



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

IN REPLY PLEASE  
REFER TO OUR FILE

December 12, 2016

Secretary Rosemary Chiavetta  
Pennsylvania Public Utility Commission  
400 North Street, 2<sup>nd</sup> Floor North  
P.O. Box 3265  
Harrisburg, PA 17105-3265

Re: City of DuBois – Bureau of Water Request for  
Approval to Increase Water Rates  
Docket No. R-2016-2554150

Dear Secretary Chiavetta:

Enclosed please find the Bureau of Investigation and Enforcement's (I&E) **Reply Brief** for this proceeding.

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

Sincerely,

Phillip C. Kirchner  
Prosecutor  
Bureau of Investigation and Enforcement  
PA Attorney I.D. #313870

PCK/sea  
Enclosure

cc: Certificate of Service  
ALJ Mark A. Hoyer

**BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Pennsylvania Public Utility Commission

v.

City of DuBois – Bureau of Water

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Docket No. R-2016-2554150

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**REPLY BRIEF  
OF THE  
BUREAU OF INVESTIGATION  
AND ENFORCEMENT**

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## **I. INTRODUCTION**

### **A. Status of the Proceeding**

The procedural history of this proceeding is detailed in the Bureau of Investigation and Enforcement's (I&E) Main Brief filed on November 29, 2016. In its Main Brief, I&E presented the evidence and law in support of its recommendation that the City of Dubois- Bureau of Water (City or Bureau of Water) be permitted to implement a revenue increase of no more than \$49,180.<sup>1</sup> This Reply Brief is supplemental to the Main Brief filed on behalf of I&E and is limited to those matters raised by the City in its Main Brief.

### **B. Evidentiary Standard and Burden of Proof**

As discussed in Main Brief, the City retains the burden of proving the reasonableness of each and every element of its claim throughout this proceeding. This standard is well-established and recognized by the Commission and courts.<sup>2</sup> A review of the evidence and arguments presented by the parties demonstrates that the City has failed in its burden because the proposed revenue fails to produce just and reasonable rates for its ratepayers.

## **II. SUMMARY OF ARGUMENT**

As will be discussed below, the City's Main Brief failed to present record evidence or law in support of its ratemaking claims. Specifically, the City has failed to demonstrate that it should be awarded recovery of numerous operating and maintenance expense claims including its allocation of the City Manager's salary, costs incurred due to its excessive unaccounted-for water (UFW), overtime expenses, and contractual services. Additionally, the City has not demonstrated that it should earn the requested 6.76%

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<sup>1</sup> I&E MB, Appendix A, Table I.

<sup>2</sup> I&E MB, p. 3.

overall rate of return based upon a hypothetical capital structure and includes a 10.5% return on equity. Failing in this burden, the City's requested \$257,604 proposed increase to jurisdictional revenue must be rejected. Given that it has ultimately failed to prove that it requires the level of increase requested in this proceeding, I&E submits that the record evidence demonstrates that the City is entitled to an increase in revenue of no more than \$49,180.

### **III. ARGUMENT**

#### **A. Rate Base**

In Main Brief, the City accurately indicated that I&E did not oppose the City's claimed plant in service or its proposed deductions and additions to rate base.<sup>3</sup> Specifically, I&E does not contest the revised rate base (less cash working capital) of \$14,727,868 and a depreciation reserve of \$371,275 as claimed by the City in the rebuttal testimony of witness Spanos.<sup>4</sup> However, the cash working capital (CWC) amount in rate base remains an issue given I&E's recommendation to adjust numerous expense claims. Using the agreed-upon 1/8<sup>th</sup> method and incorporating all of I&E's adjustments, the appropriate CWC recovery is \$61,579 in lieu of the City's requested \$71,985.

#### **B. Revenues**

The City maintains that its revenue requirement for the future test year (FTY) ending December 31, 2016 is \$3,489,635.<sup>5</sup> For the reasons presented in I&E testimony, Main Brief and addressed herein, I&E maintains that the appropriate total level of jurisdictional revenue for the City's Bureau of Water is \$849,422, which corresponds to a

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<sup>3</sup> City MB, p. 8.  
<sup>4</sup> I&E MB, p. 5.  
<sup>5</sup> City MB, p. 9.



revenue increase of \$49,180 in this case.<sup>6</sup> This recommended increase will provide the City an opportunity to earn a reasonable rate of return and ensure just and reasonable rates for its customers by eliminating overstated or unsupported ratemaking claims from rates.

## **C. Expenses**

### **1. City Manager's Salary**

In this case, the City claims that approximately 60% of its City Manager's \$114,737 annual salary should be allocated to the Bureau of Water, culminating in a yearly expense of \$68,842.<sup>7</sup> The City's allocation would result in an annual jurisdictional expense of \$19,627.<sup>8</sup> I&E disagrees that allocating 60% of the City Manager's salary to the Bureau of Water is appropriate given that there are no records supporting this allocation and it is implausible that the person who is responsible for running the entire city spends the majority of his time on water matters. Instead, I&E recommends that 25% of this salary be allocated to the Bureau of Water.

The crux of this issue is that the City Manager, John H. Suplizio, does not maintain any records of how much time he spends on matters pertaining to the Bureau of Water, but nevertheless insists that the recommended 60% allocation of his salary to the Bureau of water is appropriate. While the City claims that Mr. Suplizio's testimony in support of the 60% allocation is "one hundred percent accurate," it also admits that there is no supporting documentation and no quantifiable metrics that support his position.<sup>9</sup>

<sup>6</sup> I&E MB, Appendix A, Table I.

<sup>7</sup> I&E MB, p. 14; I&E St. No. 2-SR, pp. 35-36.

<sup>8</sup> I&E MB, p. 14; I&E St. No. 2-SR, pp. 35-36.

<sup>9</sup> City MB, pp. 26-28.

Mr. Suplizio's claim that he "just know[s] what [he] do[es] during a day"<sup>10</sup> is insufficient to meet the City's obligation to prove that its entire claim for his salary is an element of just and reasonable rates.

In an attempt to support this 60% allocation, the City bootstraps the City Manager allocation to the unrelated allocation of the Public Works Director who actually maintains time allocation records.<sup>11</sup> To support bootstrapping Mr. Suplizio's undocumented 60% allocation on the documented salary allocation of the Public Works Director, the City claims that it is "logical" that these employees would spend their time working on the same projects.<sup>12</sup> This argument fails for two reasons. First, the City fails to address the subsequently manifest question of why two people would be doing the exact same work. Second, I&E submits that the scope of Mr. Suplizio's job description, which differs from that of the Public Works Director, belies the possibility that Mr. Suplizio spends 60% of his time working on water issues.

Specifically, as I&E explained in its Main Brief,<sup>13</sup> outside of responsibilities related to the water system, Mr. Suplizio's job description reveals that he is responsible for countless City responsibilities.<sup>14</sup> Many of these responsibilities stem from the fact that Mr. Suplizio also functions as the Chief Administrative Officer of the City, charged with overseeing all offices, departments, and agencies (excluding the Volunteer Fire Department) and he must report to both the Mayor and the City Council. Mr. Suplizio further serves as the liaison to the general public regarding policies and he is charged

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<sup>10</sup> TR, p. 33.

<sup>11</sup> City MB, pp. 26-27.

<sup>12</sup> City MB, pp. 26-27.

<sup>13</sup> I&E MB, pp. 14-15.

<sup>14</sup> I&E Exhibit No. 2, Schedule 8, pp. 5-6.

with establishing current and long-range objectives plans and policies for the City. In addition, Mr. Suplizio must also prepare for and attend all City Council Meetings and he serves as a member of multiple boards, commissions and authorities created by the City. Mr. Suplizio must also prepare and submit all county, state, and federally required reports, attest and seal all legal documents of the City, and prepare and submit all Council correspondence. Beyond that, he must supervise and maintain all aspects of the municipal land, buildings and equipment.

