



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

IN REPLY PLEASE  
REFER TO OUR FILE

February 13, 2017

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 Exceptions** 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: ALJ Mark A. Hoyer  
Certificate of Service

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 Exceptions** dated February 13, 2017, 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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## I. INTRODUCTION

On June 30, 2016, the City of DuBois - Bureau of Water (“City” or “DuBois”) filed Supplement No. 22 to Tariff Water - Pa. P.U.C. No. 4 (“Supplement No. 22”) to become effective August 29, 2016. Supplement No. 22 contains proposed changes in rates, rules, and regulations calculated to produce approximately \$257,604 (33.7%) in additional revenues from customers based on a historic test year ending December 31, 2015 and a future test year ending December 31, 2016. Pursuant to 66 Pa. C.S. § 1308(d), the filing was suspended by operation of law until March 29, 2017, unless permitted by Commission Order to become effective at an earlier date on August 11, 2016.

A Prehearing Conference was held on September 9, 2016, with Deputy Chief Administrative Law Judge (“ALJ”) Mark A. Hoyer presiding. In addition to the appearance of the Commission’s Bureau of Investigation and Enforcement (“I&E”), the Office of Consumer Advocate (“OCA”), the Office of Small Business Advocate (“OSBA”), and Sandy Township (“Sandy”) were active participants in the full litigation of this proceeding. An evidentiary hearing was held on November 10, 2016 in Harrisburg, PA.

Following the submission of Main and Reply Briefs, the Secretary’s Bureau issued the Recommended Decision (“RD”) of ALJ Hoyer on January 13, 2017, which recommends the City be granted an overall increase of \$97,534 in lieu of I&E’s recommended increase of \$49,180. Exceptions were filed by all parties on February 2, 2017. I&E now timely submits these Reply Exceptions in response to the City of DuBois’ Exceptions.

## II. REPLIES TO EXCEPTIONS

### A. Reply to City of DuBois Exception 4 – The Recommended Decision correctly normalized rate case expense in accordance with Commission precedent.

Recommended Decision: Pages 46-49

I&E Main Brief: Pages 18-19

I&E Reply Brief: Pages 9-14

#### 1. The City relies on inapplicable case law that has been superseded.

In the RD, ALJ Hoyer correctly relies upon a multitude of prior decisions from the Commission before making a well-founded<sup>1</sup> recommendation to base the normalization period of rate case expense upon the City's historical filing frequency. This results in a normalization period of 64 months. The City, however, believes that it should be allowed to recover this expense in less than half of that time.

Throughout this proceeding, DuBois relies exclusively upon *Lemont Water*<sup>2</sup> in support of its overly aggressive and unfounded rate case normalization request. This is a lone and outdated case that is not only distinguishable from the case at hand but has been clearly superseded by volumes of case law.

As noted in I&E's Reply Brief, *Lemont Water* is not applicable in this matter.

First, the Final Order in *Lemont Water* was issued in 1994, two years before the

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<sup>1</sup> *Inter alia Pennsylvania Pub. Util. Comm'n v. Borough of Quakertown*, Docket No. R-2011-2251181 (Order entered September 13, 2012); *Popowsky v. Pa. Pub. Util. Comm'n*, 674 A.2d 1149, 1154 (Pa.Cmwlth. 1996); *Pa. Pub. Util. Comm'n v. Columbia Water Co.*, 2009 Pa. PUC LEXIS 1423 (2009); *Lancaster Sewer*, 2005 Pa. PUC LEXIS at 84; *Pa. Pub. Util. Comm'n v. National Fuel Gas Distribution Corp.*, 84 Pa. PUC 134, 175 (1995); *Pa. Pub. Util. Comm'n v. Roaring Creek Water Co.*, 73 Pa. PUC 373, 400 (1990); *Pa. Pub. Util. Comm'n v. West Penn Power Co.*, 119 PUR 4th 110, 149 (Pa. PUC 1990).

<sup>2</sup> *Pennsylvania Public Utility Commission v. Lemont Water Co.*, 1994 Pa. PUC LEXIS 44, \*1819 (1994).

Commonwealth Court acknowledged the historical filing frequency standard<sup>3</sup> and several years before other Commission decisions, like *Emporium Water*, adhered to the historical filing frequency standard.<sup>4</sup> Given this precedent, *Lemont Water* has clearly been superseded for years.

Furthermore, the facts in *Lemont Water* are very different from the case at hand. In *Lemont Water*, I&E (then Office of Trial Staff or “OTS”) advocated for the use of an approximate 3-year historical filing frequency but ended up supporting Lemont’s 2-year filing frequency<sup>5</sup> in surrebuttal. This was done in conjunction with a recommendation to disallow \$56,682 of Lemont’s rate case expense claim.<sup>6</sup> In DuBois, the timing difference between the City’s recommended 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 Water* and I&E has not sought disallowance of any component of the City’s rate case expense claim.

The City further attempts to obfuscate this issue by insisting a shortened normalization period is merited because rate case filings may become more frequent in the future.<sup>7</sup> The City has repeatedly and glaringly failed to address the fact that this

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<sup>3</sup> *Popowsky v. Pennsylvania Public Utility Commission*, 674 A.2d 1149, 1154 (1996)

<sup>4</sup> *Pennsylvania Public Utility Commission v. Emporium Water Company*, Docket No. R-2014-2402324, Pg. 48 (Order entered January 28, 2015).

