TESI-Sewer Statement No. 1R

4-17-08 JES

HB

DOCUMENT FOLDER

PENNSYLVANIA PUBLIC UTILITY COMMISSION

v.

TOTAL ENVIRONMENTAL SOLUTIONS, INC.
Treasure Lake Sewer Division

Docket No. R-00072495

Rebuttal Testimony

of

Scott D. Fogelsanger, Principal
AUS Consultants

Rebuttal Testimony of Scott D. Fogelsanger

Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

A. My name is Scott D. Fogelsanger. I am employed in the position of Principal with AUS Consultants, which specializes in rate filings, various financial studies including valuation, depreciation, and cost of service studies. AUS Consultants is located at 275 Grandview Avenue, Suite 100, Camp Hill, Pennsylvania, 17011.

Q. MR. FOGELSANGER, WHAT IS THE NATURE OF YOUR REBUTTAL TESTIMONY?

A. This statement is in rebuttal to the direct testimony of the Office of Trial Staff (OTS) Witness Debra J. Backer and Office of Consumer Advocate (OCA) Witness Marilyn J. Kraus. My testimony will address the following items:

- Salaries and Wages
- Payroll Taxes
- Chemicals
- Rental of Building
- Insurance – General Liability
- Rate Case Costs
- Miscellaneous Other Expenses
- Office Supplies

Q. WILL YOU DISCUSS THE OTS AND OCA POSITION FOR EACH OF THE ITEMS YOU WISH TO ADDRESS?

A. Yes, I will.

Q. WOULD YOU PLEASE DISCUSS THE OCA'S POSITION CONCERNING THE REDUCTION IN SALARIES AND WAGES?

A. OCA Witness Kraus has stated that the Company has not supported the December 31, 2007 salaries and wages in this proceeding. Her reduction is based on several factors. First, she refers to the Supporting Data where the Company claimed that most of the pro forma increase was attributable to "a higher than normal level of capitalized salaries and wages" during 2006. Second, she assumes that the salaries and wages at December 31, 2006 are accurately stated. And third, she increases the December 31, 2006 salaries and wages by 3% to reflect the 2007 salaries and wages increases. Based on these adjustments, she is recommending a reduction of $20,309.

Q. DO YOU AGREE WITH OCA WITNESS KRAUS'S REDUCTION IN SALARIES AND WAGES?

A. No. I do not. It must be noted that the reference that she refers to in the Supporting Data was incorrect. The 2006 salaries and wages were not lower as a result of a higher than normal level of capitalized salaries and wages. In fact, the salaries and wages were understated due to incorrect coding. During 2006,

the total salaries and wages for the Company (both water and sewer) totaled $240,309 (total salaries and wages of $246,239 less capitalization of $5,930). This amount was based on the actual employee W-2 forms. The amount that was reflected on the Company's books was $186,577 which is $53,732 less. These amounts are reflected in the additional information that was provided in response to OTS-RE-4-D for the water division. Refer to Attachment 1. This reiterates the fact that the 2006 salaries and wages were substantially understated.

Q. WHAT IS YOUR RECOMMENDATION CONCERNING THE COMPANY'S CLAIM FOR SALARIES AND WAGES?

A. I recommend utilizing the actual salaries and wages for the year ending December 31, 2007. For the year ended December 31, 2007, the salaries and wages (expensed) totaled $115,211. Refer to Attachment 2. Therefore, I am recommending an expense adjustment of $26,649 ($115,211 - $88,562). This is $8,967 higher than claim that was made in the Supporting Data.

Q. WOULD YOU PLEASE DISCUSS THE OCA'S POSITION CONCERNING THE REDUCTION IN PAYROLL TAXES?

A. OCA Witness Kraus has proposed a reduction in payroll taxes of $1,554 based on her adjustment to the salaries and wages.

Q. DO YOU AGREE WITH OCA WITNESS KRAUS'S REDUCTION IN PAYROLL TAXES?

A. No. I do not. The payroll taxes should be based on the actual 2007 salaries and wages of $119,338. Therefore, I am recommending an expense adjustment of $1,103 ($11,804 - $10,701). This is $473 higher than claim that was made in the Supporting Data. Refer to Attachment 3.

Q. WOULD YOU PLEASE DISCUSS THE OTS'S POSITION CONCERNING THE REDUCTION IN CHEMICAL COSTS?

A. OTS Witness Backer has proposed a reduction in chemical costs of $546. Her recommendation was based on the checks and check aprons that the Company provided that supported only $17,905 of the total claim of $18,451.

Q. DO YOU AGREE WITH OTS WITNESS BACKER'S REDUCTION IN CHEMICAL COSTS?

A. No. I do not. The Company has supplied checks and check aprons that totaled $17,905. It must be noted that the general ledger was previously supplied that detailed the total cost of $18,451: The Company has substantiated the claim for $18,451. Therefore, OTS Witness Backer's adjustment should be denied.

Q. WOULD YOU PLEASE DISCUSS THE OTS'S POSITION CONCERNING THE RENTAL OF THE OFFICE BUILDING?

A. OTS Witness Backer has recommended a reduction of $4,049 to the Company's claim because the Company incorrectly classified an expense. At issue, are the telecommunication costs of $4,049 that were booked to this account. Refer to Attachment 4.

Q. DO YOU AGREE WITH OTS'S POSITION FOR THE REDUCTION IN RENTAL OF THE OFFICE BUILDING?

A. Yes, I do with one exception. OTS Witness Backer correctly removed the telecommunication from the rental of the office building expense. But she eliminates this expense amount and does not correctly reflect it in the proper account. I will include this expense as a separate line item identified as Account No. 775.6 – Telecommunications. Therefore, the two (2) adjustments are offsetting and the net adjustments total $0.

Q. WOULD YOU PLEASE DISCUSS THE OTS'S POSITION CONCERNING THE REDUCTION IN GENERAL LIABILITY INSURANCE?

A. OTS Witness Backer has proposed a reduction in general liability insurance of $23,770. This reduction was based on her claim that the Company failed to

prove the expense amount and how the allocation among divisions was determined.

Q. DO YOU AGREE WITH OTS WITNESS BACKER'S REDUCTION IN THE GENERAL LIABILITY INSURANCE?

A. No. I do not. The Company provided all the necessary support to substantiate the general liability claim of $83,956. The Company renews its' general liability insurance every October. The new premium that went into effect in October 2007 was for $323,250 annually. Based on this, the allocated portion to Company is $85,789. The allocation is based on the depreciated utility plant in service at December 31, 2006. Refer to Attachment 5. This results in an expense increase of $1,833.

Q. WOULD YOU PLEASE DISCUSS THE OTS'S AND OCA'S POSITION CONCERNING THE REDUCTION IN RATE CASE COSTS?

A. OTS Witness Backer has reduced the rate case costs by $46,955. Her basis for the adjustment was that the Company only provided support of $31,889 and the normalization period should be based on a five (5) year period. OCA Witness Kraus is recommending a normalization period of five (5) years and results in a reduction of $21,333.

Q. **DO YOU AGREE WITH OTS WITNESS BACKER OCA WITNESS KRAUS'S ADJUSTMENTS TO THE RATE CASE COSTS?**

A. No, I do not. It appears that OTS Witness Backer is capping the rate case costs at $31,889. Obviously, the Company has incurred and will incur additional rate case costs. The Company will be providing updates of the rate case costs throughout the proceeding. Based on invoices, that don't include some February and all of March costs, the rate case costs are $66,110. Refer to Attachment 6.

Both witnesses propose a five (5) year normalization period be utilized. They chose the five (5) year period since the Company had not filed a general rate increase during the last five (5) years. This is correct but the Company management is aware that they should have sought rate relief prior to now. Based on the increasing costs of operation and potentially more stringent DEP standards, it is very unrealistic that the Company can wait another five (5) years for its' next rate filing. Therefore, a three (3) year normalization period is appropriate.

Q. **WOULD YOU PLEASE DISCUSS THE OTS-S AND OCA'S POSITION REGARDING THE ADJUSTMENT TO REMOVE BANK CHARGES FROM THE MISCELLANEOUS OTHER EXPENSES?**

A. OTS Witness Backer and OCA Witness Kraus have proposed a reductions in miscellaneous other expenses for bank charges of $5,813 and $3,975. Their recommendations were to exclude the bank charges because they claim these charges are not appropriate for inclusion in ratemaking expenses.