Additionally, Mr. Suplizio also supervises training, safety technique seminars, supplies procurement, and he maintains an open-door for all personnel. On top of all of these other responsibilities, Mr. Suplizio is obligated to present an annual budget and capital program to the City Council and to ensure the adequacy and soundness of the City's financial structure. Mr. Suplizio must make recommendations and provide counsel regarding all municipal operations, fiscal policy, and future needs of the City of DuBois. This must be done contemporaneous with making all required reports available for public inspection and assessing industry trends concerning legislation, arbitration, and collective bargaining. Finally, Mr. Suplizio must write and deliver presentations to City Council regarding Human Resource policies and practices, maintain an effective system of communication throughout the city, and represent the City in issues of public concern and to the business and finance community.

Taking into account the countless responsibilities that Mr. Suplizio is tasked with in fulfilling his roles as City Manager and Chief Administrative Office of the City, it is beyond the scope of belief that he devotes only 40% of his work time in fulfilling those responsibilities. Yet, this is precisely what the City wants the Commission to believe

when it asks the Commission to accept that 60% of his work time is devoted to water operations. The City also wants the Commission to overlook the facts that Mr. Suplizio is neither a certified water system operator nor an engineer,<sup>15</sup> and that his job description does not contain a requirement that he have any skill or knowledge specific to water or public utilities.<sup>16</sup> On these facts, I&E avers that the City's claim is not only unsupported by evidence, but it is contrary to the evidence.

As noted by I&E in its Main Brief, a lack of supporting evidence, as now exhibited by the City, has been rejected by the Commission as insufficient in the past<sup>17</sup> and clearly is not the "substantial" evidence required by the Commission to support expense claims.<sup>18</sup> Further, the City's claim is directly contradicted by the City Manager's position description,<sup>19</sup> which has been utilized as a check upon salary expenses by the Commission before.<sup>20</sup> In sum, the City's claim for this expense is entirely unsupported and hinges solely upon the general approximation of the employee whose salary allocation is at issue. This has historically been unacceptable to the Commission and, accordingly, is unacceptable in this case and should be rejected.

In the absence of timesheets or further evidence to support the City's figures, I&E maintains that 25% of Mr. Suplizio's salary should be attributable to the Bureau of

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<sup>15</sup> TR, p. 36.

<sup>16</sup> OCA MB, p. 31; I&E Exhibit No. 2, Schedule 8, pp. 5-6.

<sup>17</sup> *Pennsylvania Public Utility Commission v. Borough of Quakertown*, Docket No. R-2011-2251181, pp. 24-25 (Order entered September 13, 2012).

<sup>18</sup> 66 Pa. C.S.A. § 315(a) & *Lower Frederick Twp. v. Pennsylvania Public Utility Commission*, 48 Pa. Cmwlth. 222, 226-227, 409 A.2d 505, 507 (1980). See also, *Brockway Glass v. Pennsylvania Public Utility Commission*, 63 Pa. Cmwlth. 238, 437 A.2d 1067 (1981).

<sup>19</sup> I&E Exhibit No. 2, Schedule 8, pp. 5-6.

<sup>20</sup> *Pennsylvania Public Utility Commission v. Borough of Media Water Works*, 72 Pa. P.U.C. 144, Docket No. R-891289, pp. 24-25 (Order entered Feb. 1, 1990).

Water, which is closely aligned with OCA Witness Everett's 24% allocation.<sup>21</sup> This allocation is based upon the supported percentage of the City's finance personnel salary whose work is relevant to the City as a whole, similar to Mr. Suplizio.<sup>22</sup> I&E's recommendation is made with the recognition that a portion of Mr. Suplizio's time and, commensurately, his salary is attributable to the Bureau of Water's operations. The allocation consistent with the finance personnel provides the most appropriate available substitute for time records for Mr. Suplizio, whose work is clearly devoted to multiple areas City operations. Accordingly, I&E maintains that \$28,684 of Mr. Suplizio's salary should be allocated to the Bureau of Water, instead of the \$68,842 proposed by the City.<sup>23</sup> This translates into \$8,178 allocated to jurisdictional ratepayers.<sup>24</sup>

Given I&E's recommended adjustment to the allocation of the City Manager salary, there must be a corollary adjustment to the Health Insurance and Other Benefits Expenses related to this position. Consistent with the recommended salary allocation above of 25%, I&E recommends that these related expenses also be allocated 25%, resulting in a \$1,592 Health Insurance Adjustment and a \$6,847 adjustment to Other Benefits Expense.<sup>25</sup>

## **2. Administration Benefits Expenses**

In Rebuttal, the City discovered that it had not accounted for Unemployment Compensation, FICA, Medicare, or Worker's Compensation pertaining to its claim for Health Insurance and Other Benefits for Administrative Employees. The total of this

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<sup>21</sup> I&E St. No. 2-SR, p. 23.

<sup>22</sup> OCA St. No. 1, p. 35.

<sup>23</sup> I&E St. No. 2-SR, pp. 25.

<sup>24</sup> I&E MB, p. 16; I&E St. No. 2-SR, pp. 25.

<sup>25</sup> I&E St. No. 2-SR, p. 27.

expense was \$41,170. The City claimed an allocation of 42.5% to the Bureau of Water. This resulted in a total system claim of \$17,493 for allocation of additional administrative other benefits to the Bureau of Water. Based on I&E's recommended 33.37% composite allocation, I&E recommended a total system downward adjustment of \$3,755 resulting in an allowance of \$13,738.<sup>26</sup> The City's claim for jurisdictional ratepayers was \$4,987. I&E recommended a downward adjustment for jurisdictional ratepayers of \$1,071, which resulted in an allowance for jurisdictional ratepayers of \$3,916.<sup>27</sup>

To be clear, I&E does not dispute the City's claims for these expenses but instead recommends that the City's 43.5% allocation to the Bureau of Water be reduced to 33.37%. As shown on the table below, I&E agreed with many of the City's proposed allocations assigned to the Bureau of Water; however, for the reasons discussed above, it disagreed with the City's 60% allocation of the City Manager's salary and instead recommended a 25% allocation of that salary. Due to I&E's recommended reduction to the City Manager's allocation factor, it reduced the City's overall 42.5% allocation to I&E's recommended composite allocation of 33.37%.<sup>28</sup> In its Main Brief, the City argues that I&E's recommendation should be rejected because it disagrees with I&E's recommended 25% allocation of the City Manager's salary to the Bureau of Water.<sup>29</sup> For the reasons discussed above and in the I&E Main Brief and testimony, I&E continues to recommend the City Manager's salary be allocated 25% to the Bureau of Water. Based on that recommendation, a corresponding adjustment must be made to this category of

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<sup>26</sup> I&E St. No. 2-SR, p. 35.

<sup>27</sup> I&E St. No. 2-SR, p. 36

<sup>28</sup> I&E St. No. 2-SR, p. 29.

<sup>29</sup> City MB, p. 29.

expense. The resulting composite allocation factor, the calculation of which is shown in the chart below, is 33.37%.

	<b>Per book -2015</b>	<b>% of Allocation to Water</b>	<b>Allocated amount</b>	<b>Revised % of Allocation to water</b>	<b>Revised Allocated amount</b>
City Manager Salary	\$109,208	60.00	\$65,525	<b>25.00</b>	\$27,302
Public Works Director Salary	\$79,251	60.70	\$48,105	60.70	\$48,105
Finance Salaries (Net of Clerical Salaries)	\$200,415	24.00	\$48,100	24.00	\$48,100
Clerical Billing Salaries	<u>\$30,416</u>	54.00	<u>\$16,425</u>	54.00	<u>\$16,425</u>
Total	<u><b>\$419,290</b></u>		<u><b>\$178,155</b></u>		<u><b>\$139,932</b></u>
Composite Allocation Factor			<b>42.50%</b>		<b>33.37%</b>

This adjustment is proper to ensure jurisdictional ratepayers are not being charged for expenses which are not properly allocated to the Bureau of Water.

### 3. Rate Case Expense Normalization Period

I&E does not contest the City's overall rate case expense of \$225,505,<sup>30</sup> comprised of \$90,202 of jurisdictional expense.<sup>31</sup> However, I&E opposes the City's proposed 30-month normalization period and instead recommends a 64-month normalization period, resulting in an annual jurisdictional allowance of \$42,282.<sup>32</sup> Normalization is a ratemaking technique used to smooth out the effects of an expense item that occurs at regular intervals but in irregular amounts, and is a proper adjustment to make the test year expense representative of normal operations. It is well settled that the Commission

<sup>30</sup> Tr., p. 33.

