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November 2, 2023

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

Dear Secretary Chiavetta:

Attached for electronic filing please find the Office of Consumer Advocate's Exceptions in the above-referenced proceeding.

Copies have been emailed to the parties listed on the enclosed Certificate of Service.

Respectfully submitted,

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Certificate of Service

*4882-2755-9052

CERTIFICATE OF SERVICE

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

I hereby certify that I have this day served a true copy of the following document, the Office of Consumer Advocate's Exceptions, upon parties of record in this proceeding in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant), in the manner and upon the persons listed below. This document was filed electronically on the Commission's electronic filing system.

Dated this 2nd day of November 2023.

SERVICE BY E-MAIL ONLY

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Dated: November 2, 2023
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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	Docket Nos. R-2023-3040258
v.	:	C-2023-3040567
	:	C-2023-3040746
Columbia Water Company	:	

EXCEPTIONS OF THE
OFFICE OF CONSUMER ADVOCATE

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Dated: November 2, 2023

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I. INTRODUCTION

On October 23, 2023, the Public Utility Commission's (PUC or Commission) Office of Administrative Law Judge issued the Recommended Decision (R.D.) of Administrative Law Judges (ALJs) Long and Collins regarding Columbia Water Company's (CWC or Company) proposed increase to water rates. Although ALJ Long and Collins' overall recommendation is more reasonable than CWC's proposals, the OCA files these Exceptions where the ALJs did not adopt OCA's adjustments.

II. EXCEPTIONS

Exception 1: The ALJs Erred by Using One, Abnormally High Year Instead of an Average of Years as the Basis for Setting the Level of Materials and Supplies Expense Recovered in Future Rates. R.D. at 27-30; OCA M.B. at 14-19; OCA R.B. at 9-12.

As discussed on pages 14 to 18 of the OCA's Main Brief, CWC has claimed a total of $432,400 for materials and supplies expense as of December 31, 2023. This is based on the Company, first, using the HTY 2022 expense of $377,390 that was the highest level experienced in the past five years, and then adding $55,010 to the base amount of expense to set the end of FTY level of expense for ratemaking. OCA M.B. at 14; OCA St. 1 at 8. The OCA made a two-step adjustment, first to reduce the historic test year (HTY) expense by $59,017, from the abnormal high of $377,390 to $318,373, based on the average of actual expense for the most recent three years. OCA M.B. at 14-16, App. A, Table II, col. G, ln. 32; OCA Sch. JLR-7SR. Second, the OCA reduced the future test year (FTY) going level adjustment by $14,400, to reflect a five-year normalization of an included $18,000 cost for unusual road restoration work. OCA M.B. at 16-18, App. A, Table II, col. G, ln. 33; OCA Sch. JLR-8SR.

The ALJ agreed with the OCA and rejected the FTY going level adjustment. R.D. at 16-18. For the HTY, however, the ALJ accepted the Company's argument that based on its current, actual levels of spending to date, it will exceed its claimed level of materials and supplies expense for the FTY. In so doing, the ALJ discounted evidence from the OCA's expert that material costs that had risen due to shortages could be expected to abate as shortages end and that the Federal Reserve's efforts to slow inflation will have the effect of preventing new or additional inflation from negating the change in materials costs as supply chain constraints ease. OCA St. 1SR at 3-12.

The amount allowed for this expense should not turn on whether the Company's projections for the 2023 Material and Supplies costs are accurate. The dispositive fact is that Materials and Supplies is a highly variable expense that can and has changed greatly depending on activity in a given year, and if unit costs for supplies go up or down in relation to the quantity of the supply purchased. This variability is clear from the data, which showed significant swings before and after inflation rose in 2021: "Materials and Supplies expenses fluctuate from year to year. Hence, no single year is representative of the normal level of expenses. OCA St. 1 at 8, 10.

	2018	2019	2020	2021	2022
Materials and Supplies Expense	$277,720	$319,473	$282,301	$295,427	$377,390
		Change	Change	Change	Change
		$41,753 15%	$37,172 12%	$13,126 5%	$81,963 28%

Normalization based upon three years is appropriate in this context, to protect ratepayers from overcollection of these expenses from customers. Using normalization gives weight to the Company's actual HTY level of expense, while also accounting for the variation of actual Materials and Supplies expense experienced by the Company over three years. OCA M.B. at 14-

16; OCA St. 1 at 7-9; OCA St. 1SR at 12-13. Moreover, using an average of years rather than relying on a single year is consistent with case law addressing the purpose of normalization: "to smooth out the effects of an expense item that occurs at regular intervals, but in irregular amounts" to make the test year representative of normal operations. *Pa. PUC v. Total Environmental Solutions, Inc. – Treasure Lake Water Div.*, 2008 Pa. PUC LEXIS 1227 at *72, *100; *Pa. PUC et al. v. PECO Energy – Gas Div.*, 2021 Pa. PUC LEXIS 241 at *56, 59.

