, OCA witness Ashley Everette alleged that certain projects (*e.g.*, Heating and Air Conditioning System; Mains for High Street; Fire Hydrant on High Street; Billing, Payroll, and Accounting Software; and Phone System) should be excised from the rate base calculation because their start or completion dates were not established as of the time the City answered data requests regarding these projects. OCA Statement No. 1S, p. 3, lines 7-8 and 16-18.

Ms. Everette's proposals do not reflect the information provided on the record. Mr. Spanos stated that such projects would be complete in the future test year, after making the necessary adjustments to account for projects originally slated for completion in 2016, but no longer expected to be in service by December 31, 2016. City Statement No. 3-R, pp. 2-3, lines 7-18; *see also* Exhibit_(JJS-1R). The City also provided an update confirming that most of the improvements were already in progress. City Statement No. 3-R, p. 3, lines 4-5 and line 24; and p. 4, line 1 and lines 14-15. Of the remaining projects, Mr. Spanos testified that these projects do not require advance planning or significant lead time. City Statement No. 3-R, p. 3, lines 4-5. For example,

City Witness Mr. Suplezio testified that the High Street project will be completed in November 2016, and yet Ms. Everette proposes to remove it from the rate base because the City had not commenced the project by the time the November 10, 2016 evidentiary hearing occurred. *See* OCA Statement No. 1, p. 2, lines 12-23; and p. 3, lines 1-11. As such, Ms. Everette's recommendations are without merit and should be dismissed.

It is unreasonable to accept the OCA's proposed rate base when OCA's only basis for these additional reductions from the rate base is the lack of an established start date and completion date for small projects that do not require significant lead time or planning. City Statement No. 3-R, p. 4, lines 5-15. Accordingly, the City's revised rate base, excluding cash working capital, of \$14,727,868 should be accepted without modification.

3. Deductions from Rate Base

Retirements for the period of December 31, 2012, to December 31, 2015, include \$5,300 for Account 316.00 Electric Pumping Equipment, \$8,096 for Account 320.00 Purification System, and \$25,800 for Account 329.00 Transportation Equipment. Exhibit_(JJS-1), pp. 1-4. Projected retirements for the period of December 31, 2015 to December 31, 2016 include \$2,700 for Account 312.63 Miscellaneous Structures and Improvements and \$6,700 for Account 322.0 Mains and Accessories. Exhibit_(JJS-2), p. II-4. None of the other parties challenged these deductions from the rate base.

4. Conclusion

None of the parties oppose the City's proposals regarding plant in service or deductions from the rate base. Furthermore, none of the parties object to the City's proposed additions to the rate base, except for OCA – whose arguments are flawed and therefore should be dismissed. As such, all of the City's adjustments to its rate base are appropriately calculated and should be accepted without modification.

B. Revenues

The City's total revenue requirement for the future test year ("FTY") ending December 31, 2016, is \$3,489,635. City Statement No. 2, p. 3, lines 19-20. Despite the City's comprehensive and balanced approach to developing its revenue requirement, various parties propose inappropriate and misguided adjustments to this figure. Accordingly, the PUC should dismiss the other parties' proposed adjustments to City revenues except for adjustments adopted by the City.

1. Falls Creek

a. Background

Falls Creek Borough ("Falls Creek") is a municipality located in Jefferson and Clearfield counties. Currently, Falls Creek is subject to a Department of Environmental Protection ("DEP") Consent Order with regard to its water system. *See* Tr. at p. 56, line 11. In order to meet the requirements of its DEP consent order, Falls Creek has pursued connections with other water system operators, including both Sandy Township and the City. *See id.* at 56, lines 5-21. Notably, the City's proposed rate filing does not reflect revenues or expenses associated with a potential interconnection with Falls Creek. However, the City plainly disclosed that it has held discussions with Falls Creek regarding a potential interconnection. *See* City Statement No. 1-R, p. 3. The City has repeatedly and consistently confirmed that it has not entered into an agreement to serve Falls Creek or incurred any expenses for facilities that would serve Falls Creek. *See* Tr. at p. 27, lines 19-23. Accordingly, the potential Falls Creek project remains unknown, unmeasurable, and inapplicable to the present rate proceeding, notwithstanding the efforts and innuendo on behalf of Sandy Township.

b. Notifications to PUC Regarding Interconnection with Falls Creek

While both OCA and I&E concur that a connection to Falls Creek will not be completed in the future test year, both argue that the City should be required to report a future line extension

to serve Falls Creek. OCA Statement No. 1S, p. 47, lines 3-4; Tr. at p. 32, lines 13-16. In response to questioning on this matter during the evidentiary hearing on November 10, 2016, the City Manager suggested that the City would provide such notice. *See* Tr. at p. 32, lines 13-16. However, the City Manager further noted that he is not a lawyer and does not make such determinations for the City. Tr. at p. 57, lines 20-25, and p. 58, lines 1-2. The Commission should not bind the City to additional notice requirements beyond the existing requirements that may be applicable for a future extension of service outside of its municipal boundaries. Such notice requirements are unnecessary and burden the City with additional administrative obligations. Accordingly, the blanket proposal to require the City to provide notice of any future connection to Falls Creek, should be rejected.

c. Sandy Township Position on Falls Creek

Sandy Township raises several questions regarding Falls Creek, all of which fall outside the scope of this proceeding and are inconsistent with the applicable laws and regulations or incomprehensibly vague. Sandy Township purports that it is "public and common knowledge" that Falls Creek Borough will be "abandoning its surface water source and connecting a main water supply line to the City" Sandy Township Statement No. 1, p. 4, lines 3-5. Sandy Township next argues that the PUC should prevent the City from benefitting from a connection to Falls Creek. Sandy Township Statement No. 1, p. 6, lines 1-7. As discussed below, Sandy Township offers no factual or legal basis for these arguments.

Sandy Township's allegations lack substance. The City has been forthcoming with the parties about its discussions with Falls Creek and its general willingness to explore the feasibility of a bulk service connection. *See* City Statement No. 1R, p. 3. Although the City conferred with Falls Creek regarding the possibility of an interconnection, the fact remains that no such agreement

was reached and executed between Falls Creek and the City. *See* Tr. at 27. This distinction has been obfuscated by Sandy Township's persistent references to proposals, statements, and other developments from Falls Creek, not the City. *See* Sandy Township Statement 1SR, Attachment 1 (attaching news article referencing approval of engineering contract by Falls Creek Municipal Authority). In truth, the City has consistently affirmed that it has conducted discussions with Falls Creek, but the parties have not been able to reach an agreement to date, and commencement of service remains a mere possibility for some uncertain point in the future.

The City Manager testified to this fact at the November 10, 2016, evidentiary hearing as follows:

Q: Has the City of DuBois entered into a contract or other agreement to provide bulk water service to Falls Creek?

A: No, we haven't entered into any contract with Falls Creek.

Tr. at p. 27, lines 19-23.

Q: Mr. Niesen referenced that the Falls Creek Borough had approved what he titled, per the May 4, 2016 article that you looked at, an Intergovernmental Cooperation Agreement for the purchase of water from DuBois. You stated that you do not recall seeing an agreement, an Intergovernmental Cooperation Agreement, for the purchase of water from DuBois; is that correct?

A: Correct.

Tr. at p. 59, lines 16-22.

Q: Have you seen any kind of agreement from Falls Creek regarding the purchase of water from the City of DuBois?

A: No.

Tr. at p. 60, lines 16-18.

While a connection to Falls Creek may materialize in the future, the parties have not "obtained necessary local and state regulatory approvals or reached agreement on construction plans, siting, or cost responsibility." City Statement No. 1-R, p. 3, lines 21-23. As a result, commencement of the service, even if an agreement were reached in the short-term, would still

remain uncertain in terms of schedule and implementation. Accordingly, the project is still speculative and the PUC should not jeopardize the City's ability to effectively fund its system operations by reaching forward to recognize future revenue that may not manifest because of these uncertainties. City Statement No. 1-R, p. 4, lines 1-8.

Additionally, Sandy Township's proposals for the PUC to impute revenues from Falls Creek should be rejected as contrary to established ratemaking principles. Sandy Township argues that the PUC should "assume the existence of Falls Creek purchased water revenue for purposes of determining the City Water Bureau's need for additional annual revenue from outside City customers." See Sandy Township Statement No. 1, p. 5. As clarified by the City Manager, there are too many unknown variables that would impact the rates charged to Falls Creek for any future service to estimate revenues at this time. See City Statement No. 1-R, p. 4. For example, Sandy Township's revenue projections assume Falls Creek would take service at standard outside-customer rates, but the City cannot determine where the interconnection would be or whether Falls Creek would be properly classified as a tariff customer or a contract customer. See *id.* at 4. Recognizing revenue from sales to Falls Creek in this proceeding would contravene the bedrock ratemaking principle that only known and measurable revenues can be recognized for ratemaking purposes. *Pa. Pub. Util. Comm'n. v. PPL Gas Utils. Corp.* 102 Pa. P.U.C. 325, **28-30 (2007) ("The Company's claim for expenses associated with the remediation of unknown sites is speculative, and fails the basic ratemaking tenet that expenses must be known and measurable in order to be recoverable."). Therefore, Sandy Township's proposal to impute revenues from an unknown and unmeasurable potential future source of revenues should be denied.

Sandy Township's request for undefined and vague action with regard to Falls Creek should also be dismissed. As an alternative to imputing revenue from Falls Creek, Sandy Township

argues the PUC should "take steps" to ensure the City does not benefit from sales to a new customer after a rate increase. *See* Sandy Township Statement No. 1, p. 6. Despite Sandy Township's efforts to obfuscate the record, the fact remains that the City has no agreement to serve Falls Creek. *Tr.* at p. 27, lines 19-23. Even if the City were to reach an agreement, the parties would need to complete the project implementation phase before such facilities could be placed into public service. *See* City Statement No. 1-R, p. 4; *see also* *Tr.* at 28. There is no basis for the Commission to jeopardize the City's financial viability by recognizing revenues that will not occur in the future test year and may never materialize at all. *See* City Statement No. 1-R, p.4.

For the above reasons, the Commission must deny Sandy Township's unsubstantiated proposals to reflect revenue or otherwise act on unknown and unmeasurable revenues from potential future sales to Falls Creek.

2. Union Township Contract Sales

As noted above, the City provides bulk water service to Union Township through contract sales. Sandy Township appears to contest the validity of the contract by asking the Commission to impute sales to Union Township at the full tariff rate for purposes of reviewing the City's proposed rate increase. This proposal is fundamentally unreasonable, contrary to the public interest, and should be denied by the Commission.

No party disputes that Union Township currently pays a rate of \$2.00 per 1,000 gallons for its water service. *See* Sandy Township Statement No. 1, p. 9, lines 13-15. Without attempting to address the underlying reasons for Union Township's reduced rate, "Sandy Township proposes that revenue at the higher tariff rate level be reflected for water sales to Union Township and assumed for the purpose of determining any rate increase that the Public Utility Commission might allow for the City Water Bureau." Sandy Township Statement No. 1, p. 9, lines 18-24. In other words, Sandy Township's proposal "would require the City to impute revenue it does not actually

receive, meaning the City would not actually receive the revenue deemed necessary to continue providing safe and high quality water service to its customers." City Statement No. 1-R, p. 7, lines 5-8.