<sup>31</sup> I&E St. No. 2-SR, p. 36.

<sup>32</sup> *Id.*

normalizes rate case expense.<sup>33</sup> While the City argues that I&E’s recommended 64-month normalization period relies upon an “overly rigid application of the general rule favoring normalization of rate case expense based on recent filings,”<sup>34</sup> I&E’s normalization method is consistent with precedent of both the Commission and the Commonwealth Court. Specifically, in determining the length of normalization, it is well settled that the Commission primarily looks at a utility’s historic frequency of base rate case filings, not at its intentions to file in the future.<sup>35</sup>

In this case, the City’s requested 30-month normalization period is not based upon its historic frequency of base rate case filings. Instead, the City’s normalization period was determined by relying only upon one isolated time interval, the time between when its last tariff was placed into effect and the current filing, which equals 2.5 years (30 months).<sup>36</sup> According to City witness Heppenstall, the 30-month normalization period recognizes that rate case expenses should be “spread out over a number of years” and would also “allow[s] the City to recover rate case expense in a reasonable amount of time.”<sup>37</sup> Yet, neither of witness Heppenstall’s supporting rationales provide a viable basis for use of a 30-month normalization period because they ignore the City’s actual filing history except for the very last filing interval.

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<sup>33</sup> *Pennsylvania Public Utility Commission v. Apollo Gas Co.*, 54 Pa. PUC 358, 373 (1980); See, also, *Pennsylvania Public Utility Commission. Carnegie Natural Gas Co.*, 54 Pa. PUC 381 (1980); *Pennsylvania Public Utility Commission v. National Fuel Gas Distribution Corp.*, 54 Pa. PUC 401, 416-417 (1980); *Pennsylvania Public Utility Commission v. Philadelphia Electric Co.*, 56 Pa. PUC 155, 176 (1982); *Pennsylvania Public Utility Commission v. West Penn Power Co.*, 73 Pa. PUC 454 (1990); *Pennsylvania Public Utility Commission v. National Fuel Gas Distribution Corp.*, 73 Pa. PUC 552 (1990).

<sup>34</sup> City MB, p. 22.

<sup>35</sup> *Popowsky v. Pennsylvania Public Utility Commission*, 674 A.2d 1149, 1154 (1996); *Pennsylvania Public Utility Commission v. Emporium Water Company*, R-2014-2402324, Final Order, p. 48 (Order entered on January 28, 2015); *Pennsylvania Public Utility Commission v. Borough of Media Water Works*, 72 Pa PUC 144 (1990); *Pennsylvania Public Utility Commission v. City of Lancaster- Sewer Fund*, R-00049862 (2005).

<sup>36</sup> City St. No. 2-R, p. 13.

<sup>37</sup> *Id.*



On the other hand, I&E witness Patel explained his reliance upon the City's actual historical filing frequency in determining the appropriate normalization period:

[I]n contrast to the City's 2.5 year normalization period (30-month period), I recommend a 64-month normalization period. The normalization period of 64 months is reasonable and validated by historic data given the City's actual base rate filing history in the past three rate cases. Based on the following data, the City has an average historic base rate case filing frequency of every 64 months when considering the cases filed since 2005 (I&E Exhibit No. 2, Schedule 1).

Docket no.	Date Filed	Elapsed Time
R-2016-2554150	June 30, 2016	40 months
R-2013-2350509	March 1, 2013	88 months
R-00050671	October 28, 2005	-

Using the City's last three base rate case filing dates, the average interval is 64 months  $[(40 \text{ mo.} + 88 \text{ mo.}) \div 2 \text{ intervals}]$ . The City's requested 30-month recovery period is not supported by its historic filing record.<sup>38</sup>

As I&E witness Patel thoroughly explained, his recommended 64-month normalization period considered the City's actual historical filing data, and thus it provides the best reflection of a normal, annual level of the City's rate case expenses during the estimated life of new rates.

Additionally, despite the City's reliance upon *Lemont Water*<sup>39</sup> to stand for the proposition that deviation from the historical filing frequency is appropriate where filing frequencies have recently decreased,<sup>40</sup> *Lemont Water* is not determinative in this case. First, the Final Order in *Lemont Water* was issued in 1994, two years before the

<sup>38</sup> I&E St. No. 2, pp. 8-9.

<sup>39</sup> *Pennsylvania Public Utility Commission v. Lemont Water Co.*, 1994 Pa. PUC LEXIS 44, \*1819 (1994).

<sup>40</sup> City MB, p. 22.

Commonwealth Court acknowledged the historical filing frequency standard<sup>41</sup> and several years before other Commission decisions, like *Emporium Water*, adhered to the historical filing frequency standard.<sup>42</sup> Beyond the fact that *Lemont Water* is outdated precedent, it must also be acknowledged that the circumstances in that case are different than the ones here.

In *Lemont Water*, I&E initially recommended the use of an approximately 3-year historical filing frequency, but it later accepted Lemont's 2-year filing frequency.<sup>43</sup> Notably, I&E's final recommendation in *Lemont Water* was also made in conjunction with its recommendation to disallow \$56,682 of Lemont's rate case expense claim.<sup>44</sup> Here, the facts and circumstances are completely distinguishable from *Lemont Water*. In this case, the timing difference between the City's recommendation normalization period of 30-months and I&E's 64-month recommendation, a difference of 34 months, is much longer than the 12-month difference in Lemont. Additionally, I&E has not recommended disallowance of any part of the City's expense claim. Finally, intervening precedent has made it clear that actual historical filing frequency, not the City's stated intention, is now the applicable rate case expense standard. In summary, *Lemont Water* does not support the City's claim in this case.

Furthermore, the City ignores the fact that it is not guaranteed to recover every single dollar of its alleged expenses. In its Main Brief, the City attempts to support its recommended normalization period by alleging that it has been unable to recover all of its

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<sup>41</sup> *Popowsky v. Pennsylvania Public Utility Commission*, 674 A.2d 1149, 1154 (1996)

<sup>42</sup> *Pennsylvania Public Utility Commission v. Emporium Water Company*, Docket No. R-2014-2402324, p. 48 (Order entered January 28, 2015).

<sup>43</sup> *Pennsylvania Public Utility Commission v. Lemont Water Co.*, 1994 Pa. PUC LEXIS 44, \*1819 (1994).

<sup>44</sup> *Id.*

2013 rate case expenses.<sup>45</sup> The City’s argument on this basis is without merit because the City fails to recognize that normalization of rate case expense is not the same as the amortization of that expense. As the Commission has previously explained, the intent of normalization “is to estimate a level of expense to build into revenues that would approximate the normal expenses the company would incur. . . .”<sup>46</sup> On the other hand, amortization “determine[s] an appropriate period of time over which to recover the exact expense.”<sup>47</sup>

The noted difference between normalization and amortization is relevant here because ratemaking is not an exact science and it provides no guarantee that the City will collect expenses incurred dollar for dollar, as would occur through amortization. Instead, normalization is a tool to help the parties and the Commission make the test year expense representative of normal operations. In this case, the review of the City’s rate case filing history reveals that an inappropriately short 30-month normalization period is not reflective of its operations and will likely result in the City over-recovering this expense.

Finally, the City’s mischaracterization of I&E witness Patel’s testimony at the evidentiary hearing in this case does not refute the validity of his recommendation. Although the City avers that witness Patel calculated I&E’s proposed normalization period without taking into account the actual 2013 rate case expense,<sup>48</sup> the record reveals that the amount of the City’s 2013 expense had absolutely no bearing on witness Patel’s

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<sup>45</sup> City MB, pp. 23-24.

<sup>46</sup> *Pennsylvania Public Utility Commission v. Emporium Water Company*, Docket No. R-2014-2402324, p. 48 (Order entered January 28, 2015).