There are two further reasons to adopt a HTY level of Materials and Supplies expense that is lower than the $377,390 allowed by the ALJs. First, the Company will still get a FTY going level adjustment of $40,610 for Material and Supplies expense.[1] OCA Sch. JLR-8SR; OCA M.B. at App. A, Table II, col. G, ln. 33. Adding $40,610 to the OCA's recommended $318,373 for the HTY results means that future rates will be set using $358,983.

Second, CWC made an alternate recommendation to reduce the HTY expense for Materials and Supplies from $377,390 to $368,406. CWC St. 2RJ at 12, Chart; *see* CWC Exh. DGS 1 at 1-15 (Revised). While the OCA disputes the specific amount proposed, inter alia, because it would give the HTY level of Materials and Supply expense weight *twice*, first as the 2022 level, and second as the base for the projected 2023 level, the alternate recommendation is support for adopting a HTY level of expense that is based on an average rather than a single year of a highly variable expense.

The OCA's exception should be granted because its adjustments to the Company's Materials and Supplies expense claim is necessary to ensure that customers will only pay a reasonable and justified level of expense in future rates. For the reasons discussed here and the additional reasons set forth in the OCA's Main and Reply Briefs, the Company's Materials and

[1] The ALJs adopted the OCA's recommended adjustment to the FTY going level expense, which reduces but does not eliminate the Company's going level adjustment. CWC's FTY $50,010 adjustment is reduced by $14,400 to $40,610. OCA St. 1SR; OCA Sch. JLR-8SR; OCA M.B. at App. A, Table II, col. G, ln. 33.

Supplies expense should be reduced by $73,417, the sum of the OCA's two adjustments. OCA M.B. at 19-20, App. A, Table II, col. G, ln. 32, 33; OCA Sch. JLR-7SR, JLR-8SR.

Exception 2: The OCA's Adjustment to Normalize Other – Maintenance Expense Is Necessary to Assure That Ratepayers Pay Only a Reasonable and Justified Level of Expense in Rates. R.D. at 31-32; OCA M.B. at 20-24; OCA R.B. at 12-13.

The reasoning and support for the OCA's adjustment to Other – Maintenance expense, and the Company's objections, mirror those for Materials and Supplies. CWC's selection of the highest level of costs experienced in the past five years as a base amount ($263,888), to which a going level adjustment is added for a FTY expense of $300,790, is not reasonable.

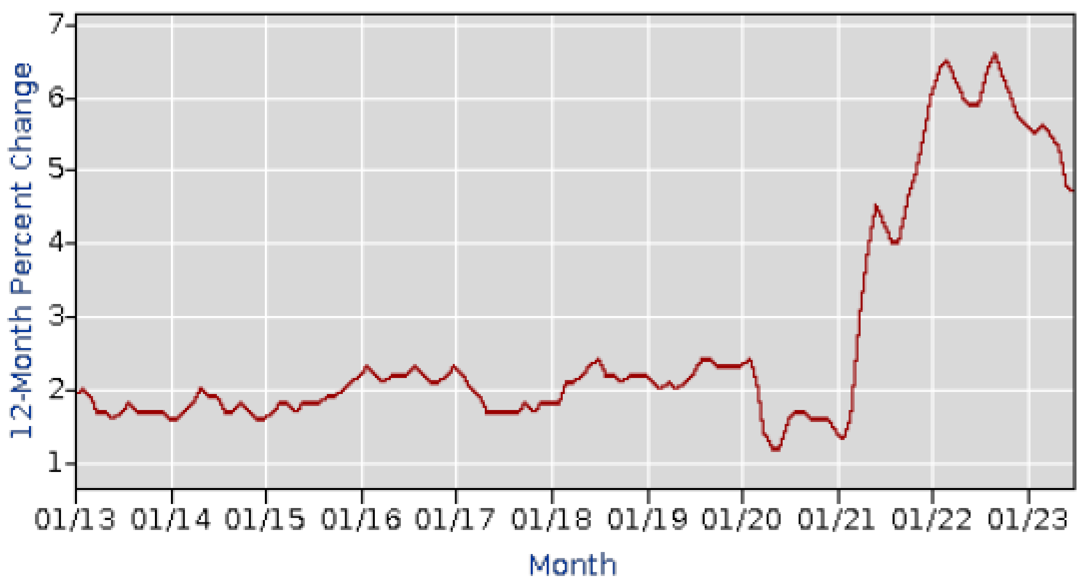
	2018	2019	2020	2021	2022
636.0 Other – Maintenance	$166,024	$202,508	$212,500	$229,295	$263,888

OCA M.B. at 20-24; OCA R.B. at 12-13.

