COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA PUBLIC UTILITY COMMISSION
COMMONWEALTH KEYSTONE BUILDING
400 NORTH STREET, HARRISBURG, PA 17120

BUREAU OF
INVESTIGATION
&
ENFORCEMENT

November 2, 2023

Via Electronic Filing
Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17120

Re: Pennsylvania Public Utility Commission v.
Columbia Water Company
Docket No. R-2023-3040258
I&E Exceptions

Dear Secretary Chiavetta,

Enclosed for electronic filing please find the Exceptions of the Bureau of Investigation and Enforcement (I&E) to the Recommended Decision of Administrative Law Judge Mary D. Long and Administrative Law Judge Charece Z. Collins that was issued on October 23, 2023 in the above-captioned proceeding.

Copies are being served on parties of record per the attached Certificate of Service. Should you have any questions, please do not hesitate to contact me.

Respectfully,

Carrie B Wright

Carrie B. Wright
Prosecutor
Bureau of Investigation and Enforcement
PA Attorney ID No. 208185
(717) 783-6156
carwright@pa.gov

CBW/ac
Enclosures

cc: Honorable Mary D. Long, Administrative Law Judge (*via email & First-Class Mail*)
Honorable Charece Z. Collins, Administrative Law Judge *(via email only)*
Office of Special Assistants (*via email – ra-OSA@pa.gov*)
Per Certificate of Service

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-2023-3040258
	:	
Columbia Water Company	:	

EXCEPTIONS
OF THE
BUREAU OF INVESTIGATION AND ENFORCEMENT

Carrie B. Wright
Prosecutor
PA Attorney ID No. 208185

Pennsylvania Public Utility Commission
Bureau of Investigation and Enforcement
Commonwealth Keystone Building
400 North Street
Harrisburg, Pennsylvania 17120

Dated: November 2, 2023

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I. INTRODUCTION

The Bureau of Investigation and Enforcement (I&E) files the following Exceptions to the Recommended Decision of Administrative Law Judges Mary D. Long and Charece Z. Collins (the ALJs) issued on October 23, 2023 in the above-captioned proceeding. I&E respectfully requests that its Exceptions be granted and that the referenced portions of the Recommended Decision (RD) be reversed or modified consistent with these Exceptions and the arguments made in I&E's pre-served testimony and exhibits, Main Brief, and Reply Brief.

A. Procedural History

I&E adopts the procedural history as set forth in the I&E Main and Reply Briefs.[1] I&E filed its Main Brief on September 12, 2023 and its Reply Brief on September 21, 2023 pursuant to the procedural schedule and ALJs' direction in this case. The Columbia Water Company (Columbia or Company), the Office of Consumer Advocate (OCA), and the Office of Small Business Advocate (OSBA) also filed their Main Briefs and Reply Briefs on September 12, 2023 and September 21, 2023, respectively. On October 23, 2023, the ALJs issued their RD. Pursuant to the Secretarial Letter filed October 23, 2023, I&E files these timely Exceptions.

B. Summary of I&E Exceptions

In its rate of return analysis, I&E recommended that Essential Utilities, Inc. not be included in the proxy group and the use of a hypothetical capital structure to arrive at the

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[1] Recommended Decision, pp. 1-2.

appropriate return on equity (ROE). The ALJs erred by rejecting I&E's position on these issues because Columbia did not meet its burden of proof by producing substantial evidence supporting why Essential Utilities should be included in the proxy group and Columbia did not produce substantial evidence to demonstrate why its actual capital structure should be used for ratemaking purposes. As the proxy group determined by the ALJs was flawed and the capital structure recommended was inappropriate, I&E asserts the ROE resulting therefrom is inappropriate and the I&E ROE should be adopted. Therefore, for the reasons explained fully below, I&E respectfully requests the Commission approve the following Exceptions.

II. I&E EXCEPTIONS

A. I&E Exception No. 1: The ALJs erred by recommending Essential Utilities, Inc. be included in the proxy group in this proceeding.

Recommended Decision: Pages 49-51
I&E Main Brief: Pages 18-19
I&E Reply Brief: Pages 9-10

The ALJs asserted that Essential Utilities, Inc. (Essential) was properly included in the proxy group in this proceeding.[2] I&E had recommended that Essential be excluded because it did not meet I&E witness Keller's criterion that at least 50% of revenues of the utility should be attributed to regulated water service.[3] Instead of relying on this rationale, the ALJs chose to rely on the Company's rationale that net operating income, rather than revenues, should be used as the basis for inclusion in or exclusion from the

2 Recommended Decision, p. 50.
3 I&E MB, p. 19.

proxy group.[4] On this basis, the ALJs recommended that Essential be included in the water proxy group.