<sup>47</sup> *Id.*

<sup>48</sup> City MB, pp. 23-24.

recommendation. Instead, witness Patel's calculation of the City's actual historical filing frequency drove his recommended 30-month normalization period and no dollar amounts factored into his calculation.<sup>49</sup> For this reason, the actual amount of the City's 2013 expense is inconsequential to witness Patel's recommendation, which was based on the *timing* of the City's rate filings. Accordingly, I&E's recommendation for a 64-month normalization period, based on the City's actual filing history and grounded in applicable precedent, is appropriate for this case. The City's unsupported recommendation for a 30-month period should be rejected.

#### **4. Unaccounted-For Water**

The City maintains that I&E's \$11,754 unaccounted-for water (UFW) adjustment is inappropriate in light of the City's improved UFW and its commitment to reducing UFW through infrastructure improvements.<sup>50</sup> This criticism is unfounded given that the City's UFW levels have not improved but have steadily increased over the past three years from 25.78% in 2013, to 26.22% in 2014, and 28.07% in 2015. In short, the City's UFW has been going in the wrong direction for years and an expense adjustment is warranted as its customers should not be required to pay for the cost to pump, treat and distribute this lost water.

The City asserts that it "has worked diligently to reduce UFW" and, in support, cites to the fact that the 2013-2015 UFW average of 26.69% is substantially below the 30.2% UFW average in 2010-2012.<sup>51</sup> The City's UFW level was 23.77% in 2012 and

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<sup>49</sup> I&E St. No. 2, pp. 8-9.

<sup>50</sup> City MB, p. 15.

<sup>51</sup> City MB, p. 16.

has steadily increased in the intervening years until it reached 28.07% in 2015.<sup>52</sup> While there has been improvement in the three year average, there is no dispute that the City's UFW levels have increased in the three recent years which the City has failed to explain.<sup>53</sup> This upward trend is concerning and the City's attempt to obscure this fact by arguing that the average is not as high as it used to be does not justify continued recovery of this imprudent expense from customers.

The City further argues that I&E's recommendation conflicts with the City of Lancaster's 2014 case when it had a three-year average of 30.7%, higher than the City's current 26.69%, and I&E did not make a UFW adjustment.<sup>54</sup> The implication that I&E has been inconsistent is unfounded given that the City's UFW was 30.2% in its 2013 base rate case and I&E did not make an adjustment.<sup>55</sup> As I&E did not adjust Lancaster's 30.7% UFW in 2014 nor did it adjust the City's 30.2% in 2013, it is disingenuous of the City to assert that I&E has been inconsistent given that I&E did not make a UFW recommendation for either utility in their prior base rate proceedings. However, the City has now filed a subsequent base rate case and its UFW remains unacceptably high and increasing every year, which is why I&E made its recommendation. Additionally, it is important to address the City's implication that I&E's recommendations must be identical in every base rate proceeding. The facts presented by utilities in their base rate cases are different and warrant independent, individualized review and recommendations. As I&E witness Cline testified, "unaccounted-for water percentages and trends should be analyzed in each unique base rate case considering, amongst other criteria, the historic

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<sup>52</sup> I&E St. No. 3-SR, p. 8.

<sup>53</sup> I&E St. No. 3-SR, p. 10.

<sup>54</sup> City MB, pp. 16-17.

<sup>55</sup> I&E St. No. 3-SR, p. 9.

trends of each specific utility.”<sup>56</sup> This is exactly what I&E did in this proceeding and, upon discovering that the City’s UFW levels have increased in 2012, 2013, 2014 and 2015, I&E maintains that its recommended \$11,754 adjustment is warranted.

## **5. Overtime Expenses**

As noted in the I&E Main Brief, the City claimed overtime expenses in two separate categories, which are Water Treatment Plant (WTP) and Transmission and Distribution Systems (T&D). Overtime pertaining to WTP was claimed at \$43,534 and Overtime pertaining to T&D was claimed at \$34,397, for the total system, based solely on expenses from the Historic Test Year (HTY).<sup>57</sup> For jurisdictional ratepayers, this translates to a claim of \$13,056 for WTP overtime and \$9,493 for T&D overtime.<sup>58</sup> I&E recommends using a three year historical average which results in a downward adjustment to the City’s total claim in the amounts of \$3,741 for WTP overtime and \$9,748 for T&D overtime.<sup>59</sup> When this figure is allocated between jurisdictional and non-jurisdictional customers, it results in a downward adjustment for jurisdictional ratepayers in the amounts of \$1,122 for WTP and \$2,689 for T&D. The resulting I&E allowance for jurisdictional ratepayers is \$11,934 for WTP overtime and \$6,804 for T&D overtime. The historical average proposed by I&E more accurately predicts this expense and also ensures that ratepayers do not pay for overtime that will not actually occur.

In its Main Brief, the City makes no argument other than overtime expense has increased since 2013.<sup>60</sup> This argument ignores the fact that overtime, by its very nature is

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<sup>56</sup> I&E St. No. 3-SR, p. 9.

<sup>57</sup> I&E MB, p. 21.

<sup>58</sup> I&E St. No. 2-SR, p. 36.

<sup>59</sup> I&E MB, p. 21.

<sup>60</sup> City MB, p. 18.

a fluctuating expense. For example, the City's overtime amount for T&D was \$22,694 in 2013, it decreased to \$16,856 in 2014 and increased to \$34,397 in 2015.<sup>61</sup> Since overtime expense is generally incurred on an as needed basis, it tends to fluctuate on a yearly basis because some years a company will need its employees to work more overtime than others due to the particular circumstances of that year. I&E's recommended three year average of historical costs provide a reasonable context for the development of future costs when the claimed expense is irregular and erratic, such as overtime. Unlike the City's claim that is based solely on one year of data, I&E's recommended three historical average has the effect of smoothing out any aberrations that occurred in the past and ensures that ratepayers are not paying for an expense that may not occur. Accordingly, I&E continues to recommend that the overtime expenses claimed by the City be modified to the more accurate and substantiated version set forth by I&E Witness Patel. As stated above, I&E recommends an allowance of \$11,934 for WTP overtime and an allowance of \$6,804 for T&D overtime for jurisdictional ratepayers.<sup>62</sup>

## **6. Payroll/FICA Tax Adjustment**

I&E's overtime adjustment addressed above requires a corresponding \$1,031 adjustment to the City's claim for Payroll and FICA taxes. The City contests I&E's proposed overtime adjustment; therefore, it also disagrees with the resulting tax adjustment.<sup>63</sup> For the reasons discussed above, I&E's overtime adjustment and resulting Payroll & FICA tax adjustment should be accepted.

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<sup>61</sup> I&E St. No. 2-SR, p. 10.

<sup>62</sup> I&E St. No. 2-SR, p. 36.

<sup>63</sup> City MB, p. 19.

## **7. Contractual Services for the Water Treatment Plant**

As noted in the I&E Main Brief, I&E recommended an adjustment to Contractual Services for the Water Treatment Plant based on a three year historic average, resulting in a \$5,497 reduction to the City's claim.<sup>64</sup> I&E and the City agree and that there was a particular set of unusual expenses pertaining to Water Shed Management Plan and Herbicide Applications that are appropriately applied to this expense category.<sup>65</sup> This is also supplemented with an agreed-upon annual monitoring expense of \$8,665. I&E and the City differ on the remaining expense amounts, however. I&E maintains that the remaining amounts are most accurately represented by the three year historical average while the City maintains that the HTY data is sufficient. Just as in testimony, in its Main Brief the City offered no other basis for its argument other than "...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 expenses under this account is not the best indicator of future expenses."<sup>66</sup>

As noted for the overtime adjustment, the incorporation of more evidence and historical data through I&E's historical average allows for more accurate prediction of expenses and it also ensures that ratepayers are not required to pay for expenses that will not actually occur. As previously noted, historical costs are relevant to the ratemaking process, and in particular provide a reasonable context for development of future costs when the claimed expense is irregular and erratic. This expense has been very erratic given that the City incurred WTP contractual expense of \$1,825 in 2013, \$865 in 2014,

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<sup>64</sup> I&E MB, p. 23.

<sup>65</sup> I&E MB, p. 23.