Notably, Sandy Township has not alleged that the arrangement between Union Township and the City is unreasonable. To the extent deemed relevant, the City avers "it is very reasonable for Union Township to pay a rate less than the sale for resale rate charged for Sandy Township's service because Union Township and Sandy Township are not similarly situated customers." City Statement No. 1-R, p. 7. Sandy Township "benefits from the City's treatment and distribution facilities, while Union Township benefits primarily from the City's treatment facilities." *See id.* Most importantly, "Union Township constructed and paid for a water main extending from its system to a meter pit at the City's water treatment plant." *See id.* Accordingly, "the water flowing to Union Township never flows through the City's distribution lines . . . [while] Sandy Township takes bulk water service at twelve (12) separate meter pits located at different points on the City's distribution system. For these reasons, the City entered into a contract with Union Township allowing the township to take bulk water service under an annual pricing formula excluding costs for infrastructure and services for which it does not benefit. *See id.*

Sandy Township also questioned whether the PUC approved the contract between the City and Union Township. Sandy Township Statement No. 1-S, p. 5. The City Manager does not have records as to whether the Union Township contract was filed with the PUC as it was executed before he became City Manager. Tr. at p. 28. To the extent the Commission requires a filed copy, the Union Township contract was admitted into the record in this proceeding as Attachment 6 to Sandy Township Statement No. 1. Moreover, the City would not object to filing the contract separately with the PUC if desired by the Commission. Tr. at 28-29.

3. Borough of Sykesville Contract Sales

The City also provides bulk water service to the Borough of Sykesville through contract sales. Sandy Township appears to contest the validity of this contract by asking the Commission to impute sales to the Borough of Sykesville at the full tariff rate for purposes of reviewing the City's proposed rate increase. This proposal must be rejected as the Borough of Sykesville takes service within the boundaries of the City and is therefore a non-jurisdictional customer. *See* City Statement No. 1-R, p. 8, lines 15-22; *see also* 66 Pa. C.S. § 1102(a)(5). Therefore, the Commission should reject any proposals concerning rates and services furnished by the City to the Borough of Sykesville.

C. Expenses.

1. Unaccounted For Water

I&E recommends reducing the City's expenses in this category due to allegedly excessive Unaccounted For Water ("UFW") percentages. As discussed below, the City avers that this recommendation is inappropriate in light of the City's improved UFW over time and its commitment to reducing UFW percentages through various infrastructure improvements.

I&E recommends that the City reduce its expenses by \$11,754 due to excessive UFW percentages. I&E Statement No. 3, p. 3, lines 3-4 and p. 16, lines 3-4; I&E Statement No. 3-SR, p. 10, lines 9-12. I&E notes that the City's average UFW percentages "for the year ended December 31, 2013, 2014, and 2015 are 25.78%, 26.22%, and 28.07%, respectively" I&E Statement No. 3, p. 13, lines 8-13. I&E asserts that "the three year average of the Company's reported [UFW] level [for 2013 through 2015] is 26.69%, which exceeds the [discretionary] 20% level considered by the Commission to be excessive and presents an undesirable increasing trend." I&E Statement No. 3, p. 13, lines 11-13.

I&E avers that the City "has continued to incur expenses for pumping, treating, and distributing more water than is necessary to serve its customers." I&E Statement No. 3, p. 14, lines 15-16. As a result, I&E believes a \$11,754 reduction in the City's UFW expenses is warranted. I&E Statement No. 3, p. 3, lines 3-4 and p. 16, lines 3-4. I&E believes that the City has not developed a plan to address UFW, and noted that the City could "eliminate the impact of this adjustment by reducing its level of [UFW] below the level that the Commission considers excessive. By doing so, the Company would reduce its power purchased and supplies and expenses." I&E Statement No. 3, p. 17, lines 3-6.

The City has worked diligently to reduce UFW on the system. As indicated by the City Manager, the average UFW for the period 2013 to 2015 of 26.69%, is substantially below the average UFW for the period 2010-2012, which was 30.2%. City Statement No. 1-R, p. 12, lines 7-8. This reduction reflects the City's substantial progress in reducing UFW since the conclusion of its 2013 rate proceeding. During the historical periods, the City conducted regular leak testing on the system to improve its UFW. *See* I&E Exhibit No. 2, Schedule 7, pp. 3-7 (showing the City conducted 5 water line leak detection surveys between December 2013 and March 2016). Furthermore, in good faith efforts to further reduce UFW, the City has adopted numerous recommendations from OCA intended to improve UFW. In his rebuttal testimony, Mr. Suplizio confirmed the City's willingness to meter all City buildings instead of using estimates, which will result in more accurate UFW data. *See* City Statement No. 1-R, p. 12, lines 2-4. Additionally, the City adopted numerous operational recommendations from OCA Witness Mr. Fought to further improve its UFW, as detailed in the City/OCA Stipulation. *See* City/OCA Stipulation.

Furthermore, the City would like to add that I&E's decision to impose a UFW adjustment conflicts with recent precedent. When the City of Lancaster initiated its 2014 rate case, it had a

higher three-year average UFW (30.7%) than the UFW for the City in this proceeding (26.69%) and yet in the City of Lancaster's case I&E did not argue for a UFW adjustment. I&E Statement No. 3-SR, p. 7, lines 11-17. Notwithstanding I&E claims that its recommendations are based upon historic trends and other criteria unique to each utility, the City submits that I&E's recommendation in the City of Lancaster case at minimum reinforces the discretionary nature of UFW adjustments. I&E Statement No. 3-SR, p. 9, lines 11-13. Therefore, in consideration of the City's recent progress and further commitments towards reducing its UFW, the Commission should deny I&E's proposed UFW adjustment.

2. Wages

Account 448.120 reflects the wages for one individual, the supervisor of the water treatment plant. City Statement No. 2-R, p. 7, line 11. In April 2016, that individual passed away, and as a result the wages reflected through June 2016 do not reflect a full six months' of wages for this position. City Statement No. 2-R, p. 7, lines 13-14. The water-related wages of the replacement employee, who will manage both the water and sewer treatment plants, are approximately \$55,310. City Statement No. 2-R, p. 7, lines 15-17. Because another individual will assume the role of the late Water Treatment Plant ("WTP") supervisor, the full amount of that salary should remain in the revenue requirement. I&E agrees with the City on this point and withdrew its recommended adjustment. I&E Statement No. 3-SR, p. 7, lines 14-19.

The City agrees with I&E's adjusted labor expenses for Accounts 448.140, 450.140, and 450.142, Labor related to WTP assets and T&D Labor related to Mains and Meters, based on the annualization of January to June 2016 actual wages and adjusts these wages for the normal pay increase of 2.5% as of 1/1/2017 for a total decrease in expense of \$57,421 or \$17,043 jurisdictional. City Statement No. 2-R, p. 7, lines 19-21, and p. 8, lines 1-3.

3. Overtime

I&E recommends various adjustments to Overtime expense for Account 448.183 Water Treatment Plant and Account 450.183 Transmission & Distribution. The City advises that the PUC reject I&E's adjustments pursuant to the rationale set forth below.

Originally, I&E recommended "an overtime expense allowance based on the annualization of January to June 2016 actual overtime expense amounts (I&E Exhibit No. 2, Schedule 3, pp. 1-2) in place of the City's claimed FTY 2016 amounts, which simply mirror the overtime expenses incurred in the HTY 2015." I&E Statement No. 2-SR, p. 9, lines 13-18. In response, the City rejected I&E's proposed adjustments. City Statement No. 2-R, p. 8, lines 22-23; p. 9, lines 10-14; and p. 10, lines 1-2. I&E subsequently revised its recommendation "for overtime based on actual expenses incurred over the last three years (2013, 2014, and 2015) . . . [and] used the average of overtime expenses incurred in the last three years (2013-2015) for [its] updated recommended allowance amounts for the FTY." I&E Statement No. 2-SR, p. 10, lines 7-11. As a result of these revised calculations, I&E now proposes revised adjustments of -\$3,741 and -\$9,749 for Accounts 448.183 and 450.183, respectively. I&E Statement No. 2-SR, p. 11, lines 6-7.

Expenses for both of these accounts have been increasing since 2013. City Statement No. 2-R, p. 8, lines 22-23; and p. 9, line 11. Overtime expenses under Account 448.183 increased from \$35,840 in 2013 to \$43,534 in 2015, respectively. City Statement No. 2-R, p. 9, line 1. Expenses under Account 450.183 also increased, from \$22,694 in 2013 to \$34,397 in 2015. City Statement No. 2-R, p. 9, lines 8-11. Based upon the historic trends for these expenditures, it is unreasonable for I&E to recommend averaging each of these costs over three years. I&E's recommended adjustments pertaining to these accounts should be rejected.

4. Payroll/FICA Taxes

No party disputes the allowance of an expense for payroll/FICA taxes of 6.20% and 1.45%, respectively. *See* I&E Statement No. 2-SR, pp. 11-12. However, I&E initially proposed to adjust the City's payroll/FICA tax adjustment to reflect its adjustment to the City's wage and overtime expenses. *See* I&E Statement No. 2-SR, p. 12. As set forth above, I&E eventually accepted the City's proposed wage expense. Accordingly, I&E modified its proposed payroll/FICA tax adjustment to reflect solely its revised overtime adjustment recommendation. *See id.*

As the City contests I&E's proposed overtime adjustment, the City also disagrees with the resulting payroll/FICA tax adjustment. City Statement No. 2-R, p. 8, lines 7-8. The City recommended labor expense adjustment of -\$57,421 or -\$17,043 jurisdictional, necessitates a payroll/FICA adjustment of -\$4,393 or -\$1,304 jurisdictional. City Statement No. 2-R, p. 8, lines 8-12.

5. WTP Contractual

The City identified two expenses that must be normalized over several years – the Watershed Inventory Management Plan and Herbicide Application – amounting to a total of \$51,082. During Rejoinder, the City made additional modifications to this expense, reflecting a revenue requirement adjustment for WTP contractual services of -\$7,465, or -\$2,239 jurisdictional. Exhibit_(CEH-3RJ).

OCA and I&E proposed to average WTP Contractual expense in order to incorporate outlier data. OCA Statement No. 1, p. 32, lines 3-11; I&E Statement No. 2, p. 19, lines 11-20. Despite the City's response in rebuttal, I&E and OCA continue to recommend that WTP contractual services expense be based upon a three-year historic average. I&E Statement No. 2-SR, p. 15, lines 7-16; OCA Statement No. 1S, p. 18, lines 7-12. In addition, I&E claimed that the City contradicted itself by rejecting I&E's adjustment based on the historical average of this

account and instead relying on the nine months of this expense in 2016. I&E Statement No. 2-SR, p. 15, line 22 through p. 16, line 21.

In the case of this kind of expense, it is more appropriate to examine the trends of these expenses rather than purely use a three-year average in developing a revenue requirement. History of expense under this account is not the best indicator of future expense. City Statement No. 2-R, p. 11, lines 1-17. The City's adjustments to this account in the filing and during subsequent testimony, as well as the actual expense recorded in this account through September 30, 2016, demonstrate that the City's filed and adjusted expense is justified and should be accepted without modification.

Furthermore, I&E's assertion that the City contradicts itself is incorrect, because it mistakenly refers to the City's rejection of I&E's adjustment to Overtime expense in its Direct Testimony (which has since been modified) based solely on six months of this expense in 2016. I&E Statement No. 2-SR, p. 15, line 22, through p. 16, line 10. For WTP contractual expense, the City relies upon 2015 and 2016 year-to-date expenses, not just six months of expense as Mr. Patel used in his Overtime adjustment in I&E Statement No. 2. Furthermore, the City did not recommend that this expense be averaged, as Mr. Patel is recommending for WTP contractual expense and overtime expense. Accordingly, the City's proposal presents a more comprehensive view of WTP contractual expenses and should be adopted in lieu of I&E's proposal.

6. Transmission & Distribution ("T&D") Contractual Services Expense

I&E's and OCA's proposed reductions in expenses allowed for Account 450.452 T&D Contractual Expense (I&E Statement No. 2, p. 20, line 1 through p. 21, line 16; and OCA Statement No. 1, p. 30, lines 1-14) would remove revenues that the City needs in order to combat UFW concerns raised by I&E Witness Ethan Cline and OCA Witness Terry Fought. I&E Statement

No. 3, p. 12, line 1, through p. 17, line 6; OCA Statement No. 2S, p. 2, line 29, through p. 8, line 15. Accordingly, the PUC should reject I&E's and OCA's adjustments for this account.