<sup>5</sup> *Pennsylvania Public Utility Commission v. Lemont Water Co.*, 1994 Pa. PUC LEXIS 44, \*1819 (1994).

<sup>6</sup> *Pennsylvania Public Utility Commission v. Lemont Water Co.*, 1994 Pa. PUC LEXIS 44, \*1819 (1994).

<sup>7</sup> City of DuBois Exceptions, Pgs. 8-9.



reasoning has been explicitly rejected by the Commission in the past.<sup>8</sup>

**2. The City’s claim of failing to recover rate case expense is entirely speculative and unfounded.**

The City mistakenly claims that “[i]njustice”<sup>9</sup> has been perpetrated because it has not been given the rate case normalization period it has sought. However, the City is never guaranteed to fully recover any normalized expense<sup>10</sup> and has confused normalization of expenses with amortization of expenses despite I&E’s explanation of the difference in its Reply Brief.<sup>11</sup>

As rightly noted by the ALJ, there was no demarcation of rate case expense or a normalization period for the expense in the last case since it was a black box settlement.<sup>12</sup> Thus the City’s claim that it has not recovered rate case expense is entirely speculative and unfounded. Accordingly, it would certainly not meet the Commission’s standard for “substantial” evidence.<sup>13</sup>

Given that the precedent in this issue is overwhelmingly in support of the ALJ’s recommendation, I&E respectfully avers that the normalization period for rate case expense in the RD is fair, reasonable and supported by record evidence. Accordingly, I&E respectfully requests that the Commission adopt this recommendation from the RD and disregard DuBois’ exception to this issue.

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<sup>8</sup> *Pennsylvania Pub. Util. Comm’n v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103, Pg. 38 (Order entered July 14, 2011); *Popowsky v. Pennsylvania Public Utility Commission*, 674 A.2d 1149, 1154 (1996); *Pennsylvania Public Utility Commission v. Emporium Water Company*, Docket No. R-2014-2402324, Pg. 48 (Order entered 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*, Docket No. R-00049862 (2005).

<sup>9</sup> City of DuBois Exceptions, Pg. 9.

<sup>10</sup> *Pennsylvania Public Utility Commission v. Emporium Water Company*, Docket No. R-2014-2402324, Pg. 48. (Order entered January 28, 2015).

<sup>11</sup> I&E Reply Brief, Pg. 12-13.

<sup>12</sup> Recommended Decision, Pg. 47.

<sup>13</sup> *Lower Frederick Twp. v. Pa. Pub. Util. Comm’n*, 409 A.2d 505, 507 (Pa.Cmwth. Ct. 1980).

**B. Reply to City of DuBois Exception 5 – The Administrative Law Judge correctly applied Commission precedent and sound ratemaking principles in rejecting the City’s proposed allocation of City Manager salary and benefits.**

Recommended Decision: Pages 38-44  
I&E Main Brief: Pages 13-17  
I&E Reply Brief: Pages 3-7

The City claims that the City Manager, Mr. Suplizio, who is neither an engineer nor a certified water system operator,<sup>14</sup> devotes 60% of his time to business pertaining to the Bureau of Water in support of its claim that 60% of his \$109,208 non-finance related salary should be recovered from Bureau of Water customers. ALJ Hoyer correctly states that “[i]n order to support allocation percentages the utility must submit evidence proving the reasonableness of the allocation methodology.”<sup>15</sup> This is also in conjunction with the requirement that evidence produced must be “substantial.”<sup>16</sup> Bearing this in mind, the only form of evidence that the City has presented in support of its claim that the City Manager spends 60% of his time on business pertaining to the Bureau of Water is his testimony. The City believes this testimony should be accepted unquestioningly solely because the City Manager “know[s] what [he] does during a day.”<sup>17</sup>

While another City witness attempted to testify about the City Manager’s salary, this witness freely admitted that she had “no direct basis” of knowledge and her testimony based entirely on what was stated by the City Manager.<sup>18</sup> As such, the only form of evidence in support of the City’s allocation is testimony unsupported and uncorroborated by timesheets or other any other form of verifiable data. In prior cases,

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<sup>14</sup> Recommended Decision, Pg. 40.

<sup>15</sup> Recommended Decision, Pg. 41.

<sup>16</sup> *Lower Frederick Twp. v. Pa. Pub. Util. Comm’n*, 409 A.2d 505, 507 (Pa.Cmwlt. Ct. 1980).

<sup>17</sup> Transcript, Pg. 32-33.

<sup>18</sup> Transcript, Pg. 70-71.

this has been found by the Commission to be entirely insufficient evidence on this issue.<sup>19</sup> The City's claim is further undercut by the ALJ's finding that he "did not find Mr. Suplizio's testimony that 60% of his time as City Manager is devoted to the Bureau of Water to be credible at all, given all of the other duties and responsibilities his job entails."<sup>20</sup>

As noted in I&E's Main Brief<sup>21</sup> and cited in the RD,<sup>22</sup> the City Manager (Mr. Suplizio) is responsible for being the Chief Administrative Officer of the City, overseeing all offices, departments, and agencies (excluding the Volunteer Fire Department) and has reporting duties to the Mayor and City Council. Mr. Suplizio further serves as liaison to the general public regarding policies and procedures, a buffer between City Council and City Employees, and is charged with establishing current and long-range objectives, plans and policies for the City. Mr. Suplizio must also prepare for and attend all Council Meetings (including preparing agendas and taking minutes) along with being a member of multiple boards, commissions and authorities created by the City. Mr. Suplizio must also prepare and submit all County, State, and Federal 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.