<sup>66</sup> City MB, p. 20.



and \$22,323 (after adjusting for abnormal activity) in 2015, which does not justify the City's \$51,138 claim.<sup>67</sup> This type of fluctuating expense is precisely why a three year average is appropriate. Accordingly, incorporating the agreed-upon components outlined above, including updates in Rejoinder, and basing the remaining amounts on three year historical averages, I&E recommends an expense reduction of \$5,497 to the City's claimed \$43,673, resulting in a total of \$38,176 for contractual services pertaining to the Water Treatment Plant.<sup>68</sup> Further broken down for jurisdictional customers, the City claimed \$15,336, which results in an adjustment of \$2,395 to outside customers, producing an I&E recommendation of \$12,941 for jurisdictional customers. The three year historical average of this expense produces the most realistic expectation for the future level of this expense.

## **8. Contractual Services for the Transmission and Distribution System**

As previously stated in I&E's Main Brief, the City claimed \$132,771 in Contractual Expenses related to its Transmission and Distribution system.<sup>69</sup> This amount is nearly nine and a half times the 2014 amount of \$14,087.<sup>70</sup> Given the fluctuating nature of this expense, utilizing a three year average is appropriate to smooth out aberrations for ratemaking purposes.<sup>71</sup> It should also be noted that the expenses incurred during the first half of 2016 totaled only \$8,650, which is *only* 6.51% of the 2015 numbers relied upon exclusively by the City of DuBois.<sup>72</sup>

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<sup>67</sup> I&E St. No. 1-SR, p. 16.

<sup>68</sup> I&E St. No. 2-SR., p. 17. *See also* I&E MB, p. 23.

<sup>69</sup> I&E MB, p. 24.

<sup>70</sup> I&E MB, p. 24.

<sup>71</sup> I&E St. No. 2, p. 21. *See also*, I&E MB, p. 24.

<sup>72</sup> I&E St. No. 2-SR, Pg. 18.

In Main Brief, the City argues that it must be given a higher amount if it is to be expected to reduce its unaccounted-for water.<sup>73</sup> However, just as with overtime expense, these expenses are on an as-needed basis and not guaranteed or expected to recur in the FTY exactly the same as the HTY expense. Therefore, it would not be proper and reasonable to accept the same expense amount for the FTY based only on that consideration. Further, as noted by OCA Witness Everette, "...utilities are not 'given' revenues in rates to incentivize them to do work that needs to be done in order to comply with Commission policies."<sup>74</sup>

The City's reliance on the highest of its last three years in setting this expense is unfair to its ratepayers. Clearly, as the past three years of expense demonstrate, this expense fluctuates. Therefore, it is imperative that the three year historic average be used so as not to unduly burden ratepayers for an expense that might be much lower than that of 2015. Just as with Overtime expense and Water Treatment Contractual Services, the three year historical average represents the best estimation of the future expense. Relying on one abnormally high year of data to set this expense would be unfair to the City's ratepayers and potentially result in rates that are not just and reasonable.

Therefore, I&E continues to recommend a total system allowance of \$92,148 for Contractual Expenses related to Transmission and Distribution system in lieu of the City's claimed \$132,771. The City claimed \$36,671 for jurisdictional customers. The resulting I&E adjustment to reflect the three year average reduces the City's jurisdictional

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<sup>73</sup>

City MB, p. 21.

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OCA St. No. 1S, p. 16.

claim by \$11,220, which results in a recommended allowance of \$25,451 for jurisdictional customers.

#### **D. Rate of Return**

As in the I&E Main Brief, I&E continues to support its overall rate of return recommendation as follows:

<u>Type of Capital</u>	<u>Ratio</u>	<u>Cost Rate</u>	<u>Weighted Cost Rate</u>
Long-Term Debt	70%	3.02%	2.11%
Common Equity	30%	7.05%	2.12%
Total	<u>100.00%</u>		<u>4.23%</u>

The rate of return of 4.23% for the City produces results that are fair, just, and reasonable to both the City and its rate payers.

#### **1. Capital Structure**

As noted in I&E's Main Brief, the City's actual capital structure is comprised of approximately 70% debt and 30% equity.<sup>75</sup> I&E continues to recommend use of the City's actual capital structure in this proceeding as opposed to the City's proposed hypothetical capital structure consisting of 50% long-term debt and 50% equity. The Commission has consistently used the actual capital structure of regulated municipal utilities in determining the appropriate rate of return.

In *Emporium 2001*,<sup>76</sup> the Commission determined the use of Emporium's actual capital structure was appropriate because if the proposed hypothetical capital structure was used, Emporium's ratepayers would be forced to pay a much higher return on rate

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<sup>75</sup> I&E MB, p. 28.

<sup>76</sup> *Pa. PUC v. Emporium Water Co.*, 95 Pa. PUC 191 (2001) (*Emporium 2001*).

base that had been financed by PennVest debt at a rate of only 1%.<sup>77</sup> In *Emporium 2006*<sup>78</sup> the Commission laid out a series of factors that supported the use of Emporium's actual capital structure. The Commission determined the following: (1) it would be consistent with Commission precedent in *Western Utilities*,<sup>79</sup> *Emporium 2001*<sup>80</sup> and *City of Lancaster*;<sup>81</sup> (2) it would recognize the interest of ratepayers in not paying a high return on PennVest debt that only cost 1%; (3) a cost of equity adjustment could be used to make up the difference between the principal due and the depreciation expense related to the PennVest-funded plant recognizing the City's need and securing timely repayment of the loan; and, (4) it would be consistent with Commission decision's in *Lower Paxton*,<sup>82</sup> *Carnegie*,<sup>83</sup> and *Riverton*<sup>84</sup> that emphasize the fact that the Commission must use discretion in balancing the interest of the utility and its ratepayers.<sup>85</sup>

In the *City of Lancaster*<sup>86</sup> the Commission discussed the use of an actual capital structure for a municipal utility under the Commission's jurisdiction. The Commission stated the following:

We conclude that based upon the unique circumstances in this proceeding that the actual capital structure must be used for ratemaking purposes to achieve a fair balance between consumers and the City. The OTS, the OCA as well as Kellogg have correctly argued that the use of a hypothetical

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<sup>77</sup> *Id.*, at 198-199.

<sup>78</sup> *Pa P.U.C. v. Emporium Water Co.*, Docket No. R-00061297 (Order entered Dec. 28, 2006) (*Emporium 2006*).

<sup>79</sup> *Pa. PUC v. Western Utilities, Inc.*, 88 Pa. PUC 124 (1998).

<sup>80</sup> *Emporium 2001*.

<sup>81</sup> *Pa PUC v. City of Lancaster – Sewer Fund*, 2006 WL 8411478.

<sup>82</sup> *Lower Paxton Township v. Pa. PUC*, 317 A.2d 917 (Pa. Commw. 1974).

<sup>83</sup> *Pa. PUC v. Carnegie Nat. Gas Co.*, 54 Pa. PUC 381 (1980).

<sup>84</sup> *Riverton Consolidated Water Company v. Pennsylvania Public Utility Commission*, 140 A.2d 114 (Pa. Super. 1958) (*Riverton*).

<sup>85</sup> *Id.*, at 52-53

<sup>86</sup> *Pa. PUC v. City of Lancaster*, Docket No. R-2010-2179103 (Order entered July 14, 2011).

capital structure will produce an inflated overall rate of return that would adversely affect consumers.<sup>87</sup>

The Commission further stated:

Additionally, we note that the capital structure represents the City's decision, in which it has full discretion, on how to capitalize the Water bureau's rate base. This actual capitalization forms the basis upon which the Water Bureau and the City attract capital.<sup>88</sup>

The Commission went on to state:

We find that the ALJ's reliance on the comparison of the City's capital structure to the comparison groups' capital structures inappropriate in this instance. The utilities in the comparison group are publicly traded companies that need to meet market norms for capital structure ratios. As the City is not traded as a separate entity and does not need to meet these same requirements the use of a hypothetical capital structure is misplaced. We find that using the City's hypothetical capital structure would impose excessive costs on customers because it requires customers to pay equity returns of over 10 percent on debt that costs, on average 4.66 percent. On the other hand, use of the actual capital structure...does not result in excessive costs to customers.<sup>89</sup>

In the current case, the City is similarly situated to the City of Lancaster. The City of DuBois provides the capital financing to the Bureau of Water. The City of DuBois has discretion to capitalize the Bureau of Water in any manner it sees fit. As noted by I&E Witness Maurer, "[t]he Bureau of Water has maintained a debt-heavy capital structure and has demonstrated through the issuance of low-cost debt...that it is able to maintain a debt-heavy capital structure."<sup>90</sup>

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<sup>87</sup> *Id.*, at 51.