Q. DO YOU AGREE WITH OTS WITNESS BACKER'S and OCA WITNESS KRAUS'S ELIMINATION OF THE BANK CHARGES?

A. No. The bank charges are related to two (2) major items as follows:

- Monthly processing fees for bank statement preparation, clearing of checks and processing of payments, and
- Monthly fees for credit card processing of customers payments.

Unfortunately, banks in general provide little if any free service to commercial customers. These costs are a normal part of doing business and are appropriate for inclusion in the rate making process.

Q. WOULD YOU PLEASE DISCUSS THE OTS'S POSITION CONCERNING THE REDUCTION IN OFFICE SUPPLIES?

A. OTS Witness Backer has proposed a reduction in office supplies of $3,494. Her recommendation was based on the checks and check aprons that the Company provided that supported only $8,170 of the total claim of $11,664.

Q. DO YOU AGREE WITH OTS WITNESS BACKER'S REDUCTION IN OFFICE SUPPLIES?

A. No. I do not. Previously, the Company had only supplied checks and check aprons that totaled $8,071. Attachment 7 contains all the checks, check aprons, and/or invoices that total $11,192. Therefore, a decrease of $472 ($11,192 - $11,664) is required.

Q. MR. FOGELSANGER, HAVE YOU REVISED THE INCOME STATEMENT AND RATE BASE SCHEDULES TO REFLECT THE ADJUSTMENTS THAT YOU HAVE PROPOSED OR ACCEPTED?

A. Yes, I have. The revised schedules are summarized in Attachment 8. The revised schedules include operating expense adjustments that total ($65,949), depreciation expense adjustment of $598, and payroll tax adjustments that total $473. Also, the utility plant in service was increased by $25,595, the reserve for depreciation was decreased by $598, and the cash working capital claim was increased by $1,273 and the overall return was increased by $2,403. As a result of these adjustments, the requested revenue increase will be reduced by $62,860 to $206,806.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY AT THIS TIME?

A. Yes, it does.

TESI-SEWER STATEMENT NO. 2
WITNESS: GARY D. SHAMBAUGH

4-17-08 JPS
#856

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PENNSYLVANIA PUBLIC UTILITY COMMISSION

v.

TOTAL ENVIRONMENTAL SOLUTIONS, INC.
Treasure Lake Sewer Division

Docket No. R-00072495

Direct Testimony

of

Gary D. Shambaugh, Principal & Director
AUS Consultants
275 Grandview Avenue, Suite 100
Camp Hill, Pennsylvania 17011

Concerning the Company's Measures of Value, Rate Base,
Accrued Depreciation and the Annual Provision for Depreciation

Q. PLEASE STATE YOUR NAME AND BUSINESS AFFILIATION.

A. My name is Gary D. Shambaugh. I am a Principal and Director of AUS Consultants with offices located in Camp Hill, Pennsylvania, Mt. Laurel, New Jersey, Greenfield, Wisconsin and Albuquerque, New Mexico. I am also a Vice President of AUS Consultants, Inc. My primary business focus is providing traditional rate making services to all types of utilities.

Q. PLEASE DESCRIBE THE SERVICES PROVIDED BY AUS CONSULTANTS.

A. AUS Consultants provides financial consulting services to the telecommunications, electric power, natural gas transmission and distribution, water steam heat and chilled water, wastewater resource recovery, solid waste disposal, and transportation industries. We also provide independent counsel to governmental and regulatory bodies and numerous industrial clients.

Our areas of expertise include economic and financial analysis, business planning, rate of return, cost of service, tariff design, ratemaking accounting, cash working capital, assistance in raising financing, capital recovery and valuation of tangible and intangible assets. AUS Consultants is a nationally and internationally recognized financial consulting firm.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND.

A. I have an Associate of Arts degree in accounting from the Harrisburg Area Community College and further studies in cost of service, customer tariff design, and depreciation. I have over 35 years experience in preparing various financial studies, including rate studies, for electric, gas, water, wastewater, steam heat, chilled water, and telephone utilities. I have provided service to and have testified before regulatory agencies regarding both municipal and investor-owned utilities in many jurisdictions including commonwealth courts, county courts, and federal bankruptcy court. I have been qualified as an expert and have provided expert testimony in matters in, but not limited to, Connecticut, Florida, Louisiana, Massachusetts, Michigan, Mississippi, New Jersey, North Carolina, Pennsylvania, Rhode Island, and South Carolina. Over the years, I have presented numerous papers relating to utility management for various industry trade associations and the University of Maine's Margaret Chase Smith Center for Public Policy. Additional information relating to my background and experience is contained in **Appendix A** to this testimony.

Q. HAVE YOU PROVIDED TESTIMONY IN OTHER REGULATORY PROCEEDINGS RELATING TO PUBLIC UTILITIES?

A. I have participated in numerous electric, natural gas, water and wastewater general rate filings during my career. In those filings I was responsible for

various aspects of the filings including, but not limited to, annual revenue requirements, annual depreciation expense, cost of service, customer tariff rate design and various rate base elements.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THIS COMMISSION?

A. Yes. During my 35 year career, I have testified before this Commission numerous times and presented testimony relative to rate making principles.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. AUS Consultants was engaged by Total Environmental Solutions, Inc. ("TESI" or the "Company") to prepare a request for increased rates for those sewer customers being provided service in the Treasure Lake subdivision located near DuBois, PA.

My associate, Scott D. Fogelsanger, has provided testimony addressing the Company's revenue requirements, present and proposed rates and other relevant issues.

I am responsible for the development of the Company's measures of value, rate base, accrued depreciation and the annual provision for depreciation. My testimony will discuss these elements of the Company's filing and present the results of the Company's claims for the Commission's consideration in this proceeding. The Company's claims for rate base and their measures of value are included in SDF Exhibit No.1.

Q. MR. SHAMBAUGH, WILL YOU PLEASE IDENTIFY EACH OF THE COMPANY'S RATE BASE CLAIMS?

A. Yes. The Company's rate base items include plant in service, reserve for depreciation, materials and supplies, cash working capital, customer advances for construction and contributions in aid of construction. Supporting Schedule No. 6, of Section 2 in SDF Exhibit No. 1, contains the details of the Company's surviving utility plant in service.

Q. WHAT IS THE COMPANY'S RATE BASE CLAIM IN THIS PROCEEDING?

A. As shown in detail in the supporting data on Page 1-16 of the original filing, the Company's claimed rate base as of December 31, 2007 is $3,073,250.

Q. WHAT ARE THE ELEMENTS OF THE COMPANY'S RATE BASE CLAIM?

A. Rate base consists of several elements. The first and largest element is the depreciated original cost of plant in service. To this amount are added the Company's claims for materials and supplies and cash working capital requirements. Also, deducted from this amount is the claim for contributions in aid of construction.

Q. PLEASE EXPLAIN HOW THE DEPRECIATED ORIGINAL COST OF PLANT AT DECEMBER 31, 2007 WAS DETERMINED.

A. The Company's depreciated original cost of plant is total plant in service less the accrued depreciation at December 31, 2007. The original cost of plant in service and the accrued depreciation, shown by detailed plant account, are set forth in Section 2, Supporting Schedule No. 6 of SDF Exhibit No. 1.

Q. PLEASE EXPLAIN THE ADDITION TO RATE BASE FOR MATERIALS AND SUPPLIES.

A. The Company's claim in the original filing is based upon an estimate of materials and supplies in inventory necessary to effectively operate the Company. The Company books the materials and supplies as a separate entry on the balance sheet on a consolidated basis. For the purpose of this filing, an estimate of materials and supplies was included until an update of materials and supplies could be determined. The Company currently maintains a consolidated balance of $18,618 in materials as of December 31, 2006. Approximately 50% of that balance is related to sewer or $9,309. The Company is revising its claim for materials and supplies.