Regarding personnel of the City, Mr. Suplizio must supervise training, safety technique seminars, supplies procurement, and maintain an open-door for all personnel. Mr. Suplizio also must present an annual budget and capital program to the City Council

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<sup>19</sup> *Pennsylvania Pub. Util. Comm'n v. Borough of Quakertown*, Docket No. R-2011-2251181, Pgs. 24-25 (Order entered September 13, 2012).

<sup>20</sup> Recommended Decision, Pg. 42.

<sup>21</sup> I&E Exhibit No. 2, Schedule 8, Pg. 5-6 of 10.

<sup>22</sup> Recommended Decision, Pgs. 39-40.

and ensure the adequacy and soundness of the City Financial Structure. Mr. Suplizio must make recommendations and provide counsel to all municipal operations, fiscal policy, and future needs of the City of DuBois. This must be done contemporaneous of making all required reports available for public inspection and assessing industry trends concerning legislation, arbitration, and collective bargaining.

Additionally, Mr. Suplizio must write and deliver presentations to City Council regarding Human Resources policies and practices while maintaining an effective system of communication throughout the city and representing the City in issues of public concern and to the business and finance community. Of course, this all must be submitted in weekly reports of all City activities to the City Council.<sup>23</sup>

Despite this broad list of responsibilities, City Witness Suplizio claims that the Bureau of Water manages to “easily take up at least 60%” of his time.<sup>24</sup> As rightly noted by the ALJ, the Commission has previously refused to accept salary allocations when the position description and the purported allocation do not synchronize, such as the case at hand.<sup>25</sup> There is certainly no record evidence to merit deviation from this precedent.

In an attempt support its claim, the City tries to tie the City Manager’s salary allocation to the unrelated allocation of the Public Works Director who does actually maintain time allocation records.<sup>26</sup> To support bootstrapping Mr. Suplizio’s undocumented 60% allocation onto the documented salary allocation of the Public Works Director, the City claims that it is logical that these employees would spend their time

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<sup>23</sup> I&E Exhibit No. 2, Schedule 8, Pgs. 5-6 of 10.

<sup>24</sup> City of DuBois Statement No. 1-R, Pg. 9.

<sup>25</sup> *Pennsylvania Pub. Util. Comm'n v. Borough of Media Water Works*, Docket No. R-891289, Pgs. 24-25 (Order entered Feb. 1, 1990).

<sup>26</sup> City of DuBois Exceptions, Pg. 10.

working on the same projects.<sup>27</sup> This argument fails for two reasons. First, the City does not 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, betrays the possibility that Mr. Suplizio spends 60% of his time working on water issues.

I&E, the OCA and, now the ALJ have recognized that in the absence of timesheets or further evidence to support the City's figure, the allocation percentage should be based on that of the City's finance personnel salary whose work is relevant to the City as a whole, similar to Mr. Suplizio.<sup>28</sup> Accordingly, I&E respectfully requests that the Commission accept the recommendation of the ALJ on this issue and disregard the City's exception.

**C. Reply to City of DuBois Exception 6 - The Administrative Law Judge's recommendation to normalize the variable Water Treatment Plant Contractual Services Expense is supported by sound ratemaking principles.**

Recommended Decision: Pages 32-37

I&E Main Brief: Pages 23-24

I&E Reply Brief: Pages 18-19

On page 35 of the RD, ALJ Hoyer correctly noted that Contractual Services Expense pertaining to the Water Treatment Plant ("WTP") has varied wildly.<sup>29</sup>

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<sup>27</sup> City of DuBois Exceptions, Pg. 10.

<sup>28</sup> Recommended Decision, Pgs. 38-42.

<sup>29</sup> Recommended Decision, Pgs. 34-35.

	2013	2014	2015	2016
January	-	-	-	-
February	-	-	-	-
March	-	-	4,427	1,044
April	-	-	-	1,181
May	-	865	3,074	1,311
June	-	-	-	2,075
July	-	-	-	7,052
August	-	-	-	5,313
September	1,825	-	-	1,591
October	-	-	5,492	n/a
November	-	-	7,263	n/a
December	-	-	2,067	n/a
	1,825	865	22,322	19,568

As depicted above, all of the 2013 expenses were recorded in September and all of the 2014 expenses were recorded in May. In 2015, a substantially lower percent of the expenses were recorded in the first five months of the year while most of the expenses were recorded in the last three months of the year.<sup>30</sup> This makes accounting for this expense particularly difficult, as noted by the ALJ.<sup>31</sup> Accordingly, the application of the normalization technique put forward by the OCA and adopted by the ALJ is a fair and just resolution that most accurately captures the on-going needs of the City on a forward-looking basis.

The City attempts to claim that the most expensive year (the Historic Test Year) should be the sole basis for this expense going forward, despite this being more than 25 times higher than the previous year (after adjusting for anomalous expenses).<sup>32</sup> The City's Exceptions illogically claim that the ALJ's recommendation should be disregarded because the City "filed adjustments to this account in the filing and during subsequent

<sup>30</sup> Recommended Decision, Pg. 35.