Account 450.452 addresses contractual expenses including costs for water leak detection, water line break repairs, GIS mapping, road work, patching and paving concrete, etc. I&E alleges that these expenses are incurred on an "as-needed basis and not guaranteed or expected to recur in the FTY exactly the same as the HTY expense, so it is not proper and reasonable to accept the same expense amount for the FTY based solely on that consideration." I&E Statement No. 2-SR, p. 19, lines 4-8. However, as the City cannot rely upon shareholder equity where earned revenues are inadequate to meeting utility obligations, it is reasonable to recognize the City will incur significant T&D contractual services expenses in meeting its obligations under the Stipulation reached with OCA. *See City/OCA Stipulation.* While I&E's proposed methodology would be reasonable under other circumstances, rigid adherence to the three-year average methodology for T&D contractual expense would not accurately reflect the City's anticipated expenses. Accordingly, the City's proposed T&D contractual service expense should be approved.

7. Rate Case

Normalization of rate case expense over a period of several years is appropriate because while the expense for a rate case is only incurred during the period of the actual rate case, the benefits of the increased rates last for more than one year. City Statement No. 2-R, p. 12, line 22, through p. 13, line 2. However, an unreasonably long normalization period, particularly for a smaller utility proposing a relatively modest rate increase, will jeopardize the utility's financial viability by effectively denying recovery of actually incurred rate case expense. *See City Statement No. 2-R, p. 13, lines 6-11; Tr. p. 63, lines 4-12.* To balance these concerns, the City proposes a 2.5 year normalization period, which acknowledges the fact that rate case expense

should be spread over a period of years and allows the City to recover rate case expense in a reasonable amount of time. City Statement No. 2-R, p. 13, lines 7-9.

However, both OCA and I&E reject the City's proposed normalization period and counter-propose different timeframes. OCA recommends a normalization period of 5 years on the belief that the "rate case expense normalization period should be based on the actual, known historical filing frequency." OCA Statement No. 1S, p. 27, lines 16-18. Meanwhile, I&E proposes a 64-month (5.33 year) normalization period for rate case expense. I&E Statement No. 3-SR, p. 5, lines 7-11. Such excessively long normalization periods reflect an overly rigid application of the general rule favoring normalization of rate case expense based on recent filings, particularly where the City has provided an explanation for the outlier period and clearly demonstrated that it would not have recovered only a fraction of its actual rate case expense from the 2013 rate case if the Commission had approved a five-year normalization period in that proceeding.

The unreasonableness of the I&E and OCA proposals is evidenced by the Commission's contrary decision in *Pa. Pub. Util. Comm'n. v. Lemont Water Co.*, 1994 Pa. P.U.C. LEXIS 44, *18-19 (1994) ("*Lemont Water*"), I&E's witness testified on appropriate normalization periods, "indicating that rates established in the Company's three most recent rate filings were in effect for periods of 52, 48 and 19 months, for an average of approximately 3 years per filing. *See Lemont Water*, at *18-19. However, the Commission accepted the Company's original projection of two years, since filing intervals have been decreasing recently." *See id.*

Both I&E and OCA propose adjustments to the City's recommended 2.5 year normalization period based on the City's rate case filing history. All parties agree that the City's three prior rate cases, inclusive of this case, were filed in 2005, 2013, and 2016, respectively. *See* I&E Statement No. 2, pp. 8-9. Averaging the interval periods between these filings would indeed produce a

normalization period of approximately 5 years. *See id.* at 9. However, the City has provided additional information indicating that a five-year interval before the next rate case would be highly unlikely. Specifically, Ms. Heppenstall explained that the City was able to avoid a rate case during the 8 years between 2005 and 2013 due to the unanticipated revenues from sales of water to shale gas companies occurring during this period. *See Tr.* at 64. As conclusively demonstrated on the record, the sales of water to shale gas companies are not expected to recur. *See id.* Therefore, and consistent with the *Lemont Water*, the Commission should deny the overly formulaic and flawed normalization periods proposed by I&E and OCA and approve the more reasonable 2.5 year period proposed by the City. *See Lemont Water*, at *18-19.

An examination of the actual history from the City's 2013 rate case further underscores the importance of rejecting the excessively long normalization periods proposed by I&E and OCA. In her rebuttal testimony, Ms. Heppenstall criticized the I&E and OCA normalization periods as unreasonable in light of the fact that, based on the City's projected rate case expense identified in testimony in the 2013 rate case, the City has only recovered 40% of the prior rate case expense as of October 2016 (*i.e.*, that the City has recovered only \$99,625 of \$251,029 in prior rate case expense). *See City Statement No. 2-R*, p. 12. I&E responded to this claim as follows:

The City has argued that the *estimated* 2013 rate case expense is not fully recovered as of October 2016. However, that 2013 rate case resulted in a black box settlement approved by the Commission on December 5, 2013, and there was no specific itemized approval of revenue or expenses. Therefore, Ms. Heppenstall's assertion that the City has only recovered 40% of its prior rate case expense as of October 2016 is speculative.

I&E Statement No. 3-SR, p. 3, lines 10-15.

At the evidentiary hearing on November 10, 2016, I&E witness D.C. Patel further confirmed that he calculated I&E's proposed normalization period on the assumption that the City had no data for the 2013 rate case expense:

- Q: Is that assertion based on your position that Ms. Heppenstall supported this statement by referencing estimated rate case expense from the 2013 rate case?
- A: Yeah, I have not verified the 2013 expenses.
- Q: I'm sorry; could you repeat the answer, please?
- A: I have not verified 2013 rate case expenses because I don't have much information about how much they [(the City)] ha[s] spent in 2013.

Tr. at p. 116, lines 23-25, p. 117, lines 1-6.

However, I&E had access to the actual 2013 rate case expense. In response to I&E-RE-21-D, the City provided a report showing it incurred \$410,291 in rate case expense for the 2013 rate case proceeding. *See* OCA Statement No. 1, Attachments to OCA Statement 1, I&E-RE-21. As a result, the City's estimate that it has only recovered 40% of the prior rate case expense as of October 2016 is actually an overstatement of the City's recovery of its 2013 rate case expense.

The City should not be forced to once again, under-recover its rate case expense, which would occur under either of I&E's or OCA's recommended normalization periods. Neither I&E nor OCA's recommended normalization periods adequately reflects the City's circumstances. As such, the PUC should approve the City's proposed 2.5 year normalization period.

8. WTP Vacant Property

OCA proposes disallowing expenses relating to the property near the water reservoir that was used by the deceased WTP Supervisor. Such expenses include telephone, electric, heat, building repairs, and maintenance for a total of \$3,592, \$572 for depreciation expense, and \$11,116 of net plant related to a vacant home previously used by the WTP Supervisor. OCA Statement No. 1S, p. 13, lines 4-9. The City disagrees with the OCA's proposed adjustments, as the property has only recently become vacant due to the death of the City's WTP Supervisor this spring. In her

rebuttal testimony, Ms. Heppenstall advised parties the property is being held for future use and the City is considering the best use of this property going forward. City Statement No. 2-R, p. 14, lines 8-11. Consistent with Ms. Heppenstall's statement, the City Manager, at the evidentiary hearing confirmed City Council has not yet voted on what to do with that property. Tr. at p. 45, line 14. OCA's recommendations are premature; until the City Council decides whether to demolish or repurpose this property, the PUC cannot accept OCA's recommendation when it is founded upon speculation. Accordingly, the property remains available for use and the PUC should reject OCA's argument for this expense category.

9. General Administrative Expenses

OCA and I&E questioned the inclusion of certain expenses under this account on grounds that such costs were irrelevant to water operations and/or that such costs should be computed in a different manner. While the City accepts some of I&E's proposals, it rejects OCA's recommendations on this issue.

The City does not directly allocate Administrative and General Expenses to the Water Fund, rather those expenses are imputed to the Water Fund in the rate filing in order to recover those expenses related to providing water service to the water customers. The expenses are recovered under Adjustment E5 (initially presented in Exhibit_(CEH-1), revised in Exhibit_(CEH-1R) and Exhibit_(CEH-3RJ).

In reviewing the City's general administrative expenses, the PUC should consider the City's ratio of administrative to total Operations and Maintenance costs, in addition to the more specific support offered by the City, as a general indicator of reasonableness. The Administrative Costs for the City of \$632,304 are approximately 31.1% of total operation and maintenance expenses, or \$1.28 per 1000 gallons. City Statement No. 2-R, p. 14, lines 22-23, and p. 15, lines 1-2. The City concluded that its "water fund Administrative and General Costs based on percentage of total

operation and maintenance costs and dollar amount per 1,000 gallons are comparable to other Pennsylvania water utilities." City Statement No. 2-R, p. 15, lines 10-12.

Notwithstanding the relative reasonableness of the City's proposed administrative expenses, OCA disputes the relevance of expenses included under this account on purported grounds that such costs are "wholly unrelated to water operations, such as removing a blighted property and purchases for the fire department." OCA Statement 1S, p. 22, lines 11-14. I&E made a similar argument, but recommended that after certain expenses were removed (*i.e.*, costs for building maintenance and repair) one-third of the expenses should be allocated to the Water Bureau. I&E Statement No. 2, p. 28, lines 4-11. I&E further indicated "the net administrative expense [should] be allocated equally between the General Fund, Water Fund, and Sewer Fund... as the miscellaneous expenses are related to the operations of the City as a whole." I&E Statement No. 2, p. 28, lines 13-15.

The City accepted I&E's recommendation regarding allocating costs equally between the General Fund, Water Fund, and Sewer Fund. Tr. at p. 62, lines 13-21. However, the PUC should reject OCA's arguments on this issue because they propose removal of expenses that do, in fact, relate to water operations.

10. Allocation of City Manager Salary

The City Manager earns \$124,076 per year. City Statement No. 2-R, p. 16, lines 8-21 and p. 17, lines 1-10. \$14,868 of that salary is included in Finance Salaries, and out of that \$14,868, 24% is allocated to the Water Fund. City Statement No. 2-R, p. 16, lines 16-17. Of the remaining portion of the City Manager's salary, \$109,208, 60% is allocated to the Water Fund. *Id.* The City avers this allocation is appropriate because (i) the City Manager testified that the estimation he spends 60% of his time on water issues is "one hundred percent accurate"; and (ii) for the balance of the City Manager's time not spent on finance-related tasks, it is logical to assume he would be

working on the same projects reflected in the Public Works Director's timesheets (which allocate 60.7% of his time is spent on water-related issues). *See* Tr. at p. 33, line 2.

Despite the City's assertions, the OCA and I&E both make speculative and unwarranted assumptions regarding the City's allocation of the City Manager's salary. OCA claims that the City Manager's position requires him to conduct many other duties, such as "supervision and management of administrators of various city departments, approval of all personnel decisions, the preparation and submission of all required reports, [and] financial planning for the City" and, as a result, it cannot be possible for him to spend 60% of his time on water issues. OCA Statement No. 1, p. 34. Accordingly, OCA believes that "it is unreasonable to allocate the majority of his salary to one City department... when Mr. Suplizio is in fact responsible for operations for the entire City." OCA Statement No. 1S, p. 21, lines 11-13.

I&E also remains misguided and skeptical of the City's request and recommends allocation of the City Manager's salary based on the revised allocation factor of 25%. I&E Statement No. 2-SR, p. 25, lines 3-4. I&E claims, without evidence, that "in the absence of time sheets or proper records of time devoted by the City Manager to water operations," it cannot believe he spends 50% of his time on water issues.