<sup>88</sup> *Id.*, at 54.

<sup>89</sup> *Id.*, at 55.

<sup>90</sup> I&E St. No. 1-SR, p. 14.

The City cites to the *Borough of Media*<sup>91</sup> case as support for the utilization of a hypothetical capital structure.<sup>92</sup> While it is true that the Commission used a hypothetical capital structure in *Borough of Media*, in *City of Lancaster* the Order stated:

Clearly, the Commission has discretion in whether to use a hypothetical capital structure. However, the Commission must always balance the interest of the utility and the customers when considering a hypothetical capital structure...Thus, there are no magic numbers for the proper percentage of debt and equity.<sup>93</sup>

The instant case is much like *Lancaster*, *Emporium 2006*, *Emporium 2001*, and *Western Utilities*.<sup>94</sup> In those cases, the Commission was concerned about shifting low cost debt into higher cost equity. Even under a hypothetical capital structure, there would still be a substantial portion of low cost debt that would have to be shifted to higher cost equity should the Commission impose this hypothetical capital structure. As noted previously, this low debt cost rate reflects the City of DuBois' ability to tax its residents. There can be no doubt that the City of DuBois' taxing power lowers the Bureau of Water's financial risk given that it is a municipal owned utility. Since the Bureau of Water's status as a municipally owned utility provides it with the opportunity to obtain debt at this low cost rate as a result of the City of DuBois' ability to tax, this low cost debt should not be shifted to higher cost equity at the expense of the ratepayers. For this reason, it is the position of I&E that the Bureau of Water does not have to be treated like an investor owned utility for ratemaking purposes and, therefore, a hypothetical capital

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<sup>91</sup> *Pa. PUC v. Borough of Media*, 77 Pa. PUC 481 (1992)(*Media*).

<sup>92</sup> City MB, pp. 39-40.

<sup>93</sup> *City of Lancaster*, Docket No. R-2010-2179103, p 53 (Order entered July 14, 2011).

<sup>94</sup> *Pa P.U.C. v. Emporium Water Co.*, Docket No. R-00061297 (Order entered Dec. 28, 2006), *Pa. P.U.C. v. Emporium Water Co.*, 95 PaPUC 191, 208 PUR4th 502 (2001), *Pa. P.U.C. v. Western Utilities, Inc.*, 88 Pa. PUC 454 (1998).

structure does not need to be imposed. As noted by I&E Witness Maurer, “[w]hile the Bureau of Water’s capital structure is atypical of the investor-owned water utility industry, the low cost of debt that the Bureau of Water is able to obtain through the City of DuBois is also atypical of the invest-owned water utility industry.”<sup>95</sup>

The use of the hypothetical capital structure requested by the DuBois would serve only to unjustly enrich the Bureau of Water. The use of this hypothetical capital structure would simply shift 20% of the City’s capital from low cost debt to higher cost equity, thus, allowing the Bureau of Water to charge its customers a higher cost rate for a misplaced portion of debt. For the reasons set forth above and in the I&E Main Brief, I&E maintains that it is clear that the use of City’s proposed hypothetical capital structure must be rejected. The City’s actual capital structure of 70% debt and 30% equity must be used as it benefits the City’s ratepayers in the form of low cost debt, and allows the City an opportunity to earn a fair rate of return.

## **2. Cost of Common Equity**

Despite the City’s argument to the contrary, the basis for I&E’s recommended cost of common equity is based on sound valuation methodology that is consistent with Commission precedent. Specifically, employing a discounted cash flow (DCF) analysis, I&E witness Maurer arrives at a cost of common equity of 8.62%,<sup>96</sup> encompassing a dividend yield of 2.31% and a growth rate of 6.31%. In order to avoid the impact of short-term anomalies and stale data, witness Maurer calculated the dividend yield by placing equal emphasis on the most recent spot and the 52-week average dividend

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<sup>95</sup> I&E St. No. 1-SR, p. 12.

<sup>96</sup> This figure has been adjusted downward to 7.05%, to account for a tax adjustment, which will be addressed more thoroughly below.

yields.<sup>97</sup> Additionally, the growth rate was calculated by using five-year projected growth rate estimates from Value Line, Yahoo! Finance, Zacks, and Morningstar and applying those rates to the Proxy group mutually endorsed by the City and I&E, resulting in an average of 6.31%.<sup>98</sup>

After completing her DCF analysis, witness Maurer conducted a Capital Asset Pricing Model (CAPM) analysis in order to confirm the results of her DCF analysis. The resulting forecasted CAPM of 7.76% and the Historic CAPM of 8.97% confirms the reasonableness of the DCF methodology employed by I&E.<sup>99</sup> Accordingly, the sound basis of witness Maurer's DCF analysis is well-supported in the evidentiary record and consistent with Commission precedent.

Conversely, the City derives a cost of equity of 10.5% based equally upon the DCF, CAPM, and the Risk Premium (RP) methodologies. In arriving at its proposed cost of equity, the City abandons Commission precedent, relies upon unwarranted size and leverage adjustments, and dismisses sound valuation methodology. The City's attempt to inflate its cost of common equity, resulting in its 10.5% recommendation, is contrary to the weight of evidence and should be rejected.

**a) The City's Critique of I&E's Cost of Common Equity  
Recommendation is without Merit**

**(1) DCF**

The City argues that I&E's recommended cost of common equity derived from its DCF results is "wholly inadequate as compared to prior Commission decisions and

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<sup>97</sup> I&E St. No. 1, p. 24.

<sup>98</sup> I&E St. No. 1, pp. 24-25.

<sup>99</sup> I&E MB, p. 32; I&E St. No. 1, pp. 26-31.



fundamentally flawed due to improper growth rates.”<sup>100</sup> Despite the City’s argument to the contrary, the basis for I&E’s recommended cost of common equity is based on sound valuation methodology that is consistent with Commission precedent.

First, the City’s contention that I&E’s recommended common equity cost rates represent a significant departure from recent Commission decisions is based on the faulty assumption that the outcome of one utility’s proceeding is determinative of the outcome of every other proceeding.<sup>101</sup> Just as the Commission has a duty to set rates that are just and reasonable for each public utility,<sup>102</sup> in this proceeding, I&E must make recommendations that are appropriate using the data and facts specific to the Bureau of Water. For this reason, the City’s references to Commission approval of cost of common equity rates for different utilities, under circumstances not of record in this case, are not determinative here. Similarly, the City’s argument that “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%”<sup>103</sup> is groundless and it should be rejected. There is no connection between the most recently authorized DSIC-related return on common equity, which is set as an incentive for a utility to maintain and improve its infrastructure, and the cost of common equity that is appropriate for the City, so no reasonable basis for comparison exists. Accordingly, this argument is based on faulty logic and it should be rejected.

Second, the City’s contention that the growth rates that I&E relied upon in calculating its common equity cost rate represented a departure from prior precedent and

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<sup>100</sup> City MB, p. 50.

<sup>101</sup> City MB, p. 50.

<sup>102</sup> 66 Pa. C.S. §1301.

<sup>103</sup> City MB, p. 50; City St. No. 4-R, p. 25.

resulted in error is erroneous.<sup>104</sup> Although I&E may have previously calculated its growth rates using a log-linear analysis, it has not done so since 2012, and witness Maurer has never used a log-linear analysis in growth rate calculation.<sup>105</sup> Additionally, I&E's decision to not use a log-linear analysis in this proceeding is consistent with prior precedent given that it did not use a log-linear analysis in the City's last rate case in 2013.<sup>106</sup> I&E witness Maurer explained why the log-linear analysis would not be appropriate in this case:

I have not used a log-linear analysis because the historical growth in earnings is not indicative of future growth for the water utility industry as demonstrated by the need for a significant amount of funds to be invested in capital improvements. This translates into replacing fully depreciated plant with new plant which increases rate base. Rate of return is applied to this increased rate base, thereby increasing earnings. It is this growth in earnings which causes the growth rate to be different from its historical rates.<sup>107</sup>

In lieu of relying on a log-linear analysis, witness Maurer relied upon forecasted growth rates in her DCF analysis. Witness Maurer's reliance upon the forecasted growth rates is appropriate because the forecasts are provided by analysts who are aware of both historic events of each company as well as what is expected at both a company and industry level.<sup>108</sup> On the other hand, witness Walker's DCF relied upon growth rates that relied more heavily upon past performance and is therefore less reliable.