<sup>31</sup> Recommended Decision, Pg. 35.

<sup>32</sup> Recommended Decision, Pg. 33.

testimony,”<sup>33</sup> which would seem to indicate that the City believes mere compliance with 52 Pa. Code § 5.332 merits this expense. The ALJ correctly found otherwise, noting that the normalization method put forward is a fair and equitable resolution to the issue presented by this expense’s fluctuations. Based on the rationale outlined in the RD, I&E avers that this City’s exception should be dismissed.

**D. Reply to City of DuBois Exception 8 – The Recommended Decision correctly applies Commission precedent and sound ratemaking principles in utilizing the Capital Structure proposed by I&E and the OCA.**

Recommended Decision: Pages 63-64  
I&E Main Brief: Pages 27-29  
I&E Reply Brief: Pages 21-25

In the RD, ALJ Hoyer correctly applied Commission precedent by recommending that the actual capital structure of 70% debt and 30% equity was appropriate for ratemaking purposes and should be adopted.<sup>34</sup> Both I&E and OCA recommended a capital structure of 70% debt and 30% equity.<sup>35</sup> City Witness Walker recommended a hypothetical capital structure of 50% debt and 50% equity, which he opined was appropriate because of the City having a “larger than typical” level of equity of 100%.<sup>36</sup> 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>37</sup> As a result, the ALJ found that the City’s claimed hypothetical

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<sup>33</sup> City of DuBois Exceptions, Pg. 14.

<sup>34</sup> Recommended Decision, Pg. 63.

<sup>35</sup> Recommended Decision, Pg. 63.

<sup>36</sup> City of DuBois Statement, No. 4, Pg. 15.

<sup>37</sup> I&E RB, Pg. 25. Recommended Decision, Pg. 61-62.

capital structure simply shifted low cost debt into higher cost equity and would “unreasonably increase costs to ratepayers.”<sup>38</sup> In addition, the RD provided a lengthy discussion of prior cases demonstrating that the “Commission has consistently used the actual capital structure of regulated municipal utilities in determining the appropriate rate of return.”<sup>39</sup> Moreover, as discussed in the RD, when the actual capital structure was recalculated through the end of the future test year, the resulting 67% debt/33% equity is nearly identical to the 70% debt/30% equity recommended in the RD.<sup>40</sup>

In its Exceptions, the City alleged that the RD unreasonably analogized the City’s circumstances to those observed in *City of Lancaster* by stating that its hypothetical capital structure would not impose excessive costs on consumers.<sup>41</sup> In *City of Lancaster*, the Commission discussed the use of an actual capital structure for a municipal utility under the Commission’s jurisdiction. The Commission held that when faced with a debt-heavy municipal water utility, “the actual capital structure must be used for ratemaking purposes to achieve a fair balance between consumers and the City... the use of a hypothetical capital structure will produce an inflated overall rate of return that would adversely affect consumers.”<sup>42</sup> Furthermore, the Commission stated that the use of a hypothetical capital structure when Lancaster was not traded as a separate entity would result in excessive costs to consumers, but the use of an actual capital structure would not.<sup>43</sup>

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<sup>38</sup> Recommended Decision, Pg. 58.

<sup>39</sup> Recommended Decision, Pg. 59-61.

<sup>40</sup> Recommended Decision, Pg. 63.

<sup>41</sup> City of DuBois Exceptions, Pg. 15.

<sup>42</sup> *Pennsylvania Pub. Util. Comm’n v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103, Pg. 51 (Order entered July 14, 2011).

<sup>43</sup> *Pennsylvania Pub. Util. Comm’n v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103, Pg. 55 (Order entered July 14, 2011).



In Exceptions, the City argued that a hypothetical capital structure was prudent because it was “similar to ratios employed by other investor-owned water companies.”<sup>44</sup> As in *City of Lancaster*, the City of DuBois is a municipality and not an investor-owned utility. The Commission has held that publicly traded companies need to meet market norms for capital structure ratios and the use of a hypothetical capital structure would impose excessive costs on customers.<sup>45</sup> The City’s claimed hypothetical capital structure would result in an extra \$224,330 yearly expense to ratepayers and was properly rejected by the ALJ.<sup>46</sup>

Additionally, the ALJ recognized that, since the Bureau of Water’s status as a municipally-owned utility provides it with the opportunity to obtain debt at a low cost rate as a result of the City’s ability to tax, this low cost debt should not be shifted to higher cost equity at the expense of the ratepayers.<sup>47</sup> The ALJ concluded that, “For this reason, the City does not have to be treated like an investor owned utility for ratemaking purposes and, therefore, a hypothetical capital structure does not need to be imposed.”<sup>48</sup> Therefore, the use of a hypothetical capital structure in this proceeding would have the equivalent cost concerns as those raised in *City of Lancaster* and would result in an excessive cost to consumers.

The City’s claim that the RD “woefully”<sup>49</sup> fails to balance the interests of the utility and its customers is unwarranted. The Commission has discretion in whether to use a hypothetical capital structure and must always balance the interest of the utility and the

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<sup>44</sup> City of DuBois Statement, No. 4, Pg. 16.