Both OCA and I&E's assumptions are baseless and inconsistent with record evidence. The City Manager's duties with regard to the City's water operations easily consume at least 60% of his time (except for time spent on finance issues).³ The City Manager testified that the City's water operations consume much more of his time in comparison to other City operations. City Statement

³ As previously noted, the City used different allocations for the City Manager's salary. The City Manager earns \$124,076 per year, \$14,868 of which is included in Finance Salaries. Out of that \$14,868, 24 percent is allocated to the Water Fund. City Statement No. 2-R, p. 16, lines 16-17. Of the remaining portion of the City Manager's salary, \$109,208, 60 percent is allocated to Water Fund operations. *Id.*

No. 1-R, p. 10, line 10. While the Public Works Director oversees general water distribution system maintenance, the City Manager is directly responsible for various aspects of water system operations, including: (i) compliance and operational issues relating to the reservoir and watershed; (ii) managing connections for new construction; and (iii) approval and oversight of water shut-offs, among other critical responsibilities. City Statement No. 1-R, p. 10, lines 5-9. Furthermore, the City Manager has to be "on call 24/7" in the event a water emergency, such as a main break, arises. City Statement No. 1-R, p. 10, lines 9-10. Should a water emergency occur, such a leak or main break, the City Manager would necessarily be on-site with the construction crew to oversee repairs. Tr. at p. 38, lines 22-23. Furthermore, the City Manager visits the water treatment plants regularly, if not daily, to oversee activities. Tr. at p. 39, line 22.

Also, the City Manager bears full responsibility for ensuring the City complies with all PUC regulations. City Statement No. 1-R p. 10, lines 11-14. Rate case preparation is a continual process based upon regular reviews of water system finances and estimated operational needs. City Statement No. 1-R, p. 10, lines 14-16. Other systems, such as the sewer system, do not require this degree of intense, complex, and consistent planning.

OCA and I&E unreasonably, and without basis in fact, assign little weight to the City Manager's testimony. Both parties take issue with the absence of time sheets for the City Manager. *See* I&E Statement No. 2-SR, p. 23; *see also* OCA Statement No. 1S, p. 21. The City submits that it is not unreasonable for the City Manager to rely on testimonial support for his salary expense, as he is also the only City employee directly serving as a witness in the rate case. Moreover, I&E Witness D.C. Patel acknowledged that time sheets are just one factor to consider in allocating employee time to the water fund. Tr. at p. 117, lines 21-23.

Given the depth and breadth of the City Manager's responsibilities for water-related matters, and given that time sheets are only one of many other ways to verify the amount of time an individual's position revolves around a specific type of activity, the PUC should disregard I&E's and OCA's recommendations and approve the City's allocation of the City Manager's salary.

11. Allocation of Health Insurance and Other Benefits for Administrative Employees

I&E recommends adjusting the allocation of Health Insurance and Other Benefits based on his recommended allocation of the City Manager Salary. I&E Statement No. 2-SR, p. 26, lines 10-14. Specifically, I&E recommends reducing the City's claimed allocation of the City Manager's health insurance expense by \$2,411 and proposes reducing the allocation of other benefits for the City Manager by \$9,761. *Id.* I&E also indicated that it accepts the City's inclusion of additional administration benefits under this cost category. I&E Statement No. 2-SR, p. 28, lines 12-14.

As indicated earlier herein, I&E and the City disagree on the allocation of the City Manager's salary to the water fund. Consistent with its recommendation to deny I&E's flawed adjustment to the allocation of the City Manager's salary, the City recommends that the PUC adopt its proposed allocation of Health Insurance and Other Benefits for Administrative Employees, as revised by City Statement No. 2-R and its Rejoinder Exhibit, Exhibit_(CEH-3RJ), and reject I&E's inappropriate adjustment to this expense category.

12. City Buildings/Computer Parts/Supplier Software

The City proposes to allocate expenses for Computer Parts/Supplies/Software as part of the City Buildings expense in the imputed Administrative Expense based on actual expense incurred in HTY (2015). *See* City Statement No. 1, Exhibit_(CEH-1), p. 25. OCA countered the City's proposed adjustment with a recommendation to normalize the average expense recorded in this Account 409.316 for 2013, 2014, and 2015. OCA Statement No. 1S, p. 24, lines 2-24.

The City disagrees with OCA's proposal, as Schedule 5 for Account 409.316 Computer Parts/Supplies/Software (located in Exhibit_(CEH-4R)) indicates that most of the expenses in this account are for ongoing expenses related to the City's information technology needs. Specifically, Ms. Heppenstall listed many of the expenses in this account and concluded "the expense items in this account related to ongoing computer needs of the City." City Statement No. 2-R, p. 22, lines 5-22. Further, as this expense has increased every year since 2013, OCA's proposal to normalize these costs is inappropriate. *Id.* To reflect observed upward expense allocation over the past three years, the Commission should base its expense allowance for Computer Parts/Supplies/Software upon the increased expense level incurred in 2015. Accordingly, OCA's adjustment should be rejected.

13. Pension

The City claimed a total pension expense (net of state aid) of \$225,233 and allocated 15% of the expense to the Water Fund based on the total number of water employees divided by the total number of City employees. *See* City Statement No. 1, p. 11. OCA concurs with the 15% allocator, but recalculated Pension expense to only include Non-Uniform Expense by eliminating the portion related to the Police Pension. The City does not dispute this action. However, OCA then misguidedly allocates 22% of the Non-Uniform Pension Expense to the Water Fund based upon a calculation that does not reflect the appropriate number of unionized Water Fund employees (8 Water Fund employees divided by 37 total City employees). City Statement No. 2-R, p. 23, lines 8-13. The City's response to I&E-RE-58 indicated that the City has 9 unionized Water Employees. Accordingly, the correct allocation should be 9 Water Fund employees divided by 38 Non-Uniform Union Employees. City Statement No. 2-R, page 24, lines 1-5. That calculation reveals the correct allocation ratio of 24%, not 22%.

As a result, the City recommends accepting OCA's adjustment to Pension Expense to include only Non-Uniform Pension Expense, with a slightly modified allocation percentage of 24%, as shown above. City Statement No. 2-R, page 24, lines 1-5. That adjustment would result in a reduction of \$23,765 or \$6,771 jurisdictional. City Statement No. 2-R, page 24, lines 1-5.

14. Miscellaneous

Sandy Township does not propose any specific adjustments to the City's proposed expenses, but generally alleges that it is "difficult to understand the need for such a large rate increase or the cost changes that justify it so soon after the Bureau increased rates by 57.1% on January 1, 2014." Sandy Township Statement No. 1, p. 3. Ironically, Sandy Townships own tariff rates reflect the reasonableness of the City's rates. Sandy Township operates a water distribution system and takes its water supply from the City, which adjacent to Sandy Township. *See* Tr. at 146 (Sandy Township Manager affirming that Sandy Township is "right beside" the City of DuBois). However, despite taking wholesale water service from the City at just \$3.77 per 1000 gallons, Sandy Township maintains a \$15.00 per 1000 first block retail rate, thereby recovering almost four times the costs of water supplied by the City from its captive residential customers. *See* City Statement No. 1-R, p. 2.

Put in perspective, even if the Commission approved the City's entire rate increase as originally filed, the initially proposed third block rate applicable to most of Sandy Township's sale for resale volumes of \$5.10 per 1000 gallons would only constitute a third of Sandy Township's present \$15.00 per 1000 gallon first block rate. *See id.* at 2-3.

While the Commission may not have jurisdiction to investigate Sandy Township's rates, it should consider the City's ability to offer water treatment and distribution service a fraction of the cost charged by Sandy Township to its end-use customers in assessing the general reasonableness of the City's rates.

D. Taxes

[Not Applicable].

E. Rate of Return⁴

1. Introduction

Mr. Walker recommends that the Commission approve rates designed to provide the Bureau of Water with an opportunity to earn an overall rate of return of 6.76%, based upon a hypothetical capital structure reflecting a common equity ratio of 50%. *See* City Statement No. 4, pp. 2, 16. Mr. Walker's overall recommended rate of return also incorporates a proposed 10.50%⁵ cost of equity and a debt cost rate of 3.02%. *See id.* at 2, Schedule 1.

OCA recommends an overall rate of return of 4.09% and a return on common equity of 8.25% (before application of a proposed 20% income tax adjustment). *See* OCA Statement No. 1S, p. 22. I&E recommends an overall rate of return of 4.23% and return on common equity of 8.62% (before application of a proposed 18% income tax adjustment). *See* I&E Statement No. 1-SR, p. 27. Neither OCA nor I&E contests the Bureau of Water's proposed debt cost rate of 3.02%, but both OCA and I&E oppose the Bureau of Water's proposed capital structure and instead base their recommendations on a capital structure of 70% debt and 30% equity.

I&E and OCA's insufficient rate of return recommendations consist of flawed capital structure and cost of common equity calculations. By all relevant metrics, the I&E and OCA recommended rates of return understate investor expectations and would deny the City a reasonable return on its plant dedicated to public service.

⁴ For purposes of this section on rate of return issues, the Bureau of Water will be referenced as a separate entity from the City. *See* City Statement No. 4, p. 1.

⁵ Should the Commission reject Mr. Walker's primary recommendation to approve a 10.50% cost of equity in order to reflect the income tax status of investors of the Bureau of Water, Mr. Walker would alternatively recommend a cost of equity of 9.56%. *See* City of DuBois Statement No. 2, p. 2.

2. Legal Standard

The difference between the Bureau of Water's proposed rate of return and OCA and I&E proposed rates of return primarily derives from a fundamental misunderstanding of the legal standard applicable to determining a reasonable rate of return for a municipal water utility offering public utility service beyond its municipal boundaries. Contrary to the belief of OCA and I&E, the Commission does not base the authorized rate of return upon the cost of capital for the municipality itself. Rather, the Commission recognizes that such municipalities engage in public utility service as enterprises and therefore authorizes the municipality to earn a rate of return for its public utility assets commensurate with the returns authorized for private corporations engaged in the same utility business.

The United States Supreme Court has outlined the principal benchmarks for a fair rate of return. In *Bluefield Water Works & Improvement Company v. P.S.C. of West Virginia*, 262 U.S. 679 (1923) ("*Bluefield*"), the Court defined a fair rate of return as follows:

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

Bluefield, at 679. As summarized by City Witness Harold Walker, *Bluefield*, established three tenets defining a fair rate of return. Under *Bluefield*, a fair rate of return must be: (1) equal to the return on investments in other business undertakings with the same level of risks (comparable earnings standard); (2) sufficient to assure confidence in the financial soundness of a utility; (financial integrity standard); and (3) adequate to permit a public utility to maintain and support

its credit, enabling the utility to raise or attract additional capital necessary to provide reliable service (the capital attraction standard). *See* City Statement No. 4, pp. 4-5.

In developing a rate of return for any regulated public utility, the Commission must ensure all public utilities have an opportunity to earn a rate of return sufficient to meet the enumerated criteria. Accordingly, the Commission should approve only a rate of return consistent with the *Bluefield* standards, including the comparable earnings standard.

3. Capital Structure

a) Introduction

The Bureau of Water proposes a capital structure of 50% debt, 50% equity. Both I&E and OCA propose a capital structure of 70% debt, 30% equity. All three parties base their capital structure recommendations on substantially similar comparable groups of utility companies with actively traded stock. The Bureau of Water used a comparable group consisting of American Sales Water Co., American Water Works Co., Inc. Aqua America, Inc., California Water Service, Middlesex Water, SJW Corp. and York Water Co. ("Water Group"). *See* City Statement No. 4, p. 10. I&E used the same comparable group as the Bureau of Water, while OCA added one additional company (Artesian Resources). *See* City Statement No. 4-R, p. 18. However, contrary to the precepts in *Bluefield*, both I&E and OCA wrongfully lobby the Commission to approve a rate of return for the Bureau of Water based on a capital structure far outside of the industry standard observed from the comparable groups.

b) Applicable Capital Structure Guidelines

As explained by Mr. Walker, it is preferable to use a utility's actual capital structure to develop a rate of return. However, this preference applies only where the utility is a financially independent entity. *See* City Statement No. 4, p. 12. Specifically "[w]hen a utility issues its own

debt that is not guaranteed by the public or private parent and has its own bond rating, regulatory and financial principles indicate to use a utility's own capital structure, unless the utility's capital structure is not representative of the utility's risk profile or where the use of actual capital structure would create atypical results." *See id.* If a utility does not provide its own financing, regulators generally look to the capital structure of the entity that does the financing, as long as this method results in just and reasonable rates. *See id.* at 13.