The ALJs' acceptance of the Company's proposal to use its 2022 per books amount of $263,888 as a base level of expense for the FTY should be rejected. The ALJs improperly adopted the Company's reasoning that it "must be permitted to recover costs it has already actually incurred and will incur this year" to provide service. R.D. at 32; CWC M.B. at 33. This suggests there is some guarantee of historic expense recovery. Rather, the purpose of the test year is to predict the level of expense "during the period for which the rates being set will function." James H. Cawley & Norman J. Kennard, *A Guide to Utility Ratemaking*, 85 (Pa. PUC 2018).[2] The ALJ erred in concluding that because the Company's projected level of expense for the FTY 2023 is consistent with its actual experience, that unadjusted level of expense must be used to set rates for the rating period. R.D. at 32. CWC did not meet its burden to show that the Company's HTY level of expense is normal. CWC has not provided any evidence that material

[2] https://www.puc.pa.gov/General/publications_reports/pdf/Ratemaking_Guide2018.pdf.

shortages will continue into future and has not provided any analysis to show the actual impact of inflation and supply chain issues on its increase in costs. OCA St. 1SR at 6-7. Further, costs are not only driven by pricing, they are also driven by the activities that occur in a given year. The Company did not provide evidence that the level of activity in 2022 was similar to prior years. *Id.* at 7; *see* OCA St. 1 at 10. CWC wants the Commission to ignore data indicating that prices are falling (as shown below in the chart from page 8 of the Company's Statement 2-RJ) and rely exclusively on its actual experience – but *only* its actual, highest expense and excluding any recognition of its actual, lower expense.



The Company's position, adopted by the ALJs, puts customers at risk that future rates will be based on an overstated, abnormal level of expense while the Company bears little risk of the converse. The OCA's adjustment to the HTY base amount is a more reasonable result because it gives weight to the Company's actual 2022 experience, as well as CWC's actual, recent experience in the two years prior to that crest, and provides an additional $36,902 increase for the FTY. OCA St. 1 at 9-11; OCA M.B. at 20-22. Further, as with Materials and Supplies, CWC made an alternate recommendation to reduce the HTY expense for Other – Maintenance expense from $263,888 to $260,545. CWC St. 2RJ at 9, Chart. As for CWC's alternative proposal for Materials and Supplies expense, the OCA objects to the specific amount proposed but the alternative recommendation is support for adopting a base level of expense that is based on an average of the Company's experience.

For the reasons discussed here and the additional reasons set forth in the OCA's Briefs, the OCA's exception should be granted because its adjustments to CWC's Other - Maintenance expense are reasonable and necessary to protect customers and is well supported in principle and on the record. The expense should be reduced by $28,600 to a normalized level. OCA M.B. at 20-22; OCA R.B. at 12-13; OCA Sch. JLR-9SR; OCA M.B. at App. A., Table II, col. G, ln. 34.

Exception 3: Rates Should Not Be Set Using a Tax Rate the Company Knows Will Be Too High. R.D. at 38-39; OCA M.B. at 30-31; OCA R.B. at 18-19.

When new rates go into effect on January 27, 2024, the effective state corporate net income tax (CNIT) rate will be 8.49%. The ALJs adopted the Company's proposal to set rates using the 8.99% rate in effect for the FTY (2023). The OCA excepts to this recommendation. Case law is clear that rates can only be found just and reasonable if they are based on the "actual taxes paid." *Bell Tel. Co. v. Pa. PUC*, 528 A.2d 268, 273 (1987) (citing *Barasch v. Pa. PUC*, 491 A.2d 94, 107 (1985)). The state income tax rates that CWC will actually pay in 2024 are known and measurable; the applicable tax rate will be 8.49%. To allow the Company to use a tax rate of 8.99% that is known to be too high violates the actual taxes paid doctrine. It should also be rejected for practical reasons.

The ALJs claim that the OCA's "concerns" about using a tax rate that expires in 2023 are "ameliorated by the Commission's requirement that future state income tax reductions be flowed-through annually through the State Tax Adjustment Surcharge (STAS)." R.D. at 39 (citing 52 Pa. Code § 69.52). In other words, the ALJs and the Company are asking the Commission to set unnecessarily and artificially higher rates until a change is made to a surcharge to decrease rates to the appropriate level, rather than developing base rates using the known and actual CNIT rate. This proposal should be rejected. It is unnecessarily complicated and would result in an overcollection of tax revenue from customers that must be then reduced through the State Tax Adjustment Surcharge. *Id*.; CWC M.B. at 47-48.