<sup>45</sup> *Pennsylvania Pub. Util. Comm’n v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103 Pg. 55 (Order entered July 14, 2011).

<sup>46</sup> I&E Statement No. 1, Pg. 14.

<sup>47</sup> Recommended Decision, Pg. 61.

<sup>48</sup> Recommended Decision, Pg. 61.

<sup>49</sup> City of DuBois Exceptions, Pg. 16.

customers when considering the appropriate capital structure.<sup>50</sup> In this case, the use of the hypothetical capital structure requested by DuBois would serve only to unjustly enrich the Bureau of Water to the detriment of its customers.<sup>51</sup> The use of this hypothetical capital structure would merely shift 20% of the City's capital from low cost debt to higher cost equity, therefore, allowing the City to charge its customers a higher cost rate for a misplaced portion of debt.<sup>52</sup>

For the reasons set forth above, it is clear that the RD balanced the important interests in this case and correctly applied Commission precedent in utilizing the capital structure proposed by I&E and the OCA. The City's actual capital structure of 70% debt and 30% equity 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. Therefore, the RD's rejection of the City's proposed hypothetical capital structure was proper and complied with the principles adopted by the Commission. Accordingly, City Exception 8 is unfounded and should be rejected.

**E. Reply to City of DuBois Exception 9 – The Recommended Decision's Cost of Equity produces a fair, just and reasonable result for both the City of DuBois and its ratepayers.**

Recommended Decision: Pages 64-74  
I&E Main Brief: Pages 29-43  
I&E Reply Brief: Pages 25-36

Throughout the entirety of this proceeding, DuBois has relied on cost of equity calculations and theories that have fundamental flaws and its rate of return witness has conjured up flaws in I&E's Commission-accepted methodology that, unsurprisingly, allows DuBois to earn more money than is fair and reasonable. These errors are further compounded by DuBois' witness basing his tax adjustment off of an inflated tax rate that

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<sup>50</sup> *Pennsylvania Pub. Util. Comm'n v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103, Pg. 53 (Order entered July 14, 2011).

<sup>51</sup> I&E Reply Brief, Pg. 25.

<sup>52</sup> I&E Reply Brief, Pg. 25.

is neither fair nor accurate. By recommending a 8.62% cost of equity modified with a 18.22% implied tax adjustment and a 3.02% debt cost rate to produce a 4.23% overall rate of return, the ALJ rightly recognized the City's rate of return witness' errors in these issues and I&E respectfully requests that the Commission do the same.

**1. The City of DuBois improperly interprets Commission precedent regarding cost of equity adjustments.**

DuBois bafflingly attempts to claim that the quote “any adjustment to the results of the market based DCF as we have previously adopted are unnecessary and will harm ratepayers”<sup>53</sup> equates to “dismissal of equity adjustments as disfavored should be rejected as contrary to Commission precedent.”<sup>54</sup> In support of this claim, DuBois relies very heavily<sup>55</sup> on an excerpt from the 2010 *City of Lancaster* case.<sup>56</sup>

In that case, the Commission made a single adjustment to the I&E (then OTS) recommended cost of equity but stated that its adjusted cost of equity remained within the range of the two Discounted Cash Flow (“DCF”) analyses put forth by I&E and explicitly disclaimed all other adjustments. What DuBois fails to note about its excerpted portion of the 2010 *City of Lancaster* case is that the lower number in the range (8.53%) was the product of the DCF analysis utilizing a growth rate forecasted by a log-linear regression analysis, which is a method no longer used by I&E. The higher number (10.87%) was the product of the DCF with the methodologies currently utilized by I&E in this proceeding.<sup>57</sup> This means that the method that produced the higher number in the *City of*

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<sup>53</sup> *Pennsylvania Pub. Util. Comm'n v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103, Pg. 79 (Order entered July 14, 2011).

<sup>54</sup> *City of DuBois Exceptions*, Pg. 19.

<sup>55</sup> *City of DuBois Exceptions*, Pg. 18.

<sup>56</sup> *Pennsylvania Pub. Util. Comm'n v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103, Pg. 79 (Order entered July 14, 2011).

<sup>57</sup> *See generally* I&E Statement No. 1.

*Lancaster* case is the only method utilized in this proceeding, making additional upward adjustments to the equity return inappropriate.

I&E avers that inflating the market-based DCF analysis is improper, will harm ratepayers and is contrary to the public interest.<sup>58</sup> Despite this, DuBois attempts to force multiple arbitrary inflations into its cost of equity calculations.

I&E notes that DuBois has only taken Exception to the RD's rejection of its risk and leverage adjustments and that it has not taken exception to the RD's rejection<sup>59</sup> of the proposed 110 basis point size effect,<sup>60</sup> therefore the size effect adjustment will not be addressed below.

**a. The City's 25 basis point risk adjustment is contrived to improperly inflate its return on common equity.**

The City's claimed risk adjustment, which the City has provided no precedent in support of, is based upon Mr. Walker's implied BBB bond rating.<sup>61</sup> However, as noted in I&E's Main Brief, risk can be demonstrated in the cost rates of long-term debt and for the City of DuBois, not only are the interest rates lower for public utility bonds than for municipal bonds by rating, but the interest rates for each of the City of DuBois notes are lower than the average public utility bond. The City of DuBois' notes are also lower than the average municipal bond and even lower than the implied interest rate for the proxy group.<sup>62</sup> As rightly noted by the ALJ,<sup>63</sup> this renders the City's risk adjustment entirely unnecessary and invalid.