The RD relies on Columbia witness D'Ascendis' statement that the financial community is more likely to rely on measures of income when making credit assessments.[5] While the financial community relies more on measures of income as Mr. D'Ascendis states, the use of percentage of revenues is appropriate as it represents the percentage of cash flow a company receives from each business segment. Revenue is the total income a business, or a business segment produces. Net operating income is an indicator of financial performance and strength as D'Ascendis described, however, net operating income is a direct result of a company's business decisions and operations. Therefore, while two companies or segments can have the same revenue, their net operating income may vary greatly depending on their performance and decisions. The purpose of a proxy group is to compile a set of companies that have similar risks to the subject utility. If less than 50% of revenues come from the regulated water business sector, the company is not comparable to the subject utility as it does not provide a similar level of regulated business. It should be noted that Essential Utilities has more revenue from its gas distribution segment, which arguably carries more risk than its water distribution operations.

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4 Recommended Decision, pp. 50-51.
5 Recommended Decision, p. 50.

Further, the ALJs' contention that I&E's decision to rely solely on revenues is flawed, ignores recent Commission precedent in which the Commission accepted I&E's methodology of relying on the percentage of revenues. First, in the 2020 Columbia Gas proceeding, the Commission accepted the ALJ's recommendation to use I&E's proxy group based on I&E's reasoning to exclude two companies based on its percentage of revenues as it most closely resembles the subject utility. In the Columbia Gas Order, the Commission noted:

> …as I&E and the ALJ pointed out, a company's revenues represent the percentage of cash flow the company receives from each business line related to providing a good or service. Therefore, if less than fifty percent of revenues come from the regulated gas sector, the company is not comparable to the subject utility as it does not provide a similar level of regulated business. See I&E St. 2 at 10. For this reason, we concur with I&E's reasoning for excluding both New Jersey Resources and Southwest Gas Holdings from its proxy group. In our view, both companies are too dissimilar to Columbia.[6]

Second, in the 2020 PECO Energy Company – Gas Division proceeding, the Commission again accepted the ALJ's recommendation to use I&E's proxy group based on I&E's reasoning to exclude two companies based on its percentage of revenues as it most closely resembles the subject utility. In the PECO proceeding, when adopting the I&E proxy group, the Commission again noted that percentage of revenues is an appropriate consideration in determining the proxy group. The Commission stated:

> In contrast, as I&E and the ALJ pointed out, a company's revenues represent the percentage of cash flow it receives from each business line related to providing a good or service.

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6 *Pa. P.U.C. v. Columbia Gas of Pennsylvania, Inc.*, Docket No. R-2020-3018835, p. 110 (Order entered February 19, 2021).

> Therefore, if less than fifty percent of revenues come from the regulated gas sector, the company is not comparable to the subject utility as it does not provide a similar level of regulated business.[7]

Therefore, it is well settled that the appropriate criterion for inclusion in a proxy group is percentage of revenues as explained by I&E, and not net operating income as recommended in the RD. As such, I&E continues to recommend Essential Utilities, Inc. be excluded from the proxy group in this proceeding.

B. I&E Exception No. 2: The ALJs erred by recommending use of the Company's actual capital structure.

Recommended Decision: Pages 45-48
I&E Main Brief: Pages 14-18
I&E Reply Brief: Pages 6-9

The ALJs recommend that the Commission utilize Columbia's actual capital structure for ratemaking purposes. Columbia's actual capital structure is composed of 36.66% long-term debt and 63.34% common equity. I&E recommended that a hypothetical capital structure of 50% debt and 50% equity be used for ratemaking purposes as this capital structure would be more similar to that of the proxy group, and thus, the industry norm.

The five-year average capital structure of I&E witness Keller's proxy group ranges from 42.44% to 58.43% long-term debt and 41.75% to 57.18% equity, with the overall five-year average being 49.16% long-term debt and 50.76% common equity.[8] This demonstrates that the hypothetical 50% long-term debt and 50% equity capital

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7 *Pa. P.U.C. v. PECO Energy Company – Gas Division*, Docket No. R-2020-3018929, p. 138 (Order entered June 22, 2021).

8 I&E Statement No. 1, p. 28.

structure imputed by I&E is far closer to the industry norm than the Company's actual capital structure, thereby making the hypothetical capital structure the appropriate capital structure to use in this instance. Further, I&E witness Keller calculated the cost savings to ratepayers if his hypothetical capital structure was utilized. In his example, Mr. Keller maintained the Company's claimed return on equity of 11.25% and claimed rate base but employed his 50%/50% capital structure. I&E witness Keller demonstrated that by simply utilizing a 50/50 capital structure, even at the Company's inflated 11.25% return on equity, ratepayers would save $279,480.[9] This amount represents a significant portion, more than a quarter, of Columbia's requested $999,990 rate increase that will have to be recovered from ratepayers.