Mr. Walker also established the importance of complying with the comparable earnings principle discussed in the context of *Bluefield*. Specifically, Mr. Walker affirms that "financial principles require adjustments in the utility's allowed rate of return on equity to adjust for risk differences, if any, between the parent and the regulated subsidiary." *See id.* Accordingly, "if the financing entity's capital structure is inconsistent relative to the capital structures of the publicly-traded proxy companies used in the cost of equity analysis and capital structures approved for other utilities that operate in the same industry... Public Utility Commissions employ a hypothetical capital structure. *See id.* at 13-14. Finally, Public Utility Commissions should also perform a risk analysis to determine "where to set the utility's return in that range based upon how the utility's risk compares with that of other utilities that operate in the same industry." *See id.* Generally, entities with more debt will be deemed to be at higher financial risk. *See id.*

As determined by Mr. Walker, hypothetical capital structures are employed to account for risk difference between a utility's capital structure and comparable groups used to develop cost of equity analyses. Additionally, a risk analysis must be performed in order to ensure compliance with the comparable earnings standard from *Bluefield*. As discussed below, only the City has proposed a capital structure recommendation consistent with these critical principles.

c) *Summary of Capital Structure Recommendations*

Upon review of the City's financial reports, City Witness Harold Walker recommended use of the 50% long-term debt, 50% equity hypothetical capital structure for rate of return purposes. Mr. Walker reasoned that the Bureau of Water does not raise its own capital and is "essentially a 'subsidiary' of the City of DuBois, although not a separate legal entity." *See id.* at 11. Mr. Walker considered use of the Bureau of Water's actual capital structure of 100% debt and 0% equity, but concluded that utilizing the hypothetical capital structure eliminates the necessity to engage controversial risk adjustments required "to calculate an equity cost rate that is far different than a subject company's ratios." *See id.* at 15. Therefore, Mr. Walker selected the 50/50 hypothetical capital structure as representative of current industry practice pursuant to the average capital structure ratio of the Water Group. *See City Statement No. 4-R, p. 4.*

To the contrary, the capital structures proposed by OCA & I&E are not supported by the industry standards reflected in their respective comparable groups. As summarized by Mr. Walker:

As shown in Schedule 2, the comparison groups used by Ms. Maurer and Ms. Everette have an average common equity ratio of 54% (54.4% rounded) and 55% (54.6% rounded), respectively. Ms. Maurer's comparison group's capital structure is more than 1.8 times larger than the common equity ratio she recommends for the Bureau of Water and Ms. Everette's comparison group's capital structure is also 1.8 times larger than the common equity ratio she recommends for the Bureau of Water.

City Statement No. 4-R, p. 9. Both I&E and OCA concur with Mr. Walker's assessment that the Bureau of Water's actual capital structure as of December 31, 2014, would produce an unreasonable capital structure of 100% debt, 0% equity. Instead, both I&E and OCA propose a hypothetical capital structure of 70% long-term debt, 30% equity, based on the proportion of the

Bureau of Water's rate base as of December 31, 2016 financed by outstanding long-term debt. *See* I&E Statement No. 1, p. 13; *see also* OCA Statement No. 1, p. 15.

As discussed in detail below, the 70/30 capital structures developed by I&E and OCA are both technically deficient, inconsistent with the capital structure ratios observed in their comparable groups, and should be rejected by the Commission.

d) The I&E and OCA Proposed Capital Structures are Technically Deficient

The capital structure calculations proposed by I&E and OCA reflect numerous technical flaws. Specifically, both I&E and OCA base their proposed capital structures on the proportion of City-issued debt allocated to the Water Bureau's rate base, but unreasonably include debt issuance discounts in the calculation. *See* City Statement No. 4-R, pp. 5, 8. Additionally, the proposed 70/30 capital structure understates the Bureau of Water's equity ratio by failing to incorporate the increase in Bureau of Water equity due to the short-term life of the S&T Bank Notes.

Both I&E and OCA calculate their recommended 70/30 capital structures by subtracting the City's issued debt allocated to the Bureau of Water (\$10,738,268) from the calculated rate base (\$14,955,294 for I&E and \$15,622,314 for OCA) in order to estimate the Water Fund equity. *See* City Statement No. 4-R, pp. 5, 8. However, both parties overstate the Bureau of Water's debt funding available to fund rate base because the \$10,738,268 of debt issuances includes \$663,868 of debt issuance discounts and expenses allocated to the Bureau of Water. *See* City Statement No. 4-R, p. 6. As the \$663,868 constitutes discounts and expenses rather than revenue from debt issuances, these funds were not available to finance rate base and should be included as such for purposes of deriving a recommended capital structure based on the proportional funding source for the Bureau of Water's rate base. Corrected for this error, the proposed 70/30 capital structure should be adjusted to a 67/33 capital structure. *See* City Statement No. 4-R, pp. 6, 8.

Additionally, the premise of deriving a recommended capital structure based on the Bureau of Water's method of funding rate base at a given point in time overstates the Bureau of Water's debt ratio because the proportion of debt to equity will decrease over time. As recognized by I&E Witness Rachel Maurer and restated by City Witness Mr. Walker, "the difference between the shorter term of the S&T Bank Notes and the longer life of the Bureau of Water's assets means that the debt will be paid off before the assets have been fully depreciated." City Statement No. 4-R, p. 6. While both I&E and OCA recommend assigning a capital structure with a debt ratio of 70%, the short life of the S&T Bank Notes will reduce the debt ratio approximately 60% by December 2018, and approximately 52% by December 2021. *See id.* at Schedule 2. Particularly as I&E and OCA have suggested that the Bureau of Water would not file another base rate case before 2021,⁶ the proposed 70/30 capital structure significantly overstates the debt ratio expected to be borne by the Bureau of Water over this time period.

To correct the overstated debt ratio, the I&E and OCA capital structures should be modified to increase the equity ratio to approximately 52%. *See id.* at Schedule 2; *see also* City Statement No. 4-R, pp. 6, 8.

e) ***The I&E and OCA Capital Structures Conflict with Industry Norms***

Notwithstanding the technical deficiencies underlying the I&E and OCA recommended capital structures, the Commission should also deny both proposals for failure to provide the Bureau of Water with a capital structure commensurate with industry norms. City Witness Harold Walker explained the significant discrepancy between the capital structures in the I&E and OCA

⁶ Both I&E and OCA recommend normalizing the City's rate case expense over approximately 5 years. *See* Section III.C.7, *supra*.

comparable groups and the capital structure recommended for the Bureau of Water by these parties. As described by Mr. Walker, the comparable groups' capital structures have much larger common equity ratios than the 30% ratio recommended for the Bureau of Water.

As shown on Schedule 2, the comparison groups used by Ms. Maurer and Ms. Everette have an average common equity ratio of 54% (54.4% rounded) and 55% (54.6% rounded), respectively. Ms. Maurer's comparison group's capital structure is more than 1.8 times larger than the common equity ratio she recommends for the Bureau of Water and Ms. Everette comparison group's capital structure is also 1.8 times larger than the common equity ratio she recommends for the Bureau of Water.

See City Statement No. 4-R, p. 9. In response to Mr. Walker's observation, I&E and OCA argue that the Bureau of Water should not be entitled to a capital structure commensurate the comparable groups because the Bureau of Water is not an investor-owned utility. OCA claims the 70/30 capital structure is appropriate because a higher equity ratio would require the Bureau of Water's ratepayers to pay equity returns for debt financing. *See* OCA Statement No. 1, p. 14. I&E makes a similar argument, alleging that use of "an industry norm hypothetical capital structure could impose excessive costs on ratepayers." I&E Statement No. 1, pp. 12-13.

The I&E and OCA concerns regarding payment of equity returns on debt costs should not supersede the Bureau of Water's entitlement to an industry norm capital structure. In *Pa. PUC v. Borough of Media*, 77 Pa. PUC 481 (1992) ("*Media*"), the Commission addressed the issue of whether a municipality regulated by the PUC as a public utility should be entitled to a capital structure commensurate with an investor-owned utility. In *Media*, the Commission rejected the same arguments proffered by I&E and OCA in this proceeding and determined that a municipal utility providing public utility service is entitled to a capital structure reflective of industry norms. *See* 77 Pa. PUC at 446.

The Commission's decision in *Media* should be applied to approve the hypothetical capital structure proposed by the Bureau of Water in this case. I&E and OCA will likely rely on the Commission's findings in *City of Lancaster – Bureau of Water v. Pennsylvania Public Utility Commission*, Docket No. R-2010-2179103 (Order entered July 14, 2011) ("*Lancaster 2010*") in an effort to support their proposed 70/30 capital structure. In *Lancaster 2010*, the Commission rejected the hypothetical capital structure proposed by the City of Lancaster upon finding that "the City's hypothetical capital structure would impose excessive costs on customers because it requires customers to pay equity returns of over 10% on debt that costs, on average 4.66%." See I&E Statement No. 1, p. 12; see also OCA Statement No. 2, p. 15.

However, the Commission also affirmed the *Lancaster 2010* decision as a narrow holding based "upon the unique circumstances in this proceeding." See *Lancaster 2010*, p. 51. Where the Commission in *Lancaster*, emphasized the possibility for excessive costs to customers as a result of hypothetical capital structure in that case, the Commission also reiterated that its authority to approve hypothetical capital structures is discretionary and based on that which would be "fair and reasonable to both the utility and the ratepayers in the computation of the cost of capital." See *id.* at 54; citing *Riverton Consolidated Water Company v. Pennsylvania Public Utility Commission*, 140 A.2d 114, 121-122 (Pa. Super. 1958) ("*Riverton*"); see also *Pennsylvania Public Utility Commission v. City of Lancaster - Sewer Fund*, Docket No. R-00049862 (Pa. PUC 2005), p. 104. Accordingly, *Lancaster* reflects a Commission finding that a hypothetical capital structure of 50/50 could result in excessive costs to customer in the context of a request to increase rates by 100% or approximately \$8.6 million. See *Lancaster 2010*, pp. 2, 55. In a proceeding such as the instant case, the Bureau of Water submits that concerns regarding excessive costs are not sufficiently present to override the general rule from *Media*.

Additionally, the Commission's decision in *Lancaster 2010*, omits discussion on the benefits of using a hypothetical capital structure in order to mitigate the otherwise critical task of determining the appropriate risk adjustments for the equity cost component of a utility's rate of return. As Mr. Walker outlined in his rebuttal testimony, both I&E and OCA develop proposed common equity cost rates from comparison groups with 54 or 55% cost of common equity ratios, and intend to apply the same unadjusted common equity cost rates to a capital structure with just a 30% cost of common equity ratio. *See* City Statement No. 4-R, p. 11.

While it would be reasonable to adopt a cost of common equity developed from the comparison groups when also adopting a capital structure consistent with the comparable groups, adopting the one without the other creates an apples to oranges mismatch requiring adjustments to the cost of common equity to reflect financial risk differences between the comparable group and the Water Bureau. *See id.* The importance of adjusting the cost of common equity to account for changes to the common equity ratio is well-documented, but the specific adjustments can be controversial. *See id.* Use of a hypothetical capital structure consistent with the comparable groups eliminates the necessity to engage in complicated risk adjustments to the cost of common equity.

f) Conclusion

For all of the above reasons, the Commission should deny the capital structures proposed by I&E and OCA and approve the Water Bureau's proposed capital structure as consistent with the capital structures of the Water Group companies.

4. Risk Analysis

If the Commission approves a capital structure inconsistent with that observed from the comparable groups, the risk differentials between the Water Bureau and the utilities in the comparable groups would require additional adjustments to the cost of common equity.