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<sup>58</sup> *Pennsylvania Pub. Util. Comm'n v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103, Pg. 79 (Order entered July 14, 2011).

<sup>59</sup> Recommended Decision, Pgs. 68-70.

<sup>60</sup> City of DuBois Exhibit HW-1, Schedule 20, Pg. 1.

<sup>61</sup> City of DuBois Statement No. 4, Pg. 59-60.

<sup>62</sup> I&E Statement No. 1, Pg. 58. *See also* I&E Exhibit No. 1, Schedule 1.

<sup>63</sup> Recommended Decision, Pg. 71.

Beyond showing that this adjustment was unsound and inapplicable, I&E put forward research<sup>64</sup> in support of its recommended disallowance of this adjustment. In Exceptions, the City relies on an article<sup>65</sup> by Dr. T.M. Zepp to support its use of size as a consideration in its risk adjustment and to supposedly rebut the research put forth by I&E. This article contains no original research and simply opines on the results of two other studies. One of these studies cannot be located despite efforts by I&E to do so and the other is simply a correlational look at a total of 4 utilities. Despite DuBois claiming otherwise in Exceptions,<sup>66</sup> this is not nearly enough data to provide support for the City's theory<sup>67</sup> considering that the Commonwealth of Pennsylvania alone has at least 87 separate water utilities.<sup>68</sup>

The only other supporting data offered by the City was an article authored by M. Annin,<sup>69</sup> but the City neglects to mention that Annin's article is not specific to the utility field, let alone municipal utilities, and does not actually rebut I&E's position.<sup>70</sup>

Considering that there is no precedent allowing the claimed risk adjustment and this is the entirety of the evidence put forth by the City in support of this adjustment, it has not provided "substantial evidence" as required by the Commission and has failed to meet its burden of proof in this claim.<sup>71</sup> As demonstrated by I&E in this proceeding, this

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<sup>64</sup> I&E Statement No. 1, Pg. 48 citing Utility Stocks and the Size Effect: An Empirical Analysis by Annie Wong. *Journal of Midwest Finance Association* (1993); I&E Statement No. 1, Pg. 47 citing Standard & Poors, Corporate Ratings Criteria, Utilities: Key Credit Factors: Business and Financial Risks in The Investor-Owned Utilities Industry, Nov. 26, 2008.

<sup>65</sup> *Utility Stocks and the Size Effect: Revisited*, Economics and Finance Quarterly, 43, 578-582.

<sup>66</sup> City of DuBois Exceptions, Pgs. 20-21.

<sup>67</sup> I&E Statement No. 1-SR, Pg. 24.

<sup>68</sup> PA PUC: Water Utilities – Annual Report Contacts: Accessed on February 6, 2017 at [http://www.puc.state.pa.us/water/pdf/Water\\_Ann\\_Rpt\\_Contacts.pdf](http://www.puc.state.pa.us/water/pdf/Water_Ann_Rpt_Contacts.pdf)

<sup>69</sup> City of DuBois Statement No. 4-R, Pg. 35.

<sup>70</sup> I&E Statement No. 1-SR, Pg. 25.

<sup>71</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).

adjustment is directly controverted by academic research and is contrary to the public interest. Accordingly, the City's claimed risk adjustment was rightly rejected by the ALJ and should be rejected by the Commission as well.

**b. The City's 70 basis point leverage adjustment is neither valid nor applicable.**

The City attempts to inflate its cost of equity calculations by 70 basis points for its claimed leverage adjustment. The ALJ correctly determined that this adjustment was improper as it has been rejected by the Commission, is not applicable in the case at hand and would unfairly harm ratepayers.<sup>72</sup>

Leverage, generally, is the use of debt capital to supplement equity capital.<sup>73</sup> What the City, through Mr. Walker, terms a "leverage" adjustment, is actually an adjustment to account for a supposed discrepancy in applying the market value cost rate of equity to the book value of the utility's equity. This would be more accurately termed a "market-to-book" adjustment.<sup>74</sup> The basis for Mr. Walker's adjustment is a comparison of the average proxy group (noted to be large investor-owned utilities) market-to-book average,<sup>75</sup> which is done to address the concern that DCF methodology will understate common equity cost rate since the results of the DCF are applied to a book value rate base while investor returns are measured relative to stock price levels.<sup>76</sup>

This idea is flawed in many ways, but it is particularly so given that this investment information is widely available to investors in today's markets, which makes

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<sup>72</sup> Recommended Decision, Pgs. 70-71.

<sup>73</sup> I&E Statement No. 1, Pg. 35.

<sup>74</sup> I&E Statement No. 1, Pg. 35.

<sup>75</sup> I&E Statement No. 1, Pg. 36.

<sup>76</sup> City of DuBois Statement No. 4, Pg. 47.

this adjustment entirely obsolete.<sup>77</sup> Beyond that, 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>78</sup> however, financial risk resides in the income statement, not market capitalization as the City asserts.<sup>79</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>80</sup>

Second, Mr. Walker’s leverage adjustment has been repeatedly rejected by this Commission.<sup>81</sup> 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>82</sup>

Third, I&E is not aware of any academic literature that supports Mr. Walker’s leverage adjustment.<sup>83</sup> While the City 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>84</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

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<sup>77</sup> I&E Statement No.1, Pg. 37.