It is not even clear how this would work. Section 69.52 of the Public Utility Code directs that the STAS should be maintained at zero unless necessitated by a change in the CNIT. 52 Pa. Code § 69.52. When new base rates take effect on January 27, 2024, the Company is required to set the STAS to zero. 52 Pa. Code §§ 69.53, 69.55. Would CWC apply a non-zero STAS effective January 1, 2024 to reflect the reduction in the CNIT from 8.99% to 8.49%, and then – rather than zero the STAS out on January 27, 2024 as required by Commission regulations – apply a non-zero STAS to flow back the difference between the actual 8.49% CNIT and the 8.99% CNIT used to calculate the rates being charged to customers?

For practical purposes and to comply with Commission regulations and caselaw addressing recovery of actual income tax expense, the Company's revenue requirement should be developed using the CNIT rate of 8.49% that will be in effect when CWC's new base rates are implemented in January 2024. OCA M.B. at 30-31; OCA R.B. at 18-19; OCA St. 1 at 24; OCA 1SR at 24-25; OCA Sch. JLR-16SR; OCA M.B. at App. A, Table II, col. M, ln. 38. The OCA's exception should be granted.

Exception 4: The ALJs Erred in Finding the Company's Equity Heavy Capital Structure Acceptable for Ratemaking, Without Acknowledgement or Mitigation of the Impact on Ratepayers. R.D. at 27, 45-48; OCA M.B. at 3-5, 33-43, 54-55; OCA R.B. at 3, 19-30.

The ALJs found CWC's capital structure of 36.66% long-term debt and 63.34% common equity reasonable for ratemaking, based upon the Commission's decisions in prior 2009 and

2013 CWC base rate cases. R.D. at 8 (FOF #27), 45-48. The ALJs acknowledged that the Commission has discretion to adopt a hypothetical capital structure for ratemaking. *Id*. at 47, n.177. However, the ALJs did not acknowledge that CWC's capital structure ratios are outside the range of the proxy groups nor did they address the outsized impact of the Company's atypical, equity heavy capital structure on the Company's revenue requirement. *See* OCA R.B. at 23-25. Instead, the ALJs erred and incorrectly placed the burden on the OCA and I&E to show the Company's capital structure is due to an "abuse of discretion" by the Company. R.D. at 47-48; *see* OCA M.B. at 41-42.

Contrary to the ALJs' finding, the Company's proposed capital structure is unreasonable for ratemaking based upon the record evidence and would unjustly and unreasonably produce rates based on an inflated revenue requirement. OCA M.B. at 38-43; OCA R.B. at 19-30. The record evidence supports the Commission's exercise of discretion to set new rates based upon the OCA's recommended hypothetical capital structure of 49.4% debt and 50.6% equity, to balance the competing interests of shareholders and consumers. OCA M.B. at 33, 38-43; OCA R.B. at 19-28. The OCA's recommended capital structure is based upon the average of the utility companies in the proxy group, which utilize equity ratios between 39.9% and 58.7%. OCA M.B. at 40. I&E's proposed 50% debt and 50% equity hypothetical capital structure is a reasonable alternative. *Id*. at 40-41.

In *Aqua 2022*, the Commission acknowledged the "veracity" of the OCA's general position "that the Commission has the discretion to employ a hypothetical capital structure where a company's actual capital structure is unreasonable or uneconomical." OCA R.B. at 23, quoting *Pa. PUC v. Aqua Pennsylvania, Inc.*, R-2021-3027385, 138 (Order May 16, 2022) (*Aqua 2022*). As discussed in the OCA's briefs, the use of the hypothetical capital structure is appropriate in cases like this one to reduce costs to ratepayers, as opposed to increasing costs. OCA M.B. at 38-39, 41; OCA R.B. at 21-23. Pennsylvania courts have upheld the use of a hypothetical capital structure where the utility's management adopts an actual capital structure that imposes an unfair cost burden on ratepayers.[3] *See, e.g.*, *T.W. Phillips Gas and Oil Co. v. Pa. PUC*, 474 A.2d 355, 362 (Pa. Commw. Ct. 1984); *Carnegie Natural Gas Co. v. Pa. PUC*, 433 A.2d 938 (Pa. Commw. Ct. 1981) (*Carnegie*). The underlying theme is an equitable one, in which the Commission and Pennsylvania courts do not allow the utility's financial interests to outweigh the public interest. *Pa. PUC v. Pennsylvania Gas and Water*, 424 A.2d 1213, 1217 (Pa. 1980) (stating that such property must be regulated in the interest of the public no less than in the interest of the utility*)*; *see also Arrowhead Pub. Serv. Corp. v. Pa. PUC*, 570, 600 A.2d 251, 257 (Pa. Commw. Ct. 1991) (supporting the Commission's use of the utility's actual cost of debt where the cost is clearly identifiable).