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<sup>104</sup> City MB, p. 50.

<sup>105</sup> I&E St. No. 1-SR, p. 15.

<sup>106</sup> I&E St. No. 1-SR, p. 15.

<sup>107</sup> I&E St. No. 1-SR, p. 16.

<sup>108</sup> I&E St. No. 1-SR, p. 17.

## **(2) Risk Premium and CAPM**

The City's criticism that I&E failed to perform a reasonable Risk Premium (RP) or CAPM analysis to check its DCF results are without merit.<sup>109</sup>

Although the City is correct that I&E did not perform an RP analysis, I&E explained its reason for declining to use that method. Specifically, the RP method is a less reliable indicator because it measures the cost of equity indirectly and risk premiums vary depending on the debt and equity being compared.<sup>110</sup> Furthermore, the RP method fails to measure the specific risk of the company.<sup>111</sup> The unreliability of the RP is further compounded in the regulatory context because regulators can never be certain that economic and regulatory conditions underlying the historical period during which the risk premiums were calculated are the same today or in the future.<sup>112</sup> Because the RP method is not a reliable indicator of the cost of equity, I&E's decision not to perform such an analysis is of no consequence and in no way invalidates its DCF calculation.

The City recognizes that I&E witness Maurer did conduct a CAPM analysis, but criticizes her analysis on two bases. First, the City argues that witness Maurer's CAPM analysis did not include a size adjustment.<sup>113</sup> As will be discussed in greater detail below, Witness Maurer has explained that a size adjustment is not warranted in this case. Second, the City disagrees with Ms. Maurer's use of a geometric mean of historical

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<sup>109</sup> City MB, p. 52.

<sup>110</sup> I&E St. No. 1, p. 19.

<sup>111</sup> I&E St. No. 1, p. 17.

<sup>112</sup> I&E St. No. 1, pp. 19-20.

<sup>113</sup> City MB, p. 52.

returns instead of an arithmetic mean to develop the market risk premium for her CAPM.<sup>114</sup>

The City's criticism of witness Maurer's CAPM risk premium is unfounded because the geometric mean is more representative of historical performance and therefore more appropriate. Ms. Maurer has explained that the geometric mean of historical returns is more appropriate in developing the risk premium because it measures the changes in returns or yields over more than one period of time.<sup>115</sup> As use of the geometric mean minimizes the effect of any particular years that deviated from normal years, it provides a more accurate representation of the typical value and therefore is a better representation of the historical market risk premium.<sup>116</sup> On the other hand, the arithmetic mean, as endorsed by the City, is more susceptible to being influenced by outliers and therefore is not the most effective representation of the central tendency of a set of numbers.<sup>117</sup> For this reason, the arithmetic mean more accurately represents the volatility of returns than historical performance, thwarting its value in developing a market risk premium. Accordingly, the City's criticism of I&E's failure to rely upon the arithmetic mean in calculating the risk premium for the CAPM analysis is unwarranted as its CAPM analysis was calculated appropriately and it served as a reliable check on I&E's DCF analysis.

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<sup>114</sup> City MB, p. 52.

<sup>115</sup> I&E St. No. 1-SR, p. 19.

<sup>116</sup> I&E St. No. 1-SR, pp. 19-20.

<sup>117</sup> I&E St. No. 1-SR, pp. 19-20.

### (3) Tax Adjustment

The City criticizes I&E's recommended tax adjustment because it used General Obligation (GO) bonds to arrive at the 18.22% tax rate instead of revenue bonds.<sup>118</sup> A tax adjustment is appropriate in this proceeding because all investment income received by investors from municipal utilities is tax exempt, requiring the cost of equity to be reduced by a tax rate that is representative of a typical municipal investor.<sup>119</sup> I&E recommended an 18.22% tax rate, which reduced its equity recommendation from 8.62% to 7.05%. The City stated that if a tax adjustment is approved, it should be a maximum of 9%, which would reduce its equity recommendation from 10.5% to 9.56%.<sup>120</sup>

In Main Brief, the City argues that "Revenue bonds are a far better measure of the Bureau's risk, as they reflect higher yields associated with investment in an enterprise fund."<sup>121</sup> This argument is flawed given that the Bureau of Water has no Revenue Bonds outstanding; it only has bank notes and in the past has issued GO Bonds. Given that investors are choosing between a Public Utility Bond and a GO Bond, these are the appropriate bonds to use to calculate this adjustment. Moreover, the City's position ignores the fact that it obtains its funding through the City of DuBois, which issues GO Bonds. The cost of common equity should reflect the risk of the underlining assets devoted to providing water service; therefore, GO Bonds should be used in this tax analysis, because those are the bonds that have financed the assets. The City's critique of

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<sup>118</sup> City MB, pp. 53-54.

<sup>119</sup> *Lancaster Water v. Pennsylvania Public Utility Commission*, 769 A.2d 567 (Pa. Cmwlth. 2001) *appeal denied*, 568 Pa. 725, 797 A.2d 916 (2002). *Pennsylvania Public Utility Commission v. City of Lancaster Water*, 197 P.U.R. 4th 156 (Pa. P.U.C. 1999). *Pennsylvania Public Utility Commission v. City of Lancaster Sewer*, Docket No. R-0005109, Order entered Feb. 2, 2001. *Pennsylvania Public Utility Commission v. City of Lancaster Sewer*, 2005 Pa. PUC LEXIS 44.

<sup>120</sup> City MB, pp. 53-54.

<sup>121</sup> City MB, p. 53.

I&E's reliance on GO bonds ignores this reality and its reliance on revenue bonds is in error given that the City has not issued such bonds and the water assets have not been financed by revenue bonds.

The City further criticizes I&E's tax adjustment because it did not attempt to match the credit quality of the GO bonds rated Aaa to Bbb with public utility bonds rated Aa to Baa.<sup>122</sup> First, such a match is impossible given that the Mergent Bond Record discontinued its record of Aaa rated public utility bonds as of December 10, 2001; therefore, Aaa rated public utility bonds cannot be included.<sup>123</sup> Moreover, Mr. Walker overstates the importance of matching the credit quality of bonds. As I&E witness Maurer explained:

The Mergent Bond Record indicates that bonds carrying the same rating are not claimed to be of absolutely equal quality. In a broad sense the bonds are alike in position, but since there are a limited number of rating classes used in grading thousands of bonds, the symbols cannot reflect the fine shadings of risks which actually exist.<sup>124</sup>

I&E has not made a claim as to the Bureau of Water's specific bond rating, and therefore used the average of all bonds available in each category to determine the marginal investor's tax rate. Since there are many "shadings" of risk in each grading, including the Aaa rated municipal rates, the use of the average is appropriate.

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<sup>122</sup> City MB, p. 52.

<sup>123</sup> I&E St. No. 1-SR, p. 21.

<sup>124</sup> I&E St. No. 1-SR, p. 22.

**b) The City Has Improperly Inflated its Cost of Common Equity Recommendation**

**(1) Equal Weighting of the DCF, RP and CAPM Results**

The City recommends that it be authorized to earn a 10.5% return on common equity based on the results of the DCF model of 10%, the Risk Premium model of 11%, the Capital Asset Pricing model of 11%.<sup>125</sup> By giving equal weight to these models, the City's proposed 10.5% equity return is overstated.