Q. PLEASE EXPLAIN THE COMPANY'S CLAIM FOR CASH WORKING CAPITAL.

A. The cash working capital claim is based on an assumed net lag (i.e., revenue lag less expense lag) of 45 days. The 45-day, or 12.5 percent-of-operating-expense method (45 days/365 days), has been approved by the Commission numerous times as a reasonable, cost effective way to calculate cash working capital for smaller utilities. The Company's pro forma claim at December 31, 2007 is $89,260.

Q. WHAT ARE THE COMPANY'S CLAIMS FOR CUSTOMER ADVANCES ("CAC") AND CONTRIBUTIONS IN AID OF CONSTRUCTION ("CIAC")?

A. The Company has deducted the "net" values of CIAC amounting to $1,285,076.

Q. PLEASE EXPLAIN THE TERM "NET"?

A. The CIAC amount is reflected on the Company's books as a liability with associated reserves for depreciation. Since the utility plant in service and book depreciation reserve is inclusive of gross utility plant in service, this item must be deducted "net" of accrued depreciation.

Q. WHAT IS THE COMPANY'S CLAIM FOR ANNUAL DEPRECIATION EXPENSE?

A. The Company's annual depreciation expense claim is $102,130.

Q. SINCE ITS LAST FILING, HAS THE COMPANY CONSISTANTLY UTILIZIED THE ANNUAL DEPRECIATION RATES AND AVERAGE SERVICE LIVES IN CALCULATING THEIR ANNUAL DEPRECIATION EXPENSE AS APPROVED BY THIS COMMISSION?

A. Yes.

Q. DO ANY OF THE MEASURES OF VALUE CLAIMED IN THIS PROCEEDING, INCLUDING ANNUAL DEPRECIATION EXPENSE, CONTAIN ANY PLANT OR ITEMS RELATED TO PENNVEST FUNDED PLANT?

A. No. The PennVest funded utility plant in service reserve for depreciation and annual depreciation expense is not part of the Company's filing.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY AT THIS TIME?

A. Yes, it does.

APPENDIX A

PROFESSIONAL QUALIFICATIONS

OF

GARY D. SHAMBAUGH, PRINCIPAL & DIRECTOR
AUS CONSULTANTS

275 Grandview Avenue, Suite 100
Camp Hill, PA 17011
717-763-9890
717-763-9931 (fax)

PROFESSIONAL QUALIFICATIONS
OF
GARY D. SHAMBAUGH
AUS CONSULTANTS

Has over thirty-five years' experience as a consultant in the public utility field. Has provided services in the areas of valuation, depreciation, original cost, cost of service, tariff rate design, customer bill frequency analysis, accounting matters and rate case filings. Consultant to gas, electric, steam heat, chilled water, telephone, water and wastewater utilities in Connecticut, Delaware, District of Columbia, Florida, Illinois, Iowa, Louisiana, Maine, Massachusetts, Michigan, Mississippi, New Hampshire, New Jersey, New York, North Carolina, Rhode Island, South Carolina, Pennsylvania, Virginia, and West Virginia.

EXPERIENCE

1972 to Date

AUS Consultants, Camp Hill, Pennsylvania. Principal & Director specializing in public utility matters. Has prepared studies and coordinated analysis related to business enterprise valuations, original and trended original cost studies, property inventories, depreciation studies, cost of service, tariff design, salvage value, financial, accounting matters and rate case filings for numerous municipal, authority and investor owned utilities. These studies have required the review of financial records, inspection of property, analysis of original cost data, the development and selection of cost indexes, selection of service lives, the determination of rate base elements, annual depreciation expense, preparation of rate filing data and the presentation of the final report and study results. Has testified before several regulatory agencies on measures of value, depreciation and valuation for gas, water and wastewater utilities. Has also testified on financial and accounting matters, original cost, cost of service, tariff design, revenues and expenses for water and wastewater utilities.

PROFESSIONAL QUALIFICATIONS
OF
GARY D. SHAMBAUGH
AUS CONSULTANTS

Representative Client List

CHILLED WATER

NRG Energy Center - Pittsburgh

ELECTRIC

Borough of Butler, NJ
Consolidated Hydro, Inc.
(CT,SC,NH,MA,ME)
Duquesne Light Company
Foster Wheeler Power Systems, Inc.
Hershey Electric Company
Pennsylvania Power Company, PA
Phelps Dodge
West Penn Power Company, PA

GAS

Columbia Gas of Pennsylvania, Inc.
Jersey Shore Gas Company
Lewistown Gas Company
Mt. Carmel Gas Company
National Fuel Gas Supply
North East Heat and Light Co.
North Penn Gas
Pennsylvania Gas and Water Co.
Pottsville Gas Company, PA
Saxonsburg Heat and Light Co.
The North Carolina Gas Service
T.W. Phillips Gas and Oil Co.

STEAM HEAT

NRG Energy Center - Pittsburgh
Bellfield Boiler Plant

TELEPHONE

Armstrong Telephone Co., WV
Armstrong Utilities, Inc.
Commonwealth Telephone Company
Empire Telephone Company
Hershey Telephone Company
Hickory Telephone Company
Illinois Consolidated Telephone Co.
Jamestown Telephone Company
Lewisberry Telephone Company
Mid-Continent Telephone Corp.
MCI Telecommunications Corp.
Ritchie Telephone Co., WV

WATER

Adams Ridge Development Company
Appalachian Utilities, Inc.
Armstrong Water Company
Artesian Water Company, DE
Back Mountain Water Company
Mercersburg Borough Authority
Merriewold Water Corporation, NY
Middlesex Water Company
Milnes Companies
Monroe Manor Water Company, Inc.

PROFESSIONAL QUALIFICATIONS
OF
GARY D. SHAMBAUGH
AUS CONSULTANTS

Bald Eagle Water Company
Bensalem Township
Blue Mountain Consolidated Water Co.
Borough of Akron
Borough of Bellefonte
Borough of Duncannon
Borough of Hanover
Borough of Lower Burrell
Borough of Media
Borough of Oakmont
Bridgeport Hydraulic, CT
Butler Water Company
CS Water & Sewer Associates
Castle Creek Water Company
Chesterfield County, VA
City of Auburn, NY
City of Creston, Iowa
City of DuBois
City of Port Richey, FL
City of Reading
Citizens Water Company of Confluence
Clearfield County Municipal Services
and Recreation Authority
Clymer Water Company
Consumers-PA Water Company
Cooperstown Water Company
Country Place Water Company, Inc.
El-Do Lake Water Company, Inc.
Emlenton Water Company
Emporium Water Company
Ewing & Other Townships, NJ
Fawn Lake Forest Water Company
Four Seasons Water Company
Fox Chapel Authority
Great Valley Water Company
Hackensack Water Company
Hawley Water Company
Hershey Water Company
Honesdale Consolidated Water Co.
Johnson Properties, Inc.
Keystone Water Company
Lake Latonka Water Company
Langhorne Spring Water Company
Lemont Water Company
Lindrick Service Corporation, FL
National American Corporation, MS
National Utilities, Inc.
New Haven Water Company, CT
New Jersey Water Company
Newtown Artesian Water Company
Northern Cambria Water Company
Oakland Beach Water Company
OSRAM SYLVANIA Products Inc.
Pennichuck Water Works, NH
Pennsylvania-American Water Company
Pennsylvania Gas and Water Company
Philadelphia Suburban Water Company
Plumer Water Company
Portsmouth Water and Fire District, RI
Presque Isle Harbor Water Co., MI
Public Service Water Company
Punxsutawney Water Company
Reynolds Water Company
Reynoldsville Water Authority
Riviera Utilities Water Co. of PA
Riverton Consolidated Water Company
Roaring Creek Water Company, Inc.
Robin Hood Lakes Water Company
Rockwood Water Company
Rolling Oaks Utilities, Inc., FL
Roulet Water Company
Scarecrow Utility, FL
Shangri-La Water Company
Spring Valley Water Company, NY
Spring Water Company of Kane
Southwestern Penna. Water Authority
Sugar Creek Water Company
J. Swiderski Utilities, Inc., FL
Tafton Water Company
The Municipal Authority of
the Borough of West View, PA
The Municipal Authority of
the Township of Robinson, PA
Total Environmental Solutions, Inc.
Tri-Valley Water Supply, Inc
Upland Water Company
Utilities, Inc. of Louisiana
Venango Water Company
Washington Run Water Works, Inc.
Waymart Water Company