I&E's recommendation, while not accepted in prior Columbia Water proceedings, allows for a capital structure similar to that of other investor-owned utilities while at the same time taking into consideration the current economic climate and the need to balance the interest of ratepayers and shareholders. The Commission's prior decisions concerning capital structure were made at a point prior to the pandemic and subsequent recent inflationary pressures on consumers. Therefore, I&E continues to recommend the Commission adopt a hypothetical capital structure for Columbia in this base rate proceeding.

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[9] I&E Statement No. 1, pp. 28-29.

C. I&E Exception No. 3: The ALJs erred in rejecting I&E's DCF and CAPM results.

Recommended Decision: Pages 59-64
I&E Main Brief: Pages 23-35
I&E Reply Brief: Pages 9-13

The ALJs recommend a ROE of 9.55% based on the average of the DCF and CAPM results of Columbia and OCA.[10] The ALJs rejected the I&E recommended ROE of 7.84% as a result of I&E excluding Essential Utilities from its proxy group. They also criticize witness Keller for not using his CAPM results as a meaningful comparison to his DCF results. The rational of the ALJs is flawed.

I&E does not believe it is appropriate to give weight to the CAPM result in its numeric calculation for the reasons given in Direct Testimony.[11] I&E witness Keller's analysis is consistent with the methodology commonly endorsed by the Commission in base rate proceedings and should be approved here. Just recently, the Commission affirmed reliance primarily on the DCF and rejected giving equal weight to the other methodologies. In *City of DuBois – Bureau of Water*, the Commission stated:

> [T]he City's cost of equity in this proceeding should be based upon the use of the DCF methodology, with the other methodology results used as a check on the reasonableness of the DCF results. We note that we have primarily relied upon the DCF methodology in arriving at previous determinations of the proper cost of equity and utilized the results of methods other than the DCF, such as the CAPM and RP methods, as a check upon the reasonableness of the DCF derived equity return calculation, tempered by informed judgement. We are not persuaded by the arguments of the City that we should assign equal weight to the multiple methodologies.[12]

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10 Recommended Decision, p. 63.
11 I&E Statement No. 1, pp. 30-39.
12 *City of DuBois – Bureau of Water*, pp. 96-97.

In *UGI Utilities, Inc. – Electric Division*, the Commission stated:

> The ALJs adopted the positions of I&E and the OCA that the DCF method should be the primary method used to determine the cost of common equity, and that the results of the CAPM should be used as a comparison to the DCF results. The ALJs found no reason to deviate from these preferred methods in this proceeding. Therefore, the ALJs recommended against the use of the RP and CE methods proffered by UGI. Further, the ALJs noted that the companies analyzed under the CE model are too dissimilar to a regulated public utility company. R.D. at 60, 76, 81-82 …[W]e shall adopt the positions of I&E and the OCA and shall base our determination of the appropriate cost of equity on the results of the DCF method and shall use the CAPM results as a comparison thereto. As both Parties noted, the use of the DCF model has historically been our preferred methodology. This was recently affirmed in *Pa. PUC, et. al v. City of DuBois – Bureau of Water*, Docket No. R-2016-2554150, *et. al.* (Order entered March 28, 2017). Like the ALJs, we find no reason to deviate from the use of this method in the instant case. Accordingly, we shall deny UGI's Exceptions on this issue.[13]

Even more recently, in both *Columbia Gas*[14] and *PECO Energy Company – Gas Division* decision,[15] the Commission affirmed I&E's use of the DCF methodology as the primary methodology to determine the return on equity with the CAPM as a comparison.

As endorsed by the Commission, I&E witness Keller did use the CAPM method as a comparison to the DCF results. As noted above, the Commission has been clear that primary reliance should be on the DCF results. I&E notes there are disadvantages associated with the CAPM and, as a result, it should not be used as a primary method. The CAPM is a less reliable model because it measures the cost of equity indirectly and

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13 *UGI Utilities, Inc. – Electric Division,* pp. 103-106.

14 *Pa. P.U.C. v. Columbia Gas*, Docket No. R-2020-3018835, p. 127 (Order entered February 19, 2021).

15 *Pa. P.U.C. v. PECO Energy Company – Gas Division,* Docket No. R-2020-3018929, p. 171 (Order entered June 22, 2021).

risk premiums vary depending on the debt and equity being compared. The CAPM uses U.S. Treasury Bonds and, typically, the return of the S&P 500 as proxies for the risk-free rate and overall market return, respectively. However, its result can be manipulated based on the inputs used; therefore, it introduces a greater amount of subjectivity with respect to determining the cost of equity of a given company.[16] CAPM has also been subject to criticism from academic literature. Regarding the comparison between the I&E DCF and CAPM analysis, in the footnote on page 63 of the RD, the ALJs state "[t]his gap of 325 basis points illustrates the potential problems related to relying solely on the DCF to establish a reasonable ROE."[17] Historically the Commission has not shied away from using the DCF primarily with and **unadjusted** CAPM as a check much as I&E has done in this proceeding. I&E would posit that rather than the spread between the DCF, which is the accurate measure of ROE, and the CAPM results demonstrating a flaw in relying largely on the DCF methods, the large spread between the results demonstrates the flaws that I&E has identified in the CAPM methodology.