As discussed in detail by City Witness Harold Walker, the Bureau of Water's water system is a risky endeavor in comparison to the Water Group. Most importantly, the size of the Bureau of Water's system exposes it to greater risk than the Water Companies. By every meaningful measure, the Bureau of Water's system is many times smaller than the Water Group. On average, the Companies in the Water Group have market capitalizations 157.9x larger than the Bureau of Water, produce 243x the revenue of the Bureau of Water, and have 152.9x the number of customers than the Borough of Water. *See* City Statement No. 4-R, p. 23. As stated by City Witness Harold Walker:

The size of a company affects risk. A smaller company requires the employment of proportionately less financial leverage (*i.e.*, debt and preferred capital) than a larger company to balance out investment risk. If investment risk is not balanced out, then a higher cost of capital is required.

See id. at 23.

Mr. Walker further describes the specific risk exposures of a small concerns engaged in the water distribution business, including the disproportionate impact of losing even a single large customer, disproportionate exposure to risks of extreme weather conditions due to lack of geographic diversity, and disproportionate susceptibility to adverse regulatory consequences. *See id.* Additional authority from Standard and Poor's affirms the lack of financial flexibility available for such smaller operations, noting that [a]dverse developments that would simply be a setback for companies with greater resources could spell the end for companies with limited access to funds. *See* City Statement No. 4, p. 25.

Mr. Walker also addresses risk more specific to the Bureau of Water. While the Bureau of Water generally faces the same operational obligations as the Water Group, the Bureau of Water is uniquely impacted as a municipal utility regulated by the Pennsylvania Public Utility Commission. Compared to municipal utilities operating entirely outside of PUC jurisdiction, the

Bureau of Water cannot raise rates for outside customers at the discretion of municipal officials. *See id.* at 26. However, in comparison to investor-owned utilities, the Bureau of Water additionally lacks the benefits of income taxes, which allow investor-owned utilities to take advantage of tax deferral provisions in the tax code and provide an operational cushion against volatile sales fluctuations due to the inclusion of tax expense in the revenue requirement. *See id.* at 27. The Bureau of Water does not enjoy these benefits, which increases the risks of its operations in comparison to investor-owned utilities. *See id.*

Additionally, Mr. Walker also highlights the Bureau of Water's debt service coverage as an indicator of risk. Revenues earned by the Bureau of Water provided debt service coverage of 0.4 to 2.8 times, which falls below the 1.8-2.1 average debt service coverage level for A-rated government utilities and lags even further behind the 5.4-5.7 times median debt service coverage for all Pennsylvania water municipal authorities. *See City Statement No. 4, p. 32.*

These risk indicators, and several others, are identified the Risk Analysis set forth on page 34 of Mr. Walker's Direct Testimony, which finds that 19 of 30 potential risk indicators favor a finding that the Bureau of Water's water system operates at a higher risk than the Water Group companies.

As explained by City Witness Harold Walker, the differential between the equity ratios observed from the comparable groups and that proposed by I&E and OCA would require a risk adjustment to the cost of common equity of 24-25%. *See City Statement No. 4-R, p. 11.*

5. Cost of Common Equity

a) Introduction

The Bureau of Water's proposed cost of common equity reflects the results of three widely recognized models. The financial community encourages use of numerous valuation methods to assign a cost of common equity. Accordingly, the Bureau of Water conducted Discounted Cash

Flow, ("DCF"), Capital Asset Pricing Model ("CAPM"), and Risk Premium ("RP") analysis to develop its recommended equity cost rate of 10.50%. To the extent the Commission deems it necessary to adjust the proposed cost of common equity to reflect the maximum income tax status of investors, the Bureau of Water recommends a common equity cost rate of 9.50%, reflecting a 9% maximum income tax adjustment.

I&E bases its recommend common equity cost rate on its DCF analysis and references a CAPM analysis solely as a check, while OCA similarly bases its recommendation solely on a DCF analysis. Both recommendations should be rejected in favor of the Bureau of Water's market-reflective proposed cost of common equity.

b) A Cost of Common Equity Rate Should Reflect Data from Multiple Valuation Models

The financial community and the Commission precedent support consideration of multiple valuation methods for calculating a common equity cost rate. As stated by Mr. Walker:

The application of any single model to estimate common equity is not appropriate because the security price for which the equity cost rate is being estimated reflects the application of many models used in the valuation of the investment. That is, the price of any security reflects the collective application of many models. Accordingly, if only one model is used to estimate common equity cost rates, that cost rate will most likely be different from the collective market's cost rates because the collective valuation in the market reflects more than one method.

City Statement No. 4, p. 39. Mr. Walker also references similar statements from numerous financial authorities, including the following statement from the National Society of Rate of Return

Analysts:

No cost of equity model or other concept is recommended or emphasized, nor is any procedure for employing any model recommended... it remains important to recognize that alternative methods exist and have merit in cost of capital estimation. To this end, analysts should be knowledgeable of a broad spectrum of cost of capital techniques and issues.

See id. Similarly to the positions advocated by financial experts, the Commission has long supported use of the DCF analysis, with reference to the results of other models as a check. *See Lancaster 2010*, p.p. 72-73. More recently, the Commission also approved a proposed cost of common equity developed from the same three models used by the Bureau of Water in this proceeding. *See Pennsylvania Public Utility Comm'n v. Emporium Water Company*, PUC Docket No. R-2014-2402324 (Order entered Jan. 28, 2015) ("*Emporium*"), p. 34.

For the reasons set forth above, the Bureau of Water finds it appropriate to assign equal weight to multiple equity cost valuations. At minimum, the Commission should continue its historic practice of using other valuation models as a check against the DCF.

c) Bureau of Water Proposed Cost of Common Equity Rate

(1) Bureau of Water DCF Analysis

Mr. Walker's Direct Testimony outlined the Bureau of Water's DCF calculation. As set forth therein, the DCF model is "based upon the assumption that the price of a share of stock is equal to a future stream of cash flows to which the holder is entitled." City Statement No. 4, p. 40. Accordingly, a market DCF calculation requires a determination of both a dividend yield and a share price growth rate. Based on the Water Group, Mr. Walker calculated a dividend yield of 2.5%. *See id.* at 40. To determine a growth rate, Mr. Walker referenced various published growth rates including: (1) historic growth rates; (2) projected growth rates from First Call, Reuters, Zacks Investment Research, and Value Line; (3) Earnings Per Share ("EPS") growth rates reflecting changes in return rates on book common equity over time; (4) and industry-specific growth rates from Zacks and First Call. *See id.* at 41-42. Based on the range of published growth rates, Mr. Walker calculated an expected 6.7% growth rate for the Water Group, which, as applied to the 2.5% dividend yield, produces an overall market value DCF cost rate estimate of 9.3%. *See id.* at 44.

Mr. Walker also recommends important adjustments to correct the DCF calculation to reflect current market conditions. In the current financial climate, Mr. Walker advises "less weight be given to the resultant market value DCF cost rate due to the market's current market capitalization ratios and the impact that the market-to-book ratios has on the DCF results." *See id.* As further described by Mr. Walker, "[t]he traditional DCF derived cost rate for common equity will continuously understate or overstate investors' return requirements as long as stock prices continually sell at or below book value." *See id.* This occurs because a traditional DCF model assumes that stock prices will be driven to book value over time. *See id.* Mr. Walker describes this phenomenon in greater detail as follows:

Under traditional DCF theory, price will equal book value ($M/B=1.00$) only when a company is earning its cost of capital. Traditional DCF theory maintains that a company is under-earning its cost of capital when the market price is below book value ($M/B<1.00$), while a company over-earning its cost of capital will have a market price above its book value ($M/B>1.00$). If this were true, it would imply that the capitalistic free-market is not efficient because the overwhelming majority of stocks would currently be earning more than their cost of capital. Table 7 shows that most stocks sell at an M/B that is greater than 1.0.

See id. at 45-46. Mr. Walker further explains that this theory proves to be irrational by establishing the correlation between industrial and utility stock prices and demonstrating that industrial stock prices (as measured by tracking the S&P Industrials) have only sold at a M/B as low as 1.0 one time over the 53-year period from 1947 through 1999. *See id.* at 47. This reflects the reality that "a DCF-derived equity cost rate is applied to book value rate base, while investors returns are measured relative to stock price levels," *See id.*

To correct for the financial risk difference resulting from market capitalization ratios differing from book value capitalization ratios, Mr. Walker proposes a leverage adjustment reflecting application of the Hamada Model in conjunction with the bond yield spread between the

Water Group market value debt ratios and the corresponding book value debt ratios. *See id.* at 50. As concluded by Mr. Walker, the Hamada Model and bond yield spread supports an adjustment to the Water Bureau's proposed common equity cost rate of at least 70% (1.08% hamada est. + 0.3% yield spread= $1.38/2 = 0.70\%$). *See City Statement No. 4-R*, p. 50. After adjusting for the leverage between market value DCF cost rates and book value cost rates, the Water Bureau proposes a book value DCF cost rate of 10% for the Water Group. ($9.3\% + 0.7\% = 10\%$). *See id.*

(2) Bureau of Water CAPM Analysis

As described by Mr. Walker, the CAPM analysis assumes investors hold diversified portfolios and that market pricing only recognizes or rewards non-diversifiable (or systemic) risk because diversification removes company-specific risk (or non-systemic). *See City Statement No. 4*, p. 50. The CAPM also assumes investors will require additional or higher returns for investments carrying additional or higher risk. *See id.* This assumption is captured by assigning a beta reflecting incremental cost of additional risk above the 1.0 base risk-free rate available to investors. *See id.* Mr. Walker estimate a risk free rate of 2.7% based upon the recent and forward long-term Treasury yields. *See id.* Mr. Walker additionally used an average beta of 0.71 for the Water Group, while noting that the Water Group's betas are understated due to their small size affecting their stock price changes. *See id.*

Mr. Walker further calculated an average projected market premium for his CAPM of 9.9%, based upon Value Line's average projected total market return for the next three to five years of 12.6% less the risk-free rate of 2.7%. *See id.* at 52. He also reviewed market premiums developed from Ibbotson Associates' most recent publication concerning asset returns and concluded that the Value Line market premium has been on the low side reflective of the higher interest rate environment observed during their study (*i.e.*, 5.1%). *See id.* at 52.

Mr. Walker's CAPM, based on Ibbotson Associates' historical market returns shows a market cost rate of 8.8% for the Water Group, inclusive of a size premium adjustment reflect the risks associated with companies as comparatively small as those in the Water Group.⁷ *See id.* at 53. The CAPM based on projected market returns shows a 10.8% cost rate for the Water Group, which have been impacted by a higher interest rate environment. *See id.* As a result, Mr. Walker calculated an average market value CAPM of 10.3% based 25% on the results of the historical market returns and 75% on the projected market returns. *See id.* Finally, adjusting the market value CAPM to account for the difference in leverage between market value capitalization and book value capitalization ratios previously discussed in the context of the DCF analysis results in a cost rate of 11.0% for the Water Group applicable to book value ($10.3\% + 0.7\% = 11\%$). *See id.*

(3) Bureau of Water Risk Premium Analysis

Mr. Walker also used the Risk Premium method as a final indicator of the appropriate cost of common equity rate. The Risk Premium method measures common equity investors required premium over the long-term debt cost rate for the same company in recognition of the added risk to which the common stockholder is exposed versus long-term debt holders. *See City Statement No. 4, p. 54.* Mr. Walker determined that the estimated future long-term borrowing rate for the Water Group is 4.3%, based upon their credit profiles supporting an "A" bond rating. *See id.* To determine a common equity cost rate, it is necessary to estimate a risk premium to be added to the Water Group's prospective long-term debt rate, which generally reflects both published projected risk premiums and a probabilistic forecasted risk premium. *See id.* at 54

⁷ As noted by Mr. Walker, the Water Group companies compete for investment with much larger Industrial entities. *See City Statement No. 2, p. 46.*

Mr. Walker determined a reasonable estimate of a long-term projected risk premium to be 7.8%, based on the midpoint of the risk premium range and the average for the most recent quarter. *See id.* at 55. To calculate the probabilistic risk premium, Mr. Walker calculated annual returns for S&P utilities and bonds over the historical period 1928 – 2015. *See id.* at 55-58. Based on this data, Mr. Walker calculated a probabilistic risk premium of 5.5%. *See id.* at 58.