PROFESSIONAL QUALIFICATIONS
OF
GARY D. SHAMBAUGH
AUS CONSULTANTS

Lynn Water Company
Mad Hatter Utilities, FL
Manufacturers Water Company
Mather Water Company
MeadowCrest Water Company
Mercer Water Company
Western Pennsylvania Water Co.
Western Utilities, Inc.
Wilmington Water System, DE
Winburne Water Company
Wynnewood Water Corporation

WASTEWATER

Anglo Fabrics, et. al.
Arrowhead North Sewage Company
Benasa Realty Corp.
Borough of Caldwell, NJ
CS Water & Sewer Associates
Charleston Township Municipal Authority
Chesterfield County, VA
City of DuBois
City of Lower Burrell
City of Port Richey, FL
Clean Treatment Sewage Company
Country Place Waste
Treatment Company, Inc.
Delaware Sewer Company
East Providence Township
Municipal Authority
Fawn Township Sewer Authority
Four Seasons Sewer Company
Glendale Yearound Sewer Company
Johnson Properties, Inc.
Lindrick Service Corporation, FL
Lycoming County Water & Sewer Auth.
MPW Utilities, Inc.
Milnes Companies
The Municipal Authority of the
Borough of West View, PA
The Municipal Authority of the
Township of Robinson, PA
National American Corp., MS
North & South Shenango Joint Auth.
Pine Creek Municipal Authority
Plum Borough Municipal Sewer Auth.
Poconos Sewer Company
RHV Utility, Inc., FL
Reynolds Disposal Company
Reynoldsville Sewer Authority
Riviera Utilities Sewer Co. of PA
Rolling Oaks Utilities, Inc., FL
Shangri-La Sewer Company
J. Swiderski Utilities, Inc., FL
Total Environmental Solutions, Inc.
University Area Joint Authority
Patton-Ferguson Joint Authority
College-Harris Joint Authority
Upland Sewer Company
Utilities Inc. of PA
Westvâco Corporation
Wynnewood Sewer Corporation

REGULATORY

Delaware Public Service Commission
District of Columbia
Public Service Commission

PROFESSIONAL QUALIFICATIONS
OF
GARY D. SHAMBAUGH
AUS CONSULTANTS

PERSONAL

Education:

Graduate of the Harrisburg Area Community College with an Associate of Arts Degree in Accounting. Has successfully completed valuation and depreciation studies and programs related to the fundamentals of service life, salvage estimation and forecasting sponsored by Depreciation Programs, Inc. at Calvin College in Grand Rapids, Michigan. Has also successfully completed cost of service seminars presented by the American Water Works Association.

PROFESSIONAL AFFILIATIONS

American Water Works Association
Pennsylvania Gas Association
Pennsylvania Rural Water Association
National Association of Water Companies
National Rural Water Association
Florida Rural Water Association
New York Rural Water Association
Penna. Municipal Authorities Assn.
Society of Depreciation Professionals
West Virginia Rural Water Assn.

SPEECHES

"Water Rates" Pennsylvania Rural Water Association Training Session, State College, PA, June 21, 1988

"Revenues and Rate Design" Pennsylvania Rural Water Association, Conference and Exhibit, State College, PA, October 19, 1988

"Cost of Service and Public Utility Valuations" West Virginia Public Service District Association, EXPO 89, Charleston, WV, April 6, 1989

"Cost of Service and Public Utility Valuations" Pennsylvania Rural Water Association, Annual Conference and Exposition, Meadville, PA, May 11, 1989

"Public Utility Valuations" West Virginia Public Service District Association, August 22, 1989

"General Accounting and Record Keeping of Public Utilities" West Virginia Rural Water Association, Canaan Valley, WV, October 4, 1989

"Budgets and Rates - Creating a Positive Financial Future" West Virginia Rural Water Association, Pipestem State Park, WV, November 7, 1990

"Budgets and Rates - Creating a Positive Financial Future" Pennsylvania Rural Water Association, Butler, PA, April 9, 1991

PROFESSIONAL QUALIFICATIONS
OF
GARY D. SHAMBAUGH
AUS CONSULTANTS

SPEECHES
(continued)

"Cash Flow Analysis" - Pennsylvania Rural Water Association, State College, PA, October 10, 1991

"Uncollectible Accounts" - Pennsylvania Rural Water Association, State College, PA, March 29, 1993

"Water Rates" - Pennsylvania Department of Community Affairs, Clarion State University, May 20, 1993

"Financial Management for Public Utilities" - New York Rural Water Association, Baldwin, NY, May 25, 1993

"Forecasting Budgets and Rate Design" - National Rural Water Association, Portland, OR, October 26, 1993

"PURE '94: The Pricing of Water" - University of Maine, Augusta, ME, January 21, 1994

"The Anatomy of a Rate Filing" - Pennsylvania Rural Water Association, State College, PA, March 29, 1994

"Rate Regulation - Should Authorities be Concerned?" - Pennsylvania Municipal Authorities Association, Hershey, PA, April 11, 1995

TESTIMONY

Mr. Shambaugh has testified before the Connecticut Department of Public Utility Control, Pennsylvania Public Utility Commission, Florida Public Service Commission, Louisiana Public Service Commission, Michigan Public Service Commission, Mississippi Public Utilities Commission, North Carolina Public Utilities Commission, Rhode Island Public Utilities Commission, South Carolina Public Service Commission, the Court of Common Pleas of Allegheny County - Civil Division, PA, the Court of Common Pleas of Indian County, PA., Superior Court, Massachusetts, West Pasco County Circuit Court, Florida, and the U.S. Federal Bankruptcy Court - Middle Pennsylvania District on various rate making disciplines, such as financial feasibility, accounting matters, original cost, measures of value, revenues and expenses, cost of service, tariff design, rate base elements, rate of return, depreciation, and valuation.

PROFESSIONAL QUALIFICATIONS
OF
GARY D. SHAMBAUGH
AUS CONSULTANTS

PUBLICATIONS

"Budgets and Rates - Creating a Positive Financial Future", Pennsylvania Municipal Authorities Association's "The Authority", June 1991

"Budgets and Rates - Creating a Positive Financial Future", Pennsylvania Rural Water Association's "The Keystone Tap", August 1991

"PURE '94: The Pricing of Regulated Utilities: Water Rates", Margaret Chase Smith Center for Public Policy, University of Maine, Orono, ME, January 1994

APPENDIX B

SUMMARY OF TESTIMONY

OF

GARY D. SHAMBAUGH, PRINCIPAL & DIRECTOR
AUS CONSULTANTS

GARY D. SHAMBAUGH
SUMMARY OF TESTIMONY

Client	Docket	Subject
Anglo Fabrics, MA	CA-94-2629A	C,T
Appalachian Utilities, Inc.	R-00963557	A,D,RB,F,RR,T,OC
Back Mountain Water Company	A-210054	A,D,OC,RB,RR,T
Borough of Media - Water Works	R-901725 R-912150	F,A,D,RB,T F,A,D,RB,T
Citizens Water Company of Confluence	R-00932746	F,A,D,RB,T,RR
City of DuBois - Bureau of Water Court of Common Pleas - Clearfield County	R-912016 2002-978C.D.	A,D,RB,C,T,RR RV,C
Consumers Pennsylvania Water Company Shenango Valley Division	R-00973972	CBFA, RV
Country Place Water Company, Inc.	A-210625 R-891460 C-903064 5-90-01155	F,A F,A,D,RB,T,C,RR C,T F,A,D,RB,V,T,RR,OC (5)
Country Place Waste Treatment Company, Inc.	A-230065 R-00932568 5-90-01155	F,A F,A,D,RB,T,C,RR F,A,D,RB,V,T,RR,OC (5)
Emporium Water Company	R-00932567 R-00005945 R-00005945	F,A,D,RB,T T RV
Fawn Lake Forest Water Company	R-891383	F,A,D,RB,T F,A,D,RB,RR,T,C
Foster Wheeler Power Systems, Inc.	R-00973869	C,T
Four Seasons Water Company, Inc. - Direct Testimony - Rebuttal Testimony - Supplemental Testimony	 C-00957205 C-00957205 C-00957205	 A,D,RB,V,RR,T,OC A,D,RB,V,RR,T,OC A,D,RB,V,RR,T,OC
Keystone Water Company	R-842755 R-842756 R-842759 R-850245	RB,D RB,D RB,D RB,D
LWV Utilities, Inc. et al	95-2427CA Div. "G"	 C,F,T (7)
Manufacturers Water Company	R-00984275	C,T