The Commission provided guidance in *Aqua 2022*, favoring use of the utility's actual capital structure ratios "[i]f … *within the range* of a similarly situated proxy group of companies." OCA R.B. at 23, citing *Aqua 2022* at 139 (emphasis added).

The record is clear that the Company's proposed capital structure is atypical and *not within the range* of the utility proxy group used by both the Company and OCA. OCA M.B. at

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[3] The Commonwealth Court has stated:

> [T]he Commission has the duty to regulate utilities in a manner which provides customers with reliable service at reasonable cost. This is not to say that we may mandate to regulated utilities the proportions of debt and equity contained in their capital structures. Rather, the **actual capital structure is a matter within the discretion of corporate management; however, this does not preclude the commission from determining that a particular utility's capital structure is unreasonable or uneconomical when balancing the goals of safety, prudent management, and economy and utilize a hypothetical capital structure for rate- making purposes.**

Pa. PUC v. Carnegie Natural Gas Co., 54 Pa. PUC 381, 393 (1980) (emphasis added) (*Carnegie Pa. PUC*) *aff'd on appeal*, *Carnegie*.

38, 40; OCA R.B. at 21-24. CWC's witness conceded that the Company's 63.34% equity ratio is outside of the proxy group range, where the highest equity ratio of a proxy group company is 62.44%. OCA R.B. at 21, 28-29. The Company's proposed 36.66% debt ratio is below the 39.9% low end of the range of debt ratios for the proxy group and notably lower than the average debt ratio of the proxy group of 49.5%. OCA M.B. at 21; OCA St. 2 at 6; OCA Exh. DJG-14. Similarly, CWC's capital structure ratios are atypical compared to the I&E proxy group range. OCA M.B. at 22. In recommending use of the Company's actual capital structure ratios to set new base rates, the ALJs ignored both this record evidence and the Commission's *Aqua 2022* standard.

The ALJs also erred in concluding that the OCA and I&E had the burden of demonstrating that the Company's selected capital structure was due to an abuse of discretion by the Company. Contrary to this finding, the Company – not the OCA or I&E – has the burden of supporting the reasonableness of the Company's proposed capital structure ratios for ratemaking. R.D. at 48; OCA M.B. at 41-42; OCA R.B. at 20-21. The OCA proposed capital structure of 49.4% debt and 50.6% equity to establish just and reasonable base rates is separate from CWC's management decisions related to total capitalization. The Company's total capitalization includes some debt related to EDTMA, as well as PENNVEST debt to finance rate base excluded from the Company's claim. OCA M.B. at 41-42, OCA R.B. at 26-27. The capital structure that CWC proposed for *ratemaking* of 36.66% long-term debt and 63.34% common equity is the focus. The ALJs erred by not finding the Company's capital structure is atypical and unreasonable for setting rates. OCA M.B. at 38-39; *see Carnegie Pa. PUC* at 393.

The Commission should reject CWC's proposed capital structure as unreasonable for ratemaking, based upon the record evidence including the range of capital ratios for proxy groups and the Commission's *Aqua 2022* standard. Although the Company has incentive to use a high equity ratio of 63.34%, to result in a higher Weighted Average Cost of Capital (WACC), this benefits shareholders at the expense of ratepayers. OCA M.B. at 33, 40; OCA R.B. at 28-29. As quantified by I&E, the impact on ratepayers between CWC's equity-heavy capital structure request and the I&E recommended 50% debt and 50% equity capital structure is significant, at the Company's claimed return on equity and rate base. OCA M.B. at 40. The use of the Company's equity rich capital structure accounts for $279,480, or roughly 28% of the Company's full revenue increase request. *Id*. at 40-41; OCA R.B. at 24, 28-30. Rates set based upon the Company's capital structure with an equity ratio of 63.34% would be unreasonable and uneconomical. OCA M.B. at 38-39; OCA R.B. at 27.

The record supports adoption of the OCA proposed capital structure of 49.4% debt and 50.6% equity or the I&E 50% debt and 50% equity capital structure recommendation for ratemaking purposes, so the Company's financial interests do not outweigh the public interest. OCA M.B. at 3-5, 33-43, 54-55; OCA R.B. at 28-29. The ALJs' recommendation should not be adopted.

Exception 5: The ALJs Erred in Concluding that CWC's Cost of Equity Is 9.55%. R.D. at 59-64; OCA M.B. at 3-5, 43-55; OCA R.B. at 19-20, 28-34.