It is inappropriate to give equal weight to the different methodologies as City witness Walker proposes. The City states that "the Commission has long supported the use of DCF analysis, with reference to the results of other models as a check."<sup>126</sup> This is exactly the analysis I&E used in this proceeding as it relied upon the DCF and used the CAPM as a check. I&E witness Maurer relied upon the DCF to determine the 8.62% equity recommendation prior to the recommended tax adjustment, which when compared against the CAPM results under the forecasted and historic analyses of 7.75% (forecasted) and 8.97% (historic), is demonstrated to be reasonable.<sup>127</sup>

The City chastises I&E for relying solely on the DCF model, arguing that the financial community and Commission precedent support consideration of multiple valuation methods.<sup>128</sup> The Commission has not abandoned its reliance on the DCF and elevated the RP or CAPM as primary methods to determine the appropriate cost of common equity. The fact remains that the DCF has historically been and continues to be the methodology that the Commission relies upon. In the recent January 2014 Columbia

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<sup>125</sup> City MB, pp. 47-49.

<sup>126</sup> City MB, p. 45.

<sup>127</sup> I&E MB, p. 32.

<sup>128</sup> City MB, p. 44.

Water order, the Commission reaffirmed that the DCF, along with informed judgment, is the foundation of the cost of common equity determination:

Based on our review of the testimony, data, and the cost models presented, we believe that the evidence in this case supports an ROE finding in the reasonable range of 9.25% to 10.25% using the DCF method as the foundation...However, the small size of the company, its management effectiveness, and the results of ROE models other than DCF are all reasons to set a higher ROE. Therefore, within our indicated range of reasonableness, we conclude that a ROE of 9.75% is appropriate for our ratemaking determinations herein.<sup>129</sup>

As discussed above, the DCF was used as the “foundation” to determine the reasonable cost of equity range, and the 9.75% that the Commission ultimately approved was in the DCF’s range of reasonableness. Although the Commission commented that one of the reasons to increase the equity return was due to the results of other equity cost models, it is clear that the Commission did not afford those other models equal weight with the DCF as the City attempts to do.

## **(2) Leverage Adjustment**

As argued in I&E’s Main Brief and testimony, the City’s proposed 70 basis point leverage adjustment to the DCF, CAPM and RP analysis is unwarranted and unnecessary. Mr. Walker makes these “important adjustments to correct the DCF calculation to reflect current market conditions,” but, in actuality, it only serves to improperly inflate his DCF results from 9.3% to 10%. The proposed leverage adjustment is not supported by the way rating agencies characterize financial risk, Commission precedent or academic

<sup>129</sup>

*Pa. PUC v. The Columbia Water Company*, Docket No. R-2013-2360798, p. 43 (Order entered January 23, 2014).



literature. Rather, it is a results-oriented approach solely intended to boost an equity return.

First, the City asserts that the leverage adjustment is necessary “to correct for the financial risk difference resulting from market capitalization ratios differing from book value capitalization ratios;”<sup>130</sup> however, financial risk resides in the income statement, not market capitalization as Mr. Walker asserts.<sup>131</sup> Rating agencies assess financial risk based upon the company’s booked debt obligations and the ability of its cash flow to cover the interest payments on those obligations, not on how the company’s investments are valued in the market place.<sup>132</sup>

Second, Mr. Walker’s leverage adjustment has been repeatedly rejected by this Commission.<sup>133</sup> Importantly, as noted in I&E’s Main Brief, in the City of Lancaster’s 2011 base rate proceeding, the Commission expressly determined that the proposed leverage adjustment “will harm ratepayers.”<sup>134</sup> Third, I&E is not aware of any academic literature that supports Mr. Walker’s leverage adjustment.<sup>135</sup> While he cites to research conducted by Modigliani and Miller as support for this adjustment, it actually supports just the opposite given that it concludes that the market value of any firm is independent of its capital structure.<sup>136</sup> Moreover, Mr. Walker has misinterpreted Modigliani and Miller’s theory and used it in a way the researchers never advocated because the primary purpose of Modigliani and Miller’s research was to understand company capital

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<sup>130</sup> City MB, p. 46.

<sup>131</sup> I&E St. No. 1, p. 37.

<sup>132</sup> I&E St. No. 1, p. 37.

<sup>133</sup> I&E St. No. 1, pp. 38-39.

<sup>134</sup> I&E MB, p. 35.

<sup>135</sup> I&E St. No. 1, p. 41.

<sup>136</sup> I&E St. No. 1, pp. 40-41.

investment behavior, not the financial risk associated with a stock's market price diverging from its book value.<sup>137</sup> Accordingly, I&E submits that this proposed equity adder be rejected as it is solely designed to inflate the equity return to the detriment of the City's jurisdictional ratepayers.

### (3) Size Adjustment

The City argues that witness Maurer's CAPM analysis did not include a size adjustment.<sup>138</sup> The City adds 110 basis points<sup>139</sup> to its CAPM results to account for a perceived size effect, but it failed to support the proposed premium. The crux of its argument in favor of the 110 basis point adjustment is that the CAPM should be adjusted to include a premium for the additional risk faced by *small companies*, like the Bureau of Water.<sup>140</sup> The fatal flaw in this argument is that the Bureau of Water is not a small company, instead it is municipal utility.

The Bureau of Water's status as a municipal utility is relevant because the size factor for small companies does not translate to utilities, much less to a municipal utility.<sup>141</sup> Witness Maurer provided academic support for this premise in the form of an article published in the Journal of Midwest Finance Association by Annie Wong entitled "Utility Stocks and the Size Effect: An Empirical Analysis."<sup>142</sup> In the article, Annie Wong explained the results of her study that demonstrated that while a size adjustment may be a factor warranting consideration in the CAPM of an industrial firm, it is not similarly warranted in the context of utility rate regulation:

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<sup>137</sup> I&E St. No. 1, p. 40.

<sup>138</sup> City MB, p. 52.

<sup>139</sup> City Exhibit HW-1, Schedule 20.

<sup>140</sup> City St. No 4-R, p. 26 (emphasis added).

<sup>141</sup> I&E St. No. 1, p. 48.

<sup>142</sup> "Utility Stocks and the Size Effect: An Empirical Analysis." Journal of Midwest Finance Association in 1993, Wong, Annie, pp. 95-101.

The objective of this study is to examine if the size effect exists in the utility industry. After controlling for equity values, there is some weak evidence that firm size is a missing factor from the CAPM for the industrial but not for utility stocks. This implies that although the size phenomenon has been strongly documented for the industrials, the findings suggest that there is no need to adjust for the firm size in utility rate regulation.<sup>143</sup>

Although City witness Walker attempted to refute the conclusions of Ms. Wong's studies, his attempts to do so were unsuccessful. In one attempt, witness Walker relied upon a 2002 article by T. M. Zepp that purported to support a size premium adjustment for small water utilities.<sup>144</sup> However, witness Maurer explained that Zepp not only failed to actually re-create Ms. Wong's study, but he also relied upon results from only four water utilities, rendering faulty conclusions.<sup>145</sup> While witness Walker relied on a second article by M. Annin to support the use of size premium for utilities,<sup>146</sup> witness Maurer correctly explained that the article relied upon was not specific to utility companies and in no way refuted Dr. Wong's utility-specific article.<sup>147</sup> Accordingly, the City provides no basis for calculating a CAPM size adjustment for a municipal utility and its request for the adjustment should be denied.

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<sup>143</sup>

*Id.*

<sup>144</sup>

City St. No. 4-R, p. 35.

<sup>145</sup>

I&E St. No. 1-SR, p. 24.

<sup>146</sup>

City St. No. 4-R, p. 35.

<sup>147</sup>

I&E St. No. 1-SR, p. 25.

#### IV. CONCLUSION

For the reasons set forth in I&E's Main Brief and the instant Reply Brief, I&E maintains that the City of DuBois- Bureau of Water failed to bear its burden of proof with respect to each and every element of its rate case claims. Failing in this burden, its requested rate increase must be amended to reflect all necessary and appropriate adjustments. Accordingly, the Bureau of Investigation and Enforcement respectfully requests that the Administrative Law Judge and the Commission adopt its recommendations in this proceeding and approve a rate increase of \$49,180.

Respectfully submitted,

  
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Dated: December 12, 2016

BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

City of DuBois – Bureau of Water :  
Request for Approval to : Docket No. R-2016-2554150  
Increase Water Rates :

**CERTIFICATE OF SERVICE**

I hereby certify that I am serving the foregoing **Reply Brief** dated December 12, 2016, in the manner and upon the persons listed below, in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a party):


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