GARY D. SHAMBAUGH
SUMMARY OF TESTIMONY

Client	Docket	Subject
Mercer Water Company	R-901689	F,A,D,RB,T,RR
National Utilities, Inc.	R-00932828 R-00953416	A,D,RB,V,RR,T A,D,RB,V,RR,T
North East Heat & Light Company	R-922309	A,RB,D
OSRAM SYLVANIA Products Inc.	No. 2674	A,RV,C,CBFA,T (2)
Pennsylvania-American Water Company	R-880916 R-891208 R-00943231	RB,D RB,D OC,D
Pennsylvania Gas and Water Company Gas Division	R-821961 R-832475 R-891261	RB,D RB,D RB,D
Pennsylvania Gas and Water Company Water Divisions	R-822102 R-850178 R-870853	RB,D RB,D RB,D
Spring Brook Water Division	R-891209	RB,D
Philadelphia Suburban Water Company	R-901667 R-911892 R-00953343	RB,D RB,D OC
Pittsburgh Thermal, L.P.	R-00994641	OC,RB,RV,EPR, D,RR,A
Plum Borough Municipal Sewer Authority	GD92-05567 & GD93-20010	F,A,C,T (1)
Pocono Sewer Company	R-80011060	V,RB,D
Pocono Water Company	R-80011059	V,RB,D
Portsmouth Water and Fire District	#1988	F,A,C,D,T (2)
Presque Isle Harbor Water Company - Direct	U-9702	RB,C,D,A,T,RR (3)
Protestants - RE: Lemont Water Company	A-211690F5001 A-211690F2000	V V
Public Service Water Company Upland Water Company MPW Utilities, Inc.	A-210025F002 A-230026	F,A,OC,RB F,A,OC,RB
RHV Utility, Inc.	961220-SU	F,A,D,RV,RR,T,OC (4)

GARY D. SHAMBAUGH
SUMMARY OF TESTIMONY

Client	Docket	Subject
Riviera Utilities Water Company of Pennsylvania	R-00973992	F,A,D,RV,RR,T,OC
Riverton Consolidated Water Company	R-842675	RB,D
Roaring Creek Water Company	R-911963	OC,D
Rockwood Water Company	R-00932771	F,A,RB,RR,T,D
Tri-Valley Water Supply, Inc.	R-00953432	F,A,D,RB,T,OC
El-Do Division	R-00963806	F,A,D,RB,T,RR,OC
Total Environmental Solutions, Inc.	U-22148 Sub A	A,C,F,OC,RB,RV,T (6)
	U-22148 Sub G	C,T (6)
	W-1146 Sub 1	A,C,CBFA,D,OC,RB, RR,RV,T (9)
	01-UA-0080	A,C,CBFA,D,F,OC,RB RR,RV,T,V, (9)
	01-UA-0081	A,C,CBFA,D,F,OC,RB, RR,RV,T,V (9)
Utilities, Inc.	2000-511-5	R,RB,C,T
Waymart Water Company - Direct	R-901697	F,A,D,RB,T,C,RR
- Rebuttal	C-903013	F,A,D,RB,T,C,RR
Western Pennsylvania Water Company	R-842621	RB,D
	R-842622	RB,D
	R-842623	RB,D
	R-842624	RB,D
	R-842625	RB,D
	R-850096	RB,D
	R-850097	RB,D
	R-860397	RB,D
	R-870825	RB,D
Western Utilities, Inc.	A-210017	F,A,D,RB,T,C,RR
	R-00963856	F,A,D,RB,T,RR,

A = Rate Case Accounting
C = Cost of Service/Rate Design
CBFA = Customer Bill Frequency Analysis
D = Depreciation
EPR = Energy Price Rate
F = Financial
OC = Original Cost
RB = Rate Base Elements
RR = Rate of Return
RV = Revenues

GARY D. SHAMBAUGH
SUMMARY OF TESTIMONY

Client	Docket	Subject

T = Tariff Design
V = Valuation

All cases are before the Pennsylvania Public Utility Commission, except as noted:

(1) Court of Common Pleas of Allegheny County, PA
(2) Public Service Commission - State of Rhode Island
(3) Public Service Commission - State of Michigan
(4) Public Service Commission - State of Florida
(5) Federal Bankruptcy Court - Middle District - State of Pennsylvania
(6) Public Service Commission - Louisiana
(7) West Pasco County Court - Florida
(8) Mississippi Public Utilities Commission
(9) North Carolina Public Utilities Commission

TESI-Sewer Statement No. 2R

4-17-08 JES
1436

PENNSYLVANIA PUBLIC UTILITY COMMISSION

v.

TOTAL ENVIRONMENTAL SOLUTIONS, INC.
Treasure Lake Sewer Division

Docket No. R-00072495

Rebuttal Testimony

of

Gary D. Shambaugh, Principal & Director
AUS Consultants

Q. **MR. SHAMBAUGH HAVE YOU SUBMITTED DIRECT TESTIMONY IN THIS PROCEEDING?**

A. Yes.

Q. **WHAT IS THE NATURE OF YOUR REBUTTAL TESTIMONY?**

A. My rebuttal testimony includes an update of the 2007 fixed capital additions, annual depreciation expense claims and accrued depreciation reserve as of December 31, 2007.

In addition, my testimony will address the Office of Trial Staff's witness Antonio Maceo's testimony relative certain rate base elements, rate structure, and customer penalties.

I also have several comments relative to the direct testimonies of OCA Witness Marilyn J. Kraus and OTS Witness Debra J. Backer concerning bad debt expense and uncollectible accounts.

Update of 2007 Utility Plant In Service

Q. **MR. SHAMBAUGH DOES THE COMPANY NOW HAVE AVAILABLE THE ACTUAL 2007 UTILITY PLANT ADDITIONS AND RELATED DEPRECIATION ELEMENTS?**

A. Yes. The Company's auditors finalized the 2007 fixed capital plant additions and AUS Consultants calculated the 2007 annual depreciation expense and accrued depreciation reserves for Treasure Lake Sewer Division. This information is contained in Exhibit GDS No. 1.

Q. DO YOU HAVE ANY OTHER COMMENTS RELATIVE TO OTS WITNESS MACEO'S TESTIMONY WITH REGARD TO THE COMPANY'S RATE BASE ELEMENTS?

A. Yes. At Docket No. R-00072493, OTS Witness Hubert removed $73,195 of common plant assets from the Company's measures of value including the claimed annual expense. OTS Witness Maceo's testimony in this proceeding is silent with regard to OTS Witness Hubert's adjustments

I would expect OTS Witness Maceo to adopt Witness Hubert's adjustments and include the plant and depreciation elements in the Company's measures of value in this proceeding.

Materials and Supplies

Q. DID OTS WITNESS MACEO ELIMINATE THE COMPANY'S ORIGINAL CLAIM ($42,268) FOR MATERIALS AND SUPPLIES?

A. Yes.

Q. DID THE COMPANY PROVIDE AN UPDATE TO THE CLAIMED MATERIALS AND SUPPLIES?

A. Yes. The Company responded to OTS-RB-12-D relative to the inventoried materials and supplies for the twelve months ended December 31, 2006.

Q. WHAT IS THE COMPANY'S CLAIMED MATERIALS AND SUPPLIES IN THIS PROCEEDING?

A. In response to OTS-RB-12-D, the Company provided materials and supplies inventory by month for fiscal year 2006. From this information a 13 month average can reasonably be calculated of approximately $23,939 for the combined water and sewer operations. An allocation of 50% of this value to the sewer operations would result in a materials and supplies value of approximately $11,969 as of December 31, 2006.