The ALJs determined that an appropriate cost of equity for CWC should be based upon data for the proxy group used by both the Company and OCA, as well the results of discounted cash flow (DCF) and capital asset pricing model (CAPM) analyses. R.D. at 48-51, 59-64. The ALJs took note of the Commission's consideration in *Aqua 2022* of CAPM results as well as DCF results. *Id*. at 59. The ALJs recommended a 9.55% return on equity, arrived at by averaging the DCF and CAPM results of the Company (9.13% DCF, 11.45% CAPM) and the OCA (9.40% DCF, 8.20% CAPM). *Id*. at 48-49, 63. The ALJs resorted to averaging the OCA's and CWC's respective results, based upon their perception that each party's return on equity recommendation is "problematic" and each parties' assessments "include inputs and assumptions that bias their results." *Id*. at 49, 60. As to the separate Company and OCA CAPM analyses, the ALJs generally found them "to be valid," but the ALJs declined "to solely subscribe to either party's results." R.D. at 63.

The OCA excepts to the ALJs' recommendation of a 9.55% return on equity as overstated and contrary to the record evidence provided by the OCA. OCA M.B. at 43-55; OCA R.B. at 19-20, 28-34. Significantly, the burden lies with the Company to support each element of its ratemaking claim, including the Company's cost of equity. *Id*. at 5-7, 42; 66 Pa. C.S. § 315(a). Additionally, the OCA's cost of equity recommendations are well supported and reasonable.

First, the ALJs' perception that the Company's CAPM result is "unsatisfactory" and "equity risk may be overstated" is supported by the record. R.D. at 63; OCA M.B. at 49-51; OCA St. 2 at 35-48; OCA St. 2SR at 2-5. The Company's equity risk premium (ERP) used in its CAPM is based in part on historical averages of the difference between returns on stocks and returns on bonds from as early as 1926. OCA M.B. at 49-50; R.D. at 61. As OCA witness Garrett explained, for calculating the CAPM "what matters in the model is the current and forward-looking risk premium." OCA M.B. at 49. Indeed, the ALJs noted that in *Aqua 2022*, the Commission signaled a receptiveness to consideration of "the results of CAPM analysis because it is better suited to reflect changing market conditions." R.D. at 59-60, citing *Aqua 2022* at 154. However, comparing results from multiple models is not useful where key assumptions and inputs into the model violate accepted tenets in finance. OCA M.B. at 43-44.

OCA witness Garrett found the Company's ERP inputs and result of 10.00% in the Company's CAPM analysis unreasonable, and were significantly higher than estimates reported in expert surveys and estimated by other analysts. OCA St. 2 at 46-47; OCA M.B. at 49-50. The Company's ERP analysis includes recognition of market data as old as 1926. OCA St. 2 at 46; R.D. at 61. OCA witness Garrett rejected the Company's inclusion in its equity risk premium analysis of "Treasury yields nearly a century old [which] have no bearing on the current and forward-looking ERP, which is what matters when conducting an accurate CAPM analysis." OCA St. 2 at 46; OCA M.B. at 49. Further, the Company's overall ERP input of 10.00% is unreasonably high, compared to the three reliable and objective sources included in the OCA's ERP analysis, the highest of which was 6.0% and the average of which is 5.5%. OCA St. 2 at 46-47; OCA St. 2SR at 2-4; OCA M.B. at 49-50; OCA R.B. at 2-4. Nonetheless, the ALJs used the Company's "unsatisfactory" CAPM result of 11.45% to determine the recommended 9.55% cost of equity. R.D. at 63-64. Contrary to the analysis in the Recommended Decision, the Company's CAPM result should not be given weight in determining the appropriate cost of equity, based upon the record. OCA M.B. at 47-51.

Second, the ALJs describe the OCA CAPM result of 8.2% as based upon "valid" assessments, yet the OCA CAPM result of 8.20% "may be understated." R.D. at 63. Compared to the Company's "unsatisfactory" CAPM result of 11.45% and I&E's CAPM result based on a different proxy group, which the ALJs reject, the ALJs still cast the OCA CAPM result as "an outlier." R.D. at 63. The OCA opposes the averaging of the Company's 11.45% CAPM result with the OCA's 8.20% CAPM result, as one step in the ALJs' determination of the 9.55% recommended cost of equity. Although the ALJ's criticism of the Company's CAPM analysis and result as "unsatisfactory" is more specific and conclusive, the ALJs still treat the Company's CAPM result and OCA CAPM result the same, by averaging the two. The OCA disagrees with the ALJs' approach and result.

The OCA recommended cost of equity for use with the Company's proposed capital structure is 8.80%, the median of the OCA DCF result of 9.40% and the OCA CAPM result of 8.20%. OCA M.B. at 33, 54-55. OCA witness Garrett's development of the OCA DCF result is well documented. He obtained the stock price from the 30-day average of stock prices for each company in the proxy group, used forward-looking annualized dividends published by Yahoo! Finance for the dividend input, and two variations of growth rates. OCA M.B. at 45-46. The DCF result using a sustainable growth rate was 6.00%, compared to a 9.4% result using the analysts' DCF variation. OCA M.B. at 46. Mr. Garrett determined the 6.00% result too low and did not consider it further, when compared to the OCA CAPM results of 8.20%. OCA M.B. at 46. Higher than the Company's DCF result of 9.13%, the ALJs do not specify how the OCA DCF result is problematic or a biased result. *See* R.D. 49, 53-54, 59-64.