<sup>78</sup> City of DuBois Main Brief, Pg. 46.

<sup>79</sup> I&E Statement No. 1, Pg. 37.

<sup>80</sup> I&E Statement No. 1, Pg. 37.

<sup>81</sup> I&E Statement No. 1, Pgs. 38-39.

<sup>82</sup> I&E Main Brief, Pg. 35.

<sup>83</sup> I&E Statement No. 1, Pg. 41.

<sup>84</sup> I&E Statement No. 1, Pgs. 40-41.

Miller's research was to understand company capital investment behavior, not the financial risk associated with a stock's market price diverging from its book value.<sup>85</sup>

In Exceptions, the City mistakenly claims that this adjustment is warranted because it has "dutifully rebutted the arguments relied upon in the R.D. in opposition to the proposed leverage adjustment."<sup>86</sup> This is wholly inaccurate. The flaws in the City's 70 basis point leverage adjustment are glaring and the burden lies with the City to prove that this adjustment is warranted,<sup>87</sup> which it has failed to do. Accordingly, I&E respectfully submits that the RD's recommended rejection of this adjustment should be adopted by the Commission.

**2. The Bureau of Investigation and Enforcement's reliance upon the Discounted Cash Flow analysis is accepted by the Commission and is the most appropriate method to calculate the cost of equity.**

The City takes exception only with the growth rate utilized by I&E's DCF methodology, implicitly waiving other issues with the DCF calculations and utilization. As such, I&E will address only that issue in these replies.

As noted by the ALJ, I&E's forecasted growth rate and expected dividend yield allows the time-value of money to be considered and causes the results to be forward-looking.<sup>88</sup> The use of a growth rate and dividend yield allows I&E's DCF, unlike alternative methodologies, to measure the cost of equity directly which makes it the superior method for determining rate of return.<sup>89</sup>

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<sup>85</sup> I&E Statement No. 1, Pg. 40.

<sup>86</sup> City of DuBois Exceptions, Pg. 25.

<sup>87</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>88</sup> Recommended Decision, Pg. 66.

<sup>89</sup> Recommended Decision, Pg. 66.



The City inaccurately claims that I&E’s forecasting method is “overly narrow”<sup>90</sup> and seeks to introduce historical growth rates. As explained in I&E’s testimony and briefs, 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.<sup>91</sup> Instead, as testified to by I&E Witness Maurer, relying upon forecasted growth rates produces a more accurate result since the forecasting analysts consider both historic events of each company along with anticipated events at a company and industry level.<sup>92</sup> Bearing this in mind, I&E respectfully requests that the City’s Exception be dismissed.

**3. The Administrative Law Judge properly rejected the City’s proposed tax adjustment.**

The ALJ properly determined that I&E’s methodology, which produced an implied tax adjustment of 18.22%, was appropriate.<sup>93</sup> As noted in the RD, to determine the appropriate tax factor, I&E compared Moody’s Monthly Municipal Bond Yields to Moody’s Monthly Public Utility Bond Yields for all bond grades from August 2014 through July 2016.<sup>94</sup> The range was 8.16% to 28.43% with an average of 18.22%, which is the number utilized by I&E. The ALJ rightly found that “this simple and straightforward methodology has been accepted by the Commission and it has been found to be “reasonable” and “appropriate” in similar circumstances.”<sup>95</sup>

In Exceptions, the City audaciously asserts that the RD’s acceptance of I&E’s recommend tax adjustment is based on a “severe misunderstanding of the City’s

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<sup>90</sup> City of DuBois Exceptions, Pg. 25.

<sup>91</sup> I&E Statement No. 1-SR, Pg. 16.

<sup>92</sup> I&E Statement No. 1-SR, Pg. 17.

<sup>93</sup> Recommended Decision, Pg. 73.

<sup>94</sup> Recommended Decision, Pg. 72.

<sup>95</sup> Recommended Decision, Pg. 72.

proposal”<sup>96</sup> and that the criticisms of the City’s calculation are unwarranted because I&E and the City used the same methodology to calculate the tax adjustment<sup>97</sup>. This is an entirely incorrect assertion. In reality, DuBois previously claimed that I&E’s method “runs contrary to the underlying theory of the tax adjustment.”<sup>98</sup> At that time, the City also claimed that “[a]lthough OCA and I&E offer distinct recommendations, they are both rooted in the same fundamentally flawed logic.”<sup>99</sup> The City further wrongly asserts that the only reason it arrived at a 9% tax adjustment instead of I&E’s recommended 18.22% tax adjustment is due to “a correction by the City to an objective flaw in I&E’s calculation.”<sup>100</sup> DuBois claims that Mr. Walker “implemented all reasonable practical corrections in accordance with Commission precedent”<sup>101</sup> but conspicuously fails to cite a single time when Mr. Walker’s methods have been adopted by the Commission.