Information relative to the 2007 materials and supplies balances have not yet been released by the Company's auditors.

Rate Structure

Q. DOES THE OTS RECOMMEND THAT RATES BE PROPORTIONALLY INCREASED TO ALL CUSTOMERS IN THIS PROCEEDING?

A. Yes.

Q. DO YOU AGREE WITH THIS APPROACH TO CUSTOMER TARIFF RATE DESIGN?

A. No. In the Company's most recent rate filing, decided in 1999, the parties agreed to hold availability fees at the current rate of $4.20 per month. There are a number of reasons for this approach.

Availability fees were traditionally established by this Commission, with little or no cost of service support to be charged to undeveloped lot owners of planned subdivisions. The billing of availability fees allowed utilities in new and existing land subdivisions to allocate a portion of the utility's total annual revenue

requirement to the undeveloped lot owners. A good concept in theory, but for the majority of the utilities operating in planned subdivisions availability fees are a financial liability.

Q. PLEASE EXPLAIN.

A. Availability fees are difficult at best to collect from lot owners. Many owners have abandoned their lots or simply ignore the bill. A quick review of the Company's uncollectible accounts will confirm that most of the Company's bad debt claims originate from undeveloped lot owners. OTS Exhibit No. 2, shows of the $33,723 of bad debt expense availability customers account for all but approximately $2,288 of the total.

The Company's total annual revenue requirement is allocated to availability lots, thus automatically creating an operating revenue shortfall. The Company's financial statements will reflect inflated billed revenue, net income and possible tax liabilities.

There is virtually no economically feasible means to collect availability fees. Many of the lots are abandoned or in real estate tax purgatory. Since the Company can not collect delinquent availability fees, any increase in those fees will simply increase the amount of uncollectible accounts and ensure that the Company will experience future revenue shortfalls.

Availability fees have out lived their intended application. In fact they have caused financial harm to utilities and historically have been used as a means to simply reduce the cost of service and water use charges to active customers.

Q. DO YOU HAVE ANY OTHER COMMENTS WITH RESPECT TO AVAILABILITY CHARGES?

A. Yes. Witness Maceo makes some very general statements on page 8, lines 4 through 6. I disagree with those statements.

Q. PLEASE EXPLAIN.

A. Witness Maceo states on page 8, line 5, that "(4) the availability of utility service enhances the value of the property". This statement is only true if someone desires to build on a specific lot. The market value of any given lot is not determined by the availability of water and sewer service. If a given lot is truly "valuable" why do those owners fail to pay property taxes, homeowners association dues or real estate taxes? Many of the lots in question were purchased for speculative investment and have remained undeveloped since the early 1970's.

On page 8, line 4, the witness states "(3) the cost incurred by the utility represents the potential service to all potential customers." In his testimony, OTS Witness Maceo utilizes "potential" when describing availability customers. The reality is that availability customers currently receive no sewer service and it would be difficult at best to allocate any portion of the costs of service.

OTS Witness Maceo's position with regard to increasing availability fees is contrary to past agreements and Commission orders; I would recommend that this Commission reject Witness Maceo's position to increase availability fees and consider the elimination of availability fees for all undeveloped lots.

Customer Penalties

Q. WHAT IS OTS WITNESS MACEO'S POSITION WITH REGARD TO CUSTOMER PENALTIES?

A. Witness Maceo recommends increasing customer penalties by $7,354.

Q. DO YOU HAVE ANY COMMENTS RELATIVE TO CUSTOMER PENALTIES?

A. Yes. The Company's claimed amount of $26,527 of customer penalties is predominately related to the inability to collect availability fees. His position simply adds insult to injury. Witness Maceo wants to increase availability fees and calculate a higher penalty on those fees, thus indirectly admitting that the Company can not collect all availability fees.

The Company's filing is very conservative by claiming the $26,257 in customer penalties. Realistically, customer penalties should be no more than a few thousand dollars of the Company's annual revenue requirement.

Uncollectable Accounts

Q. DOES BOTH OTS WITNESS BACKER AND OCA WITNESS KRAUS RECOMMEND UTILIZING THE ACTUAL 2006 WRITE OFF OF $33,723?

A. Yes. The Company would agree with this approach for this proceeding.

Q. WOULD YOU LIKE TO MAKE ANY FURTHER COMMENTS REGARDING BAD DEBT EXPENSE?

A. Yes. Bad debt expense is a product of the Company's inability to collect availability fees. The Company's lack of "write-offs" does not alleviate the fact that the Company will never collect previously approved Commission rates and revenues. The promulgation of availability fees will continue the revenue shortfalls for the Company.

I would offer two (2) alternative approaches to mitigate the problem of uncollectible availability fees.

I would recommend the gradual elimination of the availability fees, a majority of the bad debt claims, customer penalties in future filings which will provide the Company with a real opportunity to collect its approved customer tariff rates and annual revenue requirement.

Or, allow the Company to consider an availability customer "inactive" after eighteen (18) consecutive months of delinquent bills. An inactive availability customer will no longer be billed or assigned a proportionate amount of the Company's annual revenue requirement. In the future, the undeveloped lot will not be allowed to connect to the water system unless all undeveloped lot fees, plus interest, are paid in full.

Water Allowance

Q. OTS WITNESS MACEO RECOMMENDS A ZERO WATER ALLOWANCE BE INCLUDED IN THE COMPANY'S RATE DESIGN IN

THEIR NEXT BASE RATE FILING. OCA WITNESS KRAUS RECOMMENDS AN ELIMINATION OF ALL OR A PORTION OF THE WATER ALLOWANCE. DO YOU HAVE ANY COMMENTS RELATIVE TO THOSE POSITIONS?

A. Yes. I believe witness Kraus' position will allow the Company the flexibility to comply with the Commission's policy while considering revenue stability.

Witness Maceo would allow only "non-sewage treatment related costs such as billing costs" in the customer charge. The Company incurs many costs that are "fixed" and totally unrelated to the "volumetric charge". I disagree with his approach to the Company's future water rate designs.

Q. DOES THIS CONCLUDE YOU TESTIMONY AT THIS TIME?

A. Yes. It does.

TESI-Sewer Statement No. 2R

PENNSYLVANIA PUBLIC UTILITY COMMISSION

v.

TOTAL ENVIRONMENTAL SOLUTIONS, INC.
Treasure Lake Sewer Division

Docket No. R-00072495

Exhibit GDS No. 1

TOTAL ENVIRONMENTAL SOLUTIONS, INC.