The ALJs' observations with regard to the OCA CAPM analysis and result of 8.20% are similarly non-specific. *See* R.D. 49, 53-54, 59-64. OCA witness Garrett addressed the conceptual underpinnings of the CAPM model linking return and risk, relative to U.S. Supreme Court *Hope* standard. OCA M.B. at 47. In the basic CAPM equation, there are only three inputs to estimate the cost of equity: the risk-free rate, the beta coefficient, and the equity risk premium.[4] OCA M.B. at 47. In calculating his risk-free rate of 3.90%, Mr. Garrett considered a 30-day average of daily Treasury yield curve rates on 30-year bonds. OCA M.B. at 48. Betas represent the sensitivity of a given security to movements in the overall market. Betas less than one – such as the beta for each proxy group company – are less risky than the market portfolio. OCA M.B. at

[4] *See* OCA St. 2, Appendix B "Capital Asset Pricing Model Theory."

48. OCA witness Garrett used betas recently published by Value Line Investment surveys to identify the average beta for the proxy group of 0.78.[5] OCA St. 2 at 44-45; OCA Exh. DJG-9.

Mr. Garrett explained that the third factor, the ERP, is the level of return investors expect above the risk-free rate in exchange for investing in risky securities. OCA M.B. at 48. To calculate his ERP, OCA witness Garrett relied on four expert surveys and implied ERP methods.[6] The OCA CAPM analysis is based upon an ERP of 5.5%, the average of those four ERP estimates. OCA M.B. at 49. Using the three inputs for the risk-free rate (3.90%), beta coefficient (0.78), and ERP of 5.5%, the Company's CAPM cost of equity is 8.2%, if imputing the average capital structure of the proxy group. OCA M.B. at 47; OCA St. 2 at 44-45, Fig. 9 CAPM Graph; OCA Exh. DJG-13.

Contrary to the recommendation of the ALJs, the 9.55% recommended cost of equity for the Company is not reasonable and should not be adopted by the Commission. The DCF and CAPM analyses conducted by OCA witness Garrett are sound in method, well-supported, and applied to the same proxy group of water utilities used by the Company. The OCA recommended cost of equity of 8.80% is based upon Mr. Garrett's professional opinion that that level of return is appropriate, in the event the Company's lower risk capital structure is adopted. OCA M.B. at 33, 55. The fact that the OCA cost of equity estimate is the median of Mr. Garrett's recommended return on equity range is due to his professional discretion. OCA M.B. at 55; OCA Exh. DJG-13. In contrast, the ALJs' 9.55% cost of equity recommendation improperly gives

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[5] The OCA Main Brief misidentified the average beta for the proxy group used by Mr. Garrett in his CAPM analysis as "0.84%." OCA M.B. at 48.

[6] As summarized in the OCA testimony and briefs, OCA witness Garrett used:

(1) The 2023 expert survey from the IESE Business School, a reported average ERP of 5.7%. OCA M.B. at 49.
(2) Dr. Damodaran, an expert on the ERP, published an implied ERP estimate of 5.1% for May 2023. OCA M.B. at 49; OCA St. 2 at 43-44.
(3) Kroll's published an estimated ERP of 6.0%, later updated to 5.5%. OCA M.B. at 49; OCA St. 2SR at 5.
(4) Mr. Garrett calculated his own implied ERP estimate of 5.4%, as the difference between a calculated expected return on the entire market of 9.3% minus the risk-free rate of 3.90%, based upon S&P 500 data over the past six years. OCA M.B. at 49; OCA St. 2 at 41-43.

weight to the Company's "unsatisfactory" and overstated CAPM results. R.D. at 63-64. In so doing, the ALJs benefit the Company, the party with the burden of proof, while diminishing the weight accorded to the OCA position. All despite the ALJs' lack of particular concern as to the substance of the OCA cost of equity analysis and recommendation.

The ALJs' recommended cost of equity of 9.55% should not be adopted and the final cost of equity allowed – if paired with the Company's actual capital structure – should be no higher than 8.80%. OCA M.B. at 33, 54-55.

Exception 6: The ALJs' Overall Cost of Capital Recommendation Is Excessive Based upon the Combination of a 9.55% Cost of Equity and the Company's Proposed Ratemaking Capital Structure. R.D. at 44-64; OCA M.B. at 3-5, 33-55; OCA R.B. at 19-34.