By weighing the published projected risk premium and probabilistic forecasted risk premium by 25% and 75%, respectively, Mr. Walker determined a reasonable estimate of investors risk to be 6.0%. *See id.* at 59. Considering the risk premium of 6.0% with prospective cost of newly-issued long term debt of 4.3% results in a market value risk premium derived cost rate of common equity of 10.3%. *See id.* Adjusting the market value risk premium to account for the difference in leverage between market value capitalization and book value capitalization ratios results in a cost rate of 11.0% for the Water Group applicable to book value ($10.3\% + 0.7\% = 11\%$). *See id.*

(4) Summary of Bureau of Water Cost of Common Equity Recommendation

The three methods described above resulted in the Water Group's equity cost rate ranging from 10.0% to 11.0%. *See City Statement No. 4, p. 59.* Based on applicable range, Mr. Walker assigns a common equity cost rate of 10.25% for the Water Group. *See id.* Additionally, to account for the Bureau of Water's small size, visibly lower credit rating, and other factors summarized in the previously referenced risk analysis, Mr. Walker recommends a common equity cost rate of 10.5% for the Bureau of Water. *See id.* at 59, 34.

d) The I&E and OCA Common Equity Cost Rates Should Be Rejected

Contrary to Mr. Walker's DCF analysis, the corresponding calculations from I&E and OCA are flawed and should be rejected. I&E calculated a DCF derived common equity cost rate of

8.62%, while OCA's DCF analysis results in a common equity cost rate of 8.25%. *See* I&E Statement No. 1-SR, p. 27; *see also* OCA Statement No. 1S, p. 22. These recommendations are wholly inadequate as compared to prior Commission decisions and fundamentally flawed due to improper growth rates. Additionally, the other parties' common equity recommendations are not supported by reasonable CAPM or Risk Premium models.

The I&E and OCA recommended common equity cost rates represent a significant departure from recent Commission decisions. In its most recent fully litigated water rate proceedings, the Commission approved a cost of common equity rate of 10%. *See Emporium*, p. 34; *see Lancaster 2010*, p. 72. Further, investors would also consider the Commission's allowed cost of common equity rate in this proceeding in the context of the PUC's most recent authorized DSIC-related return on common equity for a water utility of 9.7%. *See* City Statement No. 4-R, p. 25.

The depressed common equity cost rates recommended by I&E and OCA largely arise from their selection of unreasonable and unpublished growth rates. I&E notably departs from its prior precedents and recommends a growth rate of 6.31% based solely on forecasted EPS growth rates rather than log-linear growth rates. *See* City Statement No. 4-R, p. 25. Notably, I&E applied a log-linear analysis in *Lancaster 2010*, as noted in the following excerpt from the Commission's Order:⁸

For the growth rate analysis, the OTS used both projected earnings forecast and a log-linear regression analysis to mitigate the effects of lower base year earnings and upward bias.

⁸ At the time the Commission entered its Order in *Lancaster 2010*, I&E was known as the Office of Trial Staff or ("OTS").

See Lancaster 2010, p. 68. Mr. Walker also describes the inadequacy of I&E's proposed growth rate in comparison to the historical earnings growth rates for the comparable group of 10.9%. *See City Statement No. 4-R*, p. 25. If I&E had averaged the 6.31% EPS forecasted growth rate with the 10.9% historical earnings growth rate from its comparable group, as done in prior cases, I&E would have arrived at a 10.92% growth rate. *See id.* at 25.

OCA also calculated a flawed growth rate. Rather than incorporate published growth rates available to investors, Ms. Everette calculated her own growth rates. *See City Statement No. 4-R*, p. 30. Mr. Walker describes the shortcomings of Ms. Everette's reliance on her own growth rates in comparison to published growth rates below:

Published projected EPS growth rates are used primarily by investors. Further, academic studies verify the superiority of analysts' EPS growth forecasts over derived growth rates in predicting stock prices. Ms. Everette developed unrealistically low DCFs through the use of a low growth estimate. The market-required cost of equity represents what the market will pay for a stock based on investors' expectations of expected future growth. Investors' expectations of expected future growth are not based upon Ms. Everette's unique growth rates; they are based on investors' expectations of expected future growth.

See City Statement No. 4-R, p. 30. As explained by Mr. Walker, investors rely on available published forecasts to price utility stocks, so the individualized growth rates calculated by Ms. Everette do not reflect market expectations. *See id.* at 31. Rather, the internal growth rates calculated by Ms. Everette measure growth in book value, not stock price. *See id.* at 30. In today's environment of relatively high market-to-book ratios, internal growth is a poor proxy for investors' growth expectations.⁹ *See id.*

⁹ Additionally, OCA's DCF analysis understates the common equity cost rate from the comparison group because market-to-book ratios significantly exceed 100%. *See City Statement No. 4-R*, p. 31.

Further, neither I&E nor OCA performed *reasonable* CAPM or Risk Premium analysis to check their DCF results. OCA's proposed common equity cost rate relies solely on its DCF analysis. *See* OCA Statement No. 1, p. 16. I&E at least conducted a CAPM analysis, but critical flaws disqualify this analysis as a reliable check on I&E's DCF. First, I&E cites to an article concluding that CAPM analyses understate the returns for small utilities such as the Water Bureau, but I&E fails to make a corresponding size adjustment reflecting the findings of the article. *See* City Statement No. 4-R, pp. 26, 28. Second, I&E inappropriately used a geometric mean of historical returns instead of the appropriate arithmetic mean to develop a market risk premium for its CAPM. *See id.* at 27. As explained by Mr. Walker, the applicable financial authority, Ibbotson Associates', "states the appropriate development of the equity market premium is estimated based on the arithmetic mean total return of the S&P 500 minus the arithmetic mean income return component of 20-year government bonds from 1926-2014." *See id.*

e) Any Approved Personal Income Tax Adjustment Must Be Limited to a Maximum Adjustment of 9%

To the extent the Commission deems a tax adjustment necessary, the Bureau of Water recommends a maximum tax adjustment of 9%. *See* City Statement No. 4, p. 61. The Bureau of Water's maximum tax adjustment reasonably approximates the spread between public utility bonds and GO municipal bonds with similar credit ratings. *See* City Statement No. 4-R, p. 15. I&E's recommended tax adjustment relies on irrelevant data, while OCA's unreasonably adopts a prior tax adjustment from another proceeding. Both recommendations should be rejected and the Commission, upon determination that any tax adjustment is necessary, should limit such adjustment to the 9 % rate proposed by the Bureau of Water.

If any tax adjustment is to be applied to the cost equity cost rate in this proceeding, the adjustment should consider the numerous limitations on the Commission's ability to determine an

appropriate tax adjustment. Specifically, the measure used to implement a tax adjustment should recognize limits caused by "(1) the type of bonds used; (2) matching in credit quality; and (3) matching in the term of lives of the bonds used in the analysis. *See* City Statement No. 4, p. 61.

In terms of the type of bonds used, the Commission has historically imputed personal income taxes based on bond yield spreads between public utility and GO bonds. *See* City Statement No. 4, p. 61. However, the yield on GO bonds "measures the ability to raise taxes while the Bureau of Water's cost of common equity should reflect the risk of the underlying assets devoted to providing public service." *See* City Statement No. 4, p. 62. Revenue bonds are a far better measure of the Bureau's risk, as they reflect higher yields associated with investment in an enterprise fund. *See id.* Accordingly, correcting for the difference between the yields of GO bonds and revenue bonds would result in a lower income tax adjustment. *See id.* Unfortunately, because Moody's does not publish yields for revenue bonds, the Water Bureau has not reflected such a correction, and notes only that the proposed 9% tax adjustment should be considered a conservative adjustment due to the incorporation of yields from GO bonds instead of revenue bonds. *See id.*

As described by Mr. Walker, the Bureau of Water has also matched the credit quality of bonds used in its analysis. *See id.* With regard to matching the term of the bonds, the Bureau of Water has used the best available data, which still reflects a mismatch between the unweighted average of 20 years for Moody's GO bonds and a longer 30-year maturities for Moody's public utility bonds. *See* City Statement No. 4, p. 62.

Notwithstanding the acknowledged limitations with regard to the comparing Moody's GO bonds and public utility bonds, including their mismatched terms, the Borough has utilized the best available data to calculate a maximum tax adjustment of 9%, which, if applied to the Borough

overall recommended cost of common equity, would result in a 9.56% tax-adjusted return on equity. *See* City Statement No. 4, p. 63.

Contrary to the City's proposed maximum tax adjustment, I&E failed to use the best available data to calculate its tax adjustment. With regard to the type of bonds used in the analysis and the term of the bonds, I&E's tax adjustment reflects essentially the same inherent flaws as the Bureau of Water's, as Moody's does not publish yields for revenue bonds and the term of public utility bonds generally exceeds the average 20-year term for Moody's GO bonds. *See* City Statement No. 4-R, pp. 15-16; *see also* City Statement No. 4, p. 62. However, I&E made no attempt to match the credit quality of the GO bonds and public utility bonds used in its analysis. *See* City Statement No. 4-R, p. 16. As observed by Mr. Walker, "I&E used GO bonds with bond ratings of Aaa to Bbb; while the public utility bonds used by Ms. Maurer are rated only Aa to Baa." *See id.* Correcting for this error would reduce I&E's recommended tax adjustment from 18.22% to 9.06%, which approximates the same maximum tax adjustment calculated by the Bureau of Water. *See* City Statement No. 4, p. 16.

OCA's recommended 20% tax adjustment should be rejected as unsupported. Unlike the Water Bureau, or even I&E, OCA did not conduct an analysis of current spreads between GO bond yields or public utility bond yields. *See* City Statement No. 4, p. 17. Instead, OCA adopted the 20% tax adjustment approved in *Lancaster 2010*, which now reflects market analysis performed more than 5 years ago. *See* OCA Statement No. 1, p. 23. To date, the Commission has only approved tax adjustments based on current market data. *See* City Statement No. 4-R, p. 17. OCA's proposal to rely on outdated data should be denied.

f) Conclusion

I&E and OCA simply proposed common equity cost rates far below the boundaries of reason. I&E's recommended 8.62% cost of common equity and OCA's 8.25% cost of common

equity are, respectively 168 and 205-basis points below the 10.3% return on equity derived for the Water Group. *See* City Statement 4-R, p. 32. Compared to the projected return on equity for the Water Group, their proposed common equity costs rates are 248 and 285-basis points below the 11.1% projected return on equity for the Water Group. *See id.* These catastrophic deficits do not even reflect the inflated tax adjustments proposed by each party, which would be applied to support an equity cost rate 7.05% for I&E and 6.6% for OCA. *See* I&E Exhibit No. 1, Schedule 1; *see also* OCA Statement No. 1, p. 27. The record in this proceeding supports approval of the market based rate of return proposed by the Bureau of Water, including the hypothetical capital structure of 50% debt and 50% common equity, a debt cost rate of 3.02, and a cost of common equity of 10.5%, which combine for total return of equity of 6.76%.¹⁰

F. Miscellaneous Issue

1. Motion to Strike Portions of OCA Statement No. 2S

During the November 10, 2016, evidentiary hearing, the City made a Motion to Strike portions of OCA Statement No. 2S. Tr. at p. 135, beginning on line 6, through p. 137, ending on line 7. Specifically, the City sought to strike portions of OCA Statement No. 2S on page 3, "beginning on line 19, through page 4, ending on line 17." Tr. at p. 135, lines 6-8. The City's basis for its Motion to Strike is that the information discussed in those sections constitutes inadmissible hearsay.

In the above-referenced section of OCA Statement No. 2S, OCA Witness Terry Fought refers to conversations with City "customers" regarding the City's water quality. However, none of these conversations appear to have involved Mr. Fought. The first customer e-mailed the OCA

¹⁰ Although the City can support a total rate of return of 6.76%, the City's proposed rate increase reflects a total rate of return of 6.50%, further indicating the conservatism of the City's overall rate filing. *See* City Statement No. 2, p. 5.

information that was then passed onto Mr. Fought. Tr. at p. 140, lines 21-24. The second customer contacted one of the OCA attorneys by phone. Tr. at p. 140, lines 24-25.