Pennsylvania Water and Sewer Utilities
Treasure Lake Sewer System

Development of Average Plant Balances as of December 31, 2007

Account Number	Account Title / Description	Original Cost at 12/31/2003	Fixed Capital Additions 2004	Original Cost at 12/31/2004	Fixed Capital Additions 2005	Original Cost at 12/31/2005	Fixed Capital Additions 2006	Original Cost at 12/31/2006	Fixed Capital Additions 2007	Original Cost at 12/31/2007	Average Plant Balances
Depreciable Plant											
354.3	Structures & Impr. - System Pumping Plant	$348,444.93	$35,562.00	$382,006.93	$20,757.00	$402,763.93	$43,470.00	$446,233.93		$446,233.93	$446,233.93
354.4	Structures & Impr. - Treatment & Disposal Plant	131,866.93	11,712.00	143,578.93		143,578.93	25,026.00	168,604.93	5,731.85	174,336.58	171,470.76
354.7	Structures & Impr. - General Plant	23,281.00		23,281.00		23,281.00		23,281.00		23,281.00	23,281.00
360	Collection Sewer - Force Mains										
360.10	Cast Iron & Ductile Iron, 6"-8"	$40,666.28		$40,666.28		$40,666.28		$40,666.28		$40,666.28	$40,666.28
360.11	Cast Iron & Ductile Iron, 10" & Over	1,130.91		1,130.91		1,130.91		1,130.91		1,130.91	1,130.91
360.20	Asbestos Cement, 18" & Over	242,256.80		242,256.80		242,256.80		242,256.80		242,256.80	242,256.80
360.30	ABS, 6"-8"	278,892.71		278,892.71		278,892.71		278,892.71		278,892.71	278,892.71
360.31	ABS, 10"-15"	604,895.77		604,895.77		604,895.77		604,895.77		604,895.77	604,895.77
360.40	Plastic, 4" & Under	348,879.40		348,879.40		348,879.40		348,879.40		348,879.40	348,879.40
360.41	Plastic, 6"-8"	2,049,293.52	580.00	2,049,873.52		2,049,873.52	247.00	2,050,120.52		2,050,120.52	2,050,120.52
360.42	Plastic, 10"-14"	74,778.48		74,778.48		74,778.48		74,778.48		74,778.48	74,778.48
360.50	Valves, 4" & Under	23,712.36		23,712.36		23,712.36		23,712.36		23,712.36	23,712.36
360.51	Valves, 6"-8"	2,288.88		2,288.88		2,288.88		2,288.88		2,288.88	2,288.88
360.60	Air Release Valves	4,000.00		4,000.00		4,000.00		4,000.00		4,000.00	4,000.00
360.70	Manholes	862,024.72		862,024.72		862,024.72		862,024.72		862,024.72	862,024.72
360.80	Cleanouts	25,017.78		25,017.78		25,017.78		25,017.78		25,017.78	25,017.78
	Total Account 360	$4,557,677.41	$580.00	$4,558,257.41	$0.00	$4,558,257.41	$247.00	$4,558,504.41	$0.00	$4,558,504.41	$4,558,504.41
361	Collection Sewer - Gravity										
361.11	Cast Iron & Ductile Iron, 10" & Over	$731.14		$731.14		$731.14		$731.14		$731.14	$731.14
361.30	ABS, 6"-8"	2,399.07		2,399.07		2,399.07		2,399.07		2,399.07	2,399.07
361.31	ABS, 10"-15"	101,840.93		101,840.93		101,840.93		101,840.93		101,840.93	101,840.93
361.32	ABS, 16" & Over	29,563.00		29,563.00		29,563.00		29,563.00		29,563.00	29,563.00
361.40	Reinforced Concrete, 16" & Over	13,338.75		13,338.75		13,338.75		13,338.75		13,338.75	13,338.75
361.50	Stubs & Caps	2,296.01		2,296.01		2,296.01		2,296.01		2,296.01	2,296.01
	Total Account 361	$150,168.90	$0.00	$150,168.90	$0.00	$150,168.90	$0.00	$150,168.90	$0.00	$150,168.90	$150,168.90
363	Services	$943,842.14	$24,682.00	$968,524.14	$4,648.00	$973,173.14	$9,678.00	$982,851.14	$1,411.71	$984,262.85	$983,557.00
364	Flow Measuring Devices	0.00		0.00		0.00		0.00	326.41	326.41	163.21
371	Pumping Equipment	0.00		0.00		0.00		0.00	44,775.05	44,775.05	22,387.53
380.4	Treatment & Disposal Equipment	787,834.85	12,460.00	800,294.85	1,516.00	801,810.85		801,810.85	13,658.18	815,769.01	808,789.93
381	Plant Sewers	5,163.10		5,163.10		5,163.10		5,163.10		5,163.10	5,163.10
382	Outfall Sewer Lines	5,163.10		5,163.10		5,163.10		5,163.10		5,163.10	5,163.10
389	Other Plant & Miscellaneous Equipment	0.00		0.00		0.00		0.00	1,631.45	1,631.45	815.73
390.1	Office Furniture	1,124.00		1,124.00		1,124.00	57.00	1,181.00	364.11	1,545.11	1,363.06
390.2	Office Equipment	0.00		0.00		0.00		0.00	2,850.23	2,850.23	1,325.12
391	Transportation Equipment	34,839.88	14,115.00	48,954.88		48,954.88	9,574.00	58,528.88		58,528.88	58,528.88
393	Tools, Shop and Garage Equipment	32,920.33	828.00	33,748.33	2,697.00	36,445.33	934.00	37,379.33	3,067.44	40,478.77	38,926.05
394	Laboratory Equipment	10,837.52	714.00	11,551.52		11,551.52	1,904.00	13,455.52	898.06	14,353.61	13,904.57
395	Power Operated Equipment	30,076.25		30,076.25	2,964.00	33,040.25		33,040.25	64,812.52	97,872.77	65,366.51
	Total Depreciable Plant	$7,061,240.34	$100,853.00	$7,161,893.34	$32,803.00	$7,194,696.34	$90,890.00	$7,285,586.34	$139,456.82	$7,424,843.16	$7,355,114.79
Non-Depreciable Plant											
353.3	Land & Land Rights - System Pumping Plant	$15,991.00	$0.00	$15,991.00		$15,991.00		$15,991.00		$15,991.00	$15,991.00
353.4	Land - Treatment & Disposal	37,000.00		37,000.00		37,000.00		37,000.00		37,000.00	37,000.00
	Total Non-Depreciable Plant	$52,991.00	$0.00	$52,991.00	$0.00	$52,991.00	$0.00	$52,991.00	$0.00	$52,991.00	$52,991.00
	Total Plant in Service	$7,114,231.34	$100,853.00	$7,214,884.34	$32,803.00	$7,247,687.34	$90,890.00	$7,338,577.34	$139,456.82	$7,477,834.16	$7,408,105.79
Less: Contributions in Aid of Construction											
353.3	Land & Land Rights - System Pumping Plant	$4,758.96		$4,758.96		$4,758.96		$4,758.96		$4,758.96	$4,758.96
353.4	Land - Treatment & Disposal	12,000.00		12,000.00		12,000.00		12,000.00		12,000.00	12,000.00
354.3	Structures & Impr. - System Pumping Plant	111,184.22		111,184.22		111,184.22		111,184.22		111,184.22	111,184.22
354.4	Structures & Impr. - Treatment & Disposal Plant	56,826.56		56,826.56		56,826.56		56,826.56		56,826.56	56,826.56
354.7	Structures & Impr. - General Plant	14,636.81		14,636.81		14,636.81		14,636.81		14,636.81	14,636.81
360.1	Cast Iron & Ductile Iron, 6"-8"	21,224.71		21,224.71		21,224.71		21,224.71		21,224.71	21,224.71
360.11	Cast Iron & Ductile Iron, 10" & Over	1,130.91		1,130.91		1,130.91		1,130.91		1,130.91	1,130.91
360.2	Asbestos Cement, 16" & Over	72,108.07		72,108.07		72,108.07		72,108.07		72,108.07	72,108.07
360.3	ABS, 6"-8"	213,488.33		213,488.33		213,488.33		213,488.33		213,488.33	213,488.33
360.31	ABS, 10"-15"	495,686.98		495,686.98		495,686.98		495,686.98		495,686.98	495,686.98
360.4	Plastic, 4" & Under	15,321.29		15,321.29		15,321.29		15,321.29		15,321.29	15,321.29
360.41	Plastic, 6"-8"	604,955.47		604,955.47		604,955.47		604,955.47		604,955.47	604,955.47
360.42	Plastic, 10"-14"	22,254.26		22,254.26		22,254.26		22,254.26		22,254.26	22,254.26
360.5	Valves, 4" & Under	4,751.89		4,751.89		4,751.89		4,751.89		4,751.89	4,751.89
360.6	Air Release Valves	1,190.41		1,190.41		1,190.41		1,190.41		1,190.41	1,190.41
360.7	Manholes	334,973.03		334,973.03		334,973.03		334,973.03		334,973.03	334,973.03
360.8	Clean outs	3,035.86		3,035.86		3,035.86		3,035.86		3,035.86	3,035.86
361.11	Cast Iron & Ductile Iron, 10" & Over	731.14		731.14		731.14		731.14		731.14	731.14
361.3	ABS, 6"-8"	967.13		967.13		967.13		967.13		967.13	967.13
361.31	ABS, 10"-15"	56,823.32		56,823.32		56,823.32		56,823.32		56,823.32	56,823.32
361.32	ABS, 16" & Over	8,798.02		8,798.02		8,798.02		8,798.02		8,798.02	8,798.02
361.4	Reinforced Concrete, 16" & Over	13,338.75		13,338.75		13,338.75		13,338.75		13,338.75	13,338.75
361.5	Stubs & Caps	1,380.86		1,380.86		1,380.86		1,380.86		1,380.86	1,380.86
363	Services	74,643.02		74,643.02		74,643.02		74,643.02		74,643.02	74,643.02
380.4	Treatment & Disposal Equipment	229,845.26		229,845.26		229,845.26		229,845.26		229,845.26	229,845.26
381	Plant Sewers	1,536.55		1,536.55		1,536.55		1,536.55		1,536.55	1,536.55
382	Outfall Sewer Lines	1,536.55		1,536.55		1,536.55		1,536.55		1,536.55	1,536.55
390.1	Office Furniture	274.98		274.98		274.98		274.98		274.98	274.98
393	Tools, Shop & Garage Equipment	4,449.14		4,449.14		4,449.14		4,449.14		4,449.14	4,449.14
394	Laboratory Equipment	1,362.82		1,362.82		1,362.82		1,362.82		1,362.82	1,362.82
	Total Contributions in Aid of Construction	$2,385,004.29	$0.00	$2,385,004.29	$0.00	$2,385,004.29	$0.00	$2,385,004.29	$0.00	$2,385,004.29	$2,385,004.29
	Total Plant in Service (Net)	$4,729,227.05	$100,853.00	$4,829,880.05	$32,803.00	$4,862,683.05	$90,890.00	$4,953,573.05	$139,456.82	$5,092,829.87	$5,023,101.50