The ALJs acknowledged that the OCA's recommended cost of equity is 8.80%, in the event the Company's equity-heavy capital structure is utilized to set new rates. R.D. at 49. The ALJs further acknowledges the OCA's primary, alternative recommended cost of equity is 9.4%, if the Commission sets rates based upon the OCA proposed hypothetical capital structure. R.D. at 49, n.182. Nonetheless, the ALJs recommended that new rates be based upon a 9.55% cost of equity, applied to the Company's proposed capital structure. R.D. at 45-49, 59-64. According to the ALJs, "[t]his result is higher than the DCF results of either the Company or the OCA, but it accounts for some level of interest rate volatility that is captured by a CAPM analysis." *Id*. at 64. The ALJs concluded that the result is also reasonable for the Company's customers. *Id*.

The ALJs' conclusion that the result is reasonable for the Company's customers does not properly address the ALJs' recommendation that a high cost of equity be applied to CWC's actual capital structure which is lower risk due to the high equity ratio. OCA M.B. at 54-55; OCA R.B. at 28-30. The OCA excepts to the ALJs conclusion that the recommended 9.55% cost of equity, or any cost of equity above the OCA 9.4% DCF result, would result in reasonable rates for the Company's customers. The 9.55% return on equity recommended by the ALJs, as applied to the Company's capital structure ratios, contributes significantly to the ALJs' overall recommendation that CWC be permitted to increase base rates by $944,893, or *95%* of CWC's filed request. R.D. at 16.

As OCA witness Garrett observed, the utility has incentive to seek a higher WACC. OCA M.B. at 40; OCA St. 2 at 58-60. The utility receives this benefit when rates are set based upon a high equity ratio, because the cost of equity is higher than the cost of debt. OCA M.B. at 40. OCA witness Garrett refuted the Company's position that customers somehow benefit from the Company's high-cost, equity rich capital structure. OCA R.B. at 29. The Company's interests and ratepayers' interests are not aligned. OCA R.B. at 29. Since debt is so much cheaper than equity, having a higher debt ratio in the weighted cost of capital calculation can reduce the overall cost of capital.[7] OCA R.B. at 29; OCA St. 2SR at 8. If both the equity ratio and the cost of equity rate are high, such as the Company's full ratemaking claim, then the impact on ratepayers is unreasonable and uneconomical, as illustrated by I&E's analysis that determined more 28% of the Company's increase in revenues is tied to the Company's cost of capital claim. OCA M.B. at 40-41; OCA R.B. at 24, 28-30.

The 9.55% cost of equity recommended by the ALJs is 75 basis points higher than the OCA recommended 8.8% cost of equity, if the Company's actual capital structure is adopted. OCA MB at 33, 42-43, 54-55; OCA R.B. at 19-20, 28-29. (9.55 – 8.8 = 0.75). The 9.55% cost of equity recommended by the ALJs is 15 basis points higher than the OCA's recommended 9.4% cost of equity, if the Commission adopts the OCA hypothetical capital structure for ratemaking. OCA MB at 33, 42-43, 54-55. (9.55 – 9.4 = 0.15). Under the OCA's primary recommendation of

[7] Interest on debt is deductible for taxes, so increasing debt also adds value to the firm by reducing the firm's tax obligation. OCA St. 2 at 58. Indeed, Company witness Shambaugh corrected the Company's ratemaking claim to remove interest expense related to the EDTMA rate district. OCA M.B. at 3-5; OCA St. 1SR at 26.

a hypothetical capital structure and 9.4% cost of equity, the OCA applied its DCF-based cost of equity, as the high end of Mr. Garrett's cost of equity analyses. OCA MB at 33, 42-43, 54-55; OCA R.B. at 19-20, 28-29.

The OCA contends that the combined recommendations of the ALJs, that rates be set based upon the Company's equity-heavy capital structure and a 9.55% cost of equity elevated above both the OCA primary and alternative recommendations will unreasonably burden consumers with excessive rates. If the Commission determines to set rates based upon the Company's atypical and equity-rich capital structure, the Commission should adopt a cost of equity of 8.80% as supported by the OCA testimony and briefs. Alternatively, if the Company adopts the OCA or I&E recommended hypothetical capital structure, the appropriate cost of equity should be set no higher than the 9.40% high end of the OCA cost of equity recommendation, as based upon the OCA DCF result and consideration of the OCA CAPM result.

III. CONCLUSION

Based on the foregoing and for the reasons articulated in the OCA's Main and Reply Briefs, the OCA respectfully requests that the Commission grant the OCA's Exceptions and adopt the OCA's positions as discussed above.

Respectfully Submitted,

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Dated: November 2, 2023