City Witness Walker criticizes the bond yield spreads between public utility and General Obligation Bonds and notes that the selection only measures the tax rate of the bond investors who simultaneously hold General Obligation (“GO”) bonds and public utility bonds, meaning, it does not measure the income tax rate of the owners of the Bureau of Water nor the tax rate of other investor owned utility common stockholders so it must be adjusted.<sup>102</sup>

Mr. Walker then claims that he must consider the types of bonds used, the credit quality of those bonds, and the matching terms/lives of the bonds.<sup>103</sup> Mr. Walker then refers to uncited Bloomberg News Reports referring to Moody’s Municipal Bond Yield

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<sup>96</sup> City of DuBois Exceptions, Pg. 26.  
<sup>97</sup> City of DuBois Exceptions, Pg. 26.  
<sup>98</sup> City of DuBois Reply Brief, Pg. 45.  
<sup>99</sup> City of DuBois Reply Brief, Pg. 45.  
<sup>100</sup> City of DuBois Exceptions, Pg. 26.  
<sup>101</sup> City of DuBois Exceptions, Pg. 26.  
<sup>102</sup> City of DuBois Statement No. 4, Pg. 61.  
<sup>103</sup> City of DuBois Statement No. 4, Pg. 61.

Averages as derived from pricing data on newly issued GO Bonds that are unenhanced, unweighted averages, with composite averages representing unweighted averages of corresponding 20-year observations.<sup>104</sup>

Now, even though the City of DuBois has only utilized GO Bonds<sup>105</sup> (backed by its taxing authority) when it has procured funding for the Bureau of Water, Mr. Walker feels that the GO Bond categories he previously selected must be modified since the Bureau of Water's cost of common equity "should reflect the risk of the underlining assets devoted to providing water service."<sup>106</sup> This means that revenue bonds would be more appropriate in Mr. Walker's opinion.<sup>107</sup> These are more risky, have an alleged higher yield, and do not have their yields published by Moody's.<sup>108</sup> Although Mr. Walker alleges that the aforementioned bonds must have corrections made so that they are matched in terms of credit quality and term length, he makes no attempt to present a correction or alternative.<sup>109</sup>

After all these obstacles are addressed, Mr. Walker deduces that the appropriate tax adjustment is 9.00%, which is simply the lowest of his averaged yield spreads and is less than half of the amount utilized by I&E and the OCA. This is not a "correction,"<sup>110</sup> as asserted by DuBois, but rather this entire exercise is nothing more than Mr. Walker manufacturing an unprecedented and unsupported method to benefit his client.

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<sup>104</sup> City of DuBois Statement No. 4, Pg. 61.

<sup>105</sup> I&E Statement No. 1-SR, Pg. 20-21.

<sup>106</sup> City of DuBois Statement No. 4, Pg. 62.

<sup>107</sup> City of DuBois Statement No. 4, Pg. 62.

<sup>108</sup> City of DuBois Statement No.4, Pg. 62.

<sup>109</sup> City of DuBois Statement No. 4, Pg. 62-63.

<sup>110</sup> City of DuBois Exceptions, Pg. 26.

In Exceptions, DuBois cites a *City of Lancaster – Sewer Fund*<sup>111</sup> case from 2005, which include an adjustment to I&E’s (then OTS) tax factor but fails to note that this adjustment was simply the incorporation of updated bond yields. This was not tampering with the methodology employed, as DuBois seeks to do here, but rather the incorporation of updated market data not available at the time testimony was drafted. I&E notes that the incorporation of yields from August through November of 2016, as was done in the 2005 *City of Lancaster – Sewer Fund* case, would result in the tax factor for this case increasing to 19.57% instead of the RD’s recommended 18.22%.

The RD rightly adopted I&E’s straightforward methodology in calculating an appropriate tax adjustment in this matter, which was approved in previous Commission decisions.<sup>112</sup> Accordingly, I&E respectfully requests that the Commission deny the City’s Exception and affirm the RD on this issue.

#### **4. Conclusion**

The RD puts forth a cost of equity recommendation that is supported by record evidence and is in the public interest. The 8.62% cost of equity adopted by the ALJ, prior to a tax factor adjustment, was determined by utilizing the well accepted DCF method. This falls on the upper end of Capital Asset Pricing Model spread of 7.76% and 8.97%., which confirms the reasonableness of the DCF method utilized by I&E and accepted in the RD.<sup>113</sup> The ALJ correctly determined that the 8.62% equity return should adjusted by I&E’s recommended 18.22% tax rate, resulting in a 7.05% cost of common equity. The RD appropriately recognized that the fairness of the overall return is further bolstered by

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<sup>111</sup> *Pennsylvania Public Utility Commission v. City of Lancaster- Sewer Fund*, Docket No. R-00049862, Pgs. 108-109 (Order entered August 11, 2005).

<sup>112</sup> *Pa. Pub. Util. Comm’n v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103, Pg. 81 (Order entered July 14, 2011).

<sup>113</sup> Recommended Decision, Pg. 67.

the 1.56% debt service coverage ratio, which Standard and Poor's grades as strong.<sup>114</sup>

Accordingly, I&E respectfully requests that the Commission deny City of DuBois Exceptions in this matter and uphold the RD.

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<sup>114</sup> Recommended Decision, Pg. 73.

### III. CONCLUSION

For the foregoing reasons, I&E respectfully avers that the City of DuBois' Exceptions are unfounded and adoption of these Exceptions would be contrary to the public interest. Accordingly, I&E requests that the City Exceptions addressed above be rejected and that the RD be upheld in these issues.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Phillip C. Kirchner", written over a horizontal line.

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