In addition, while the ALJs state that they were being consistent with the determination in Columbia's 2008 and 2013 base rate cases of using the Company's actual capital structure, the ALJs deviated substantially from Columbia's prior base rate cases when it came to how the cost of equity is determined. In 2013 proceeding, the Commission did not utilize and average of the Company and OCA CAPM and DCF results, but instead determined a range of reasonableness using the DCF method as the

[16] I&E Statement No. 1, p. 51.
[17] Recommended Decision, p. 63.

foundation and determined that the midpoint of that range was the appropriate ROE.[18] In 2008, the Commission explained that in arriving at its ROE recommendation, the DCF was the primary method relied upon with using other methods as a check of those results.[19]

Additionally, it should be noted that the ALJs included the Company's CAPM result in their consideration despite stating "[g]iven the sizable gap between the Company's and OCA's equity risk premium we cannot solely subscribe to either party's result. It appears the equity risk may be overstated by the Company, and we find the Company's CAPM result unsatisfactory."[20] Even though the results were deemed "unsatisfactory" the results of that analysis were still included in the ALJs calculation of the appropriate ROE. Further, the results of OCA's CAPM were deemed "an outlier among all three parties CAPM results and may be understated."[21] I&E's CAPM results of 11.09% were criticized solely for witness Keller not using them as a meaningful comparison, not because they were either overstated or understated. Instead, the ALJs rejected I&E's ROE's recommendation in its entirety for not including Essential Utilities in its proxy group. In this proceeding, to the extent that the ALJs calculation that the average between the DCF and the CAPM results are the appropriate measure of ROE, I&E's average DCF and CAPM is 9.46% ((7.84% + 11.09%) / 2). The ALJs' calculated

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[18] *Pa. P.U.C. v. The Columbia Water Company,* Docket No. R-2013-2360798, p. 43 (Order entered January 23, 2014).

[19] *Pa. P.U.C. v. The Columbia Water Company,* Docket No. R-2008-2045157, pp. 78-79 (Order entered June 10, 2009).

[20] Recommended Decision, p. 63.

[21] Recommended Decision, p. 63.

ROE of 9.55% indicates that I&E's analysis is reasonable and should not have been disregarded for excluding a single company from its proxy group. While I&E continues to recommend a ROE of 7.84% based on the DCF with the CAPM as a comparison, this information simply demonstrates that I&E's methodology of determining the appropriate ROE was not in fact flawed. Therefore, I&E recommends that the Commission reject the ALJs' ROE analysis and adopt the I&E analysis which indicates an appropriate ROE of 7.84%.

III. CONCLUSION

For the reasons discussed herein, and as supported by the record in this proceeding, I&E respectfully requests that the Commission grant its Exceptions to the ALJs' Recommended Decision.

Respectfully submitted,

Carrie B Wright

Carrie B. Wright
Prosecutor
PA Attorney ID No. 208185

Pennsylvania Public Utility Commission
Bureau of Investigation and Enforcement
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17120

Dated: November 2, 2023

BEFORE THE
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CERTIFICATE OF SERVICE

I hereby certify that I am serving the foregoing **Exceptions** dated November 2, 2023, in the manner and upon the persons listed below:

Served via Electronic Mail Only

Whitney E. Snyder, Esq.
Thomas J. Sniscak, Esq.
Phillip D. Demanchick, Jr., Esq.
Hawke McKeon & Sniscak LLP
110 North Tenth Street
Harrisburg, PA 17101
wesnyder@hmslegal.com
tjsniscak@hmslegal.com
pddemanchick@hmslegal.com
Counsel for Columbia Water Company

Barrett C. Sheridan, Esq.
Erin L. Gannon, Esq.
Office of Consumer Advocate
555 Walnut Street
5th Floor, Forum Place
Harrisburg, PA 17101-1923
bsheridan@paoca.org
egannon@paoca.org

Steven C. Gray, Esq.
Office of Small Business Advocate
555 Walnut Street
1st Floor, Forum Place
Harrisburg, PA 17101-1923
sgray@pa.gov

Sandra E. Shaub
3282 Horizon Drive
Lancaster, PA 17601
sandishaub@comcast.net

Vincent E. Collier III
3287 Horizon Drive
Lancaster, PA 17601
vecollierIII@gmail.com

Carrie B Wright

Carrie B. Wright
Prosecutor
Bureau of Investigation and Enforcement
PA Attorney ID No. 208185
(717) 783-6156
carwright@pa.gov