None of those customers were identified or available for the City and other parties to cross examine. As a result, neither the City nor the presiding officer had an opportunity to assess the veracity of these alleged complaints. Even Mr. Fought conceded that he had not actually observed the water quality issues that were the subject of the alleged complaints, nor has he conclusively verified whether the alleged complainants are jurisdictional customers:

Q: Did you verify whether these customers are customers served directly by the City of DuBois on their distribution system or customers that take wholesale service from the City of DuBois as Sandy Township distribution customers?

A: I believe that these customers are served as jurisdictional customers.

Q: But you have not independently verified that assessment?

A: I plotted their addresses on a map and came to the conclusion that they were jurisdictional customers.

Q: Following the communication between the OCA and these customers, did you conduct a personal investigation to verify the veracity of the service claims set forth by the customers?

A: No.

So you have not -- referencing page 3 of your testimony, lines 30 and 31, you have not actually observed grayish water in the City of DuBois system?

A: No.

Tr. at p. 141, lines 6-24.

Further, in weighing the City's Motion to Strike, the Commission should consider that Mr. Fought's rebuttal testimony on this issue offers no probative value because the OCA offered the hearsay statements in support of its recommendation for the City to maintain a log of telephone complaints, which the City has already agreed to do. *See City/OCA Stipulation*. Accordingly, the Commission should strike portions of OCA Statement No. 2S, beginning on page 3, line 19, and ending on page 4, line 17.

In the event that such statements are admitted, the PUC should clarify that they may not be cited for the truth of the matter asserted. While an expert may base his opinion on facts or data he may have been aware of or personally observed, in this instance Mr. Fought did not observe these issues – they were reported to him allegedly by customers – and none of the parties have any opportunity to explore the veracity of the water quality claims delineated in OCA Statement No. 2S.

G. Rate Structure

1. Cost of Service

Witness Brian Kalcic agreed with the City's cost of service allocation in his testimony. City Statement No. 2-R, p. 25, line 6. Meanwhile, witnesses for I&E and OCA are silent on the cost of service study, but they use the cost of service allocation in Exhibit_(CEH-2) to identify the jurisdictional impact of their adjustments made in their testimony. City Statement No. 2-R, p. 25, lines 4-10. Accordingly, the City believes the parties all accept the City's cost of service study.

2. Revenue Allocation¹¹

The City has proposed Revenue Allocation set forth in Exhibit_(CEH-2), Exhibit_(CEH-2R). The City agrees with I&E and OSBA that, upon approval of an increase lower than the proposed increase, the filed increase for each customer class should be scaled back through an adjustment to the usage charges. I&E Statement No. 3, p. 32, lines 10-13; OSBA Statement No. 1, p. 5, lines 9-17. As indicated in City Statement No. 2-R, if the PUC approves half of the City's filed revenue request, or \$128,800, all of the City's proposed outside-City class increases should

¹¹ The OCA's testimony did not address revenue allocation.

be reduced by 50%. City Statement No. 2-R, p. 25, lines 17-22, and p. 26, lines 1-2. That reduction would be accomplished through a reduction in the volumetric rates, not the customer charge.

3. Tariff Structure

The City has determined that it will withdraw its proposed Rule 36.

IV. CONCLUSION

WHEREFORE, for all of the foregoing reasons, the City of DuBois – Bureau of Water respectfully requests that the Pennsylvania Public Utility Commission approve its proposed rate increase, as adjusted via its rebuttal and oral rejoinder testimony, in the amount of \$229,551, and declare the PUC's investigation be marked closed.

Respectfully submitted,

McNEES WALLACE & NURICK LLC

By



James P. Dougherty (Pa. I.D. No. 59454)
Adeolu A. Bakare (Pa. I.D. No. 208541)
Alessandra L. Hylander (Pa. I.D. No. 320967)
100 Pine Street
P.O. Box 1166
Harrisburg, PA 17108-1166
Phone: (717) 232-8000
Fax: (717) 237-5300
jdougherty@mcneeslaw.com
abakare@mcneeslaw.com
ahylander@mcneeslaw.com

Counsel to the City of DuBois – Bureau of Water

Dated: November 29, 2016

APPENDIX A

**CITY OF DUBOIS SUMMARY OF RATE CASE ADJUSTMENTS AND RATE OF
RETURN CALCULATION**

CITY OF DUBOIS
DOCKET NO. R-2016-2554150
MAIN BRIEF ADJUSTMENTS

	Total Adjustment	Allocation Factor	Jurisdictional Allocation Ratio	Jurisdictional Adjustment
Revenue				
Public Fire	(12,000)			(3,284)
Correction for Average Annual Bill	2,921			2,921
Total Revenue Adjustment	\$ (9,079)			\$ (364)
Revenue Requirement Adjustments:				
Postage	(7,194)	11	0.1616	(1,163)
Labor Expense				
WTP Plant Labor	(49,935)	2	0.2999	(14,976)
T&D Labor Mains	(3,483)	6	0.2760	(961)
T&D Labor Meters	(4,003)	8	0.2764	(1,106)
Total Labor Adjustment	(57,421)			(17,043)
Payroll/FICA Taxes				
WTP Plant Labor 7.65% Taxes	(3,820)	2	0.2999	(1,146)
T&D Labor Mains - 7.65% Taxes	(266)	6	0.2760	(74)
T&D Labor Meters - 7.65% Taxese	(306)	8	0.2764	(85)
	(4,393)			(1,304)
Health Insurance - WTP	(578)	2	0.2999	(173)
Health Insurance - T&D	30,206	6	0.2760	8,338
Chemical Expense	6,400	1	0.3102	1,985
WTP Contractual Services - REBUTTAL	932	2	0.2999	280
WTP Contractual Services - MAIN BRIEF	(7,465)	2	0.2999	(2,239)
Rate Case Expense	10,000	18	1.0000	10,000
Administrative Adjustment E5:				
Administrative Expense - REBUTTAL	(26,284)	13	0.2850	(7,491)
Administrative Expense - MAIN BRIEF	(2,323)	13	0.2850	(662)
Health Insurance and Other Benefits - Administrative Employees	17,493	13	0.2850	4,985
Engineering Expense - Labor and Benefits	(3,023)	13	0.2850	(862)
Engineering Expense - Labor Adjustment E1 & E8	(118)	13	0.2850	(34)
Engineering Contractual Services	(10,507)	13	0.2850	(2,994)
Pension Expense	(23,765)	14	0.2849	(6,771)
Total Adjustment to Administration Expense	(48,528)			(13,828)
Rate of Return*	(41,734)			(11,449)
Depreciation Expense	(6,375)			(1,643)
Adjustment to Jurisdictional Costs due to revised Cost Allocation **				(177)
Total Revenue Requirement Adjustments	\$ (126,150)			\$ (28,417)
Revenue Adjustment (see above)	9,079			364
Total Adjustments	\$ (117,070)			\$ (28,053)
Filed Jurisdictional Increase				\$ 257,604
Rejoinder Recommended Jurisdictional Increase				\$ 229,551
*Rate of Return Adjustment based on:				
Rate Base Adjustments:				
Adjustments per Rebuttal Testimony of John Spanos	(632,305)	Various		(173,364)
Cash Working Capital	(9,756)	13	0.285	(2,780)
Total	\$ (642,060)			\$ (176,144)
Rate of Return	6.50%			6.50%
Change in Rate of Return	\$ (41,734)			\$ (11,449)

** See Exhibit (CEH-2R).

City of DuBois - Bureau of Water
Recommended Fair Rate of Return
Recommended Rate Making Ratios at December 31, 2016

	<u>Recommended Ratios(1)</u>	<u>Cost Rates(2)</u>	<u>Weighted Cost</u>
Debt	50.0	3.02	1.51
Fund Equity	<u>50.0</u>	10.50	<u>5.25</u>
Overall	<u>100.0</u>		<u>6.76</u>

Notes: (1) As explained in the testimony.

(2) The debt cost rate is based on the weighted cost rate to maturity for all issues.

	<u>Capital Outstanding*</u> <u>12/31/2014</u>		<u>Recommended Rate Making Ratios Pro Forma</u> <u>12/31/2016</u>	
	<u>(000's \$)</u>	<u>Ratios</u>	<u>(000's \$)</u>	<u>Ratios</u>
Debt	?	?	\$7,811,157	50.0
Fund Equity	?	?	<u>7,811,157</u>	<u>50.0</u>
Total	<u>\$0</u>	<u>0.0</u>	<u>\$15,622,314</u>	<u>100.0</u>

* Company's financials are reported on a cash basis; therefore, the required information does not exist to calculate actual capital structure.

APPENDIX B

CONCLUSIONS OF LAW

1. The City bears the burden of proof in this proceeding and, accordingly, must establish facts by a preponderance of the evidence. *Se-Ling Hosiery, Inc. v. Margulies*, 70 A.2d 854, 857 (Pa. 1950); *Samuel J. Lansberry, Inc. v. Pa. P. U. C.*, 578 A.2d 600, 602 (Pa. Cmwlth. 1990).
2. The burden of proof is comprised of two responsibilities: the burden of persuasion and the burden of production. *Hurley v. Hurley*, 754 A.2d 1283, 1286 (Pa. Super. Ct. 2000).
3. While the burden of persuasion remains with the party bearing the burden of proof, that party can shift the burden of production to another party upon production of prima facie evidence. *See Hurley v. Hurley*, 754 A.2d 1283, 1286 (Pa. Super. Ct. 2000); *Helwig v. DOT, Bureau of Driver Licensing*, 99 A.3d 153, 158 (Pa. Commw. 2014).
4. Only known and measurable revenues can be recognized for ratemaking purposes. *Pa. Pub. Util. Comm'n. v. PPL Gas Utils. Corp.* 102 Pa. P.U.C. 325, **28-30 (2007).
5. The Commission has jurisdiction over municipal corporations extending public utility service beyond their municipal boundaries. 66 Pa. C.S. § 1102(a)(5).
6. The Commission may approve a normalization period for rate case expense shorter than the average of a public utility's prior three rate filings. *Pa. Pub. Util. Comm'n. v. Lemont Water Co.*, 1994 Pa. P.U.C. LEXIS 44, *18-19 (1994).
7. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties. *Bluefield Water Works & Improvement Company v. P.S.C. of West Virginia*, 262 U.S. 679 (1923).
8. A municipal corporation providing public utility service is entitled to a capital structure reflective of industry norms. *Pa. PUC v. Borough of Media*, 77 Pa. PUC 481 (1992); *see also Pennsylvania Public Utility Commission v. City of Lancaster - Sewer Fund*, Docket No. R-00049862 (Pa. PUC 2005), p. 104.
9. In determining the appropriate cost of common equity for a public utility, the Commission may consider a variety of valuation analysis, including a Discounted Cash Flow, Capital Asset Pricing Model, and Risk Premium calculations. *See Pennsylvania Public Utility Comm'n v. Emporium Water Company*, PUC Docket No. R-2014-2402324 (Order entered Jan. 28, 2015).

APPENDIX C

PROPOSED ORDERING PARAGRAPHS

THEREFORE, IT IS RECOMMENDED

1. That the City of DuBois – Bureau of Water shall not place into effect the rates contained in Supplement No. 22 to Tariff Water – Pa. P.U.C. No. 4 (Supplement No. 22) as originally filed;
2. That the City of DuBois –Bureau of Water shall submit a tariff supplement establishing rates designed to produce an increase in annual revenues of \$229,551, said tariff supplement to become effective upon one day's notice;
3. That the City of DuBois-Bureau of Water shall comply with the terms set forth in the Joint Stipulation of the City of DuBois and the Office of Consumer Advocate; and
4. That the Commission's rate investigation Docket No. R-2016-2554150 be marked closed.