TOTAL ENVIRONMENTAL SOLUTIONS, INC.

Pennsylvania Water and Sewer Utilities
Treasure Lake Sewer System

Development of Annual Depreciation Expense
as of December 31, 2007
Based Upon Whole Life/Average Life Depreciation

Acct. No.	Description	Average Plant Balances 12/31/2007	ASL/Iowa Curve	Depreciation Percent	2007 Annual Depreciation Amount
Depreciable Plant:					
354.3	Structures & Impr. - System Pumping Plant	$446,233.93	60-R3	1.67%	$7,452.11
354.4	Structures & Impr. - Treatment & Disposal Plant	171,470.76	60-R3	1.67%	2,863.56
354.7	Structures & Impr. - General Plant	23,281.00	60-R3	1.67%	388.79
360	Collection Sewer - Force:				
360.10	Cast Iron & Ductile Iron, 6"-8"	$40,666.28	80-R3	1.25%	$508.33
360.11	Cast Iron & Ductile Iron, 16" & Over	1,130.91	100-R3	1.00%	11.31
360.20	Asbestos Cement, 16" & Over	242,296.60	100-R3	1.00%	2,422.97
360.30	ABS, 6"-8"	278,692.71	80-R3	1.25%	3,483.66
360.31	ABS, 10"-15"	604,895.77	90-R3	1.11%	6,714.34
360.40	Plastic, 4" & Under	348,879.40	50-R3	2.00%	6,977.59
360.41	Plastic, 6"-8"	2,050,120.52	65-R3	1.54%	31,571.86
360.42	Plastic, 10"-14"	74,778.48	80-R3	1.25%	934.73
360.50	Valves, 4" & Under	23,712.36	50-R3	2.00%	474.25
360.51	Valves, 6"-8"	2,288.88	65-R3	1.54%	35.25
360.60	Air Release Valves	4,000.00	65-R3	1.54%	61.60
360.70	Manholes	862,024.72	50-R3	2.00%	17,240.49
360.80	Cleanouts	25,017.78	50-R3	2.00%	500.36
	Total Account 360	$4,558,504.41		1.56%	$70,936.73
361	Collection Sewer - Gravity:				
361.11	Cast Iron & Ductile Iron, 16" & Over	$731.14	100-R3	1.00%	$7.31
361.30	ABS, 6"-8"	2,399.07	80-R3	1.25%	29.99
361.31	ABS, 10"-15"	101,840.93	90-R3	1.11%	1,130.43
361.32	ABS, 16" & Over	29,563.00	100-R3	1.00%	295.63
361.40	Reinforced Concrete, 16" & Over	13,338.75	100-R3	1.00%	133.39
361.50	Stubs & Caps	2,296.01	50-R3	2.00%	45.92
	Total Account 361	$150,168.90		1.09%	$1,642.67
363	Services	$983,557.00	50-R3	2.00%	$19,671.14
364	Flow Measuring Devices	163.21	10-R3	10.00%	16.32
371	Pumping Equipment	22,387.53	35-R3	2.86%	640.28
380.4	Treatment & Disposal Equipment	808,789.93	40-R3	2.49%	20,138.87
381	Plant Sewers	5,163.10	50-R3	2.00%	103.26
382	Outfall Sewer Lines	5,163.10	50-R3	2.00%	103.26
389	Other Plant & Miscellaneous Equipment	815.73	20-R3	5.00%	40.79
390.1	Office Furniture	1,363.06	25-L1	4.00%	54.52
390.2	Office Equipment	1,325.12	10-LI	10.00%	132.51
391	Transportation Equipment	58,528.88	6-R3	10.95%	6,408.91
393	Tools, Shop and Garage Equipment	38,928.05	15-R3	6.05%	2,355.15
394	Laboratory Equipment	13,904.57	20-R3	5.00%	695.23
395	Power Operated Equipment	65,366.51	10-R3	10.00%	6,536.65
	Total Depreciable Plant	$7,355,114.79		1.80%	$140,180.76
Non-Depreciable Plant:					
353.3	Land & Land Rights - System Pumping Plant	$15,991.00		0.00%	$0.00
353.4	Land - Treatment & Disposal	37,000.00		0.00%	0.00
	Total Non-Depreciable Plant	$52,991.00			$0.00
	Total Plant in Service	$7,408,105.79			$140,180.76

TOTAL ENVIRONMENTAL SOLUTIONS, INC.

Pennsylvania Water and Sewer Utilities
Treasure Lake Sewer System

Development of Annual Depreciation Expense
as of December 31, 2007
Based Upon Whole Life/Average Life Depreciation

Acct. No.	Description	Average Plant Balances 12/31/2007	ASL/Iowa Curve	Depreciation Percent	2007 Annual Depreciation Amount
Less: Contributions in Aid of Construction:					
353.3	Land & Land Rights - System Pumping Plant	$4,758.96			
353.4	Land - Treatment & Disposal	12,000.00			
354.3	Structures & Impr. - System Pumping Plant	111,164.22	60-R3	1.67%	$1,856.44
354.4	Structures & Impr. - Treatment & Disposal Plant	56,826.56	60-R3	1.67%	949.00
354.7	Structures & Impr. - General Plant	14,636.81	60-R3	1.67%	244.43
360.10	Cast Iron & Ductile Iron, 6"-8"	21,224.71	80-R3	1.25%	265.31
360.11	Cast Iron & Ductile Iron, 16" & Over	1,130.91	100-R3	1.00%	11.31
360.20	Asbestos Cement, 16" & Over	72,108.07	100-R3	1.00%	721.08
360.30	ABS, 6"-8"	213,488.33	80-R3	1.25%	2,668.60
360.31	ABS, 10"-15"	495,686.98	90-R3	1.11%	5,502.13
360.40	Plastic, 4" & Under	15,321.29	50-R3	2.00%	306.43
360.41	Plastic, 6"-8"	604,955.47	65-R3	1.54%	9,316.31
360.42	Plastic, 10"-14"	22,254.26	80-R3	1.25%	278.18
360.50	Valves, 4" & Under	4,751.89	50-R3	2.00%	95.04
360.60	Air Release Valves	1,190.41	65-R3	1.54%	18.33
360.70	Manholes	334,973.03	50-R3	2.00%	6,699.46
360.80	Cleanouts	3,035.85	50-R3	2.00%	60.72
361.11	Cast Iron & Ductile Iron, 16" & Over	731.14	100-R3	1.00%	7.31
361.30	ABS, 6"-8"	967.13	80-R3	1.25%	12.09
361.31	ABS, 10"-15"	56,823.32	90-R3	1.11%	630.74
361.32	ABS, 16" & Over	8,798.02	100-R3	1.00%	87.98
361.40	Reinforced Concrete, 16" & Over	13,338.75	100-R3	1.00%	133.39
361.50	Stubs & Caps	1,389.86	50-R3	2.00%	27.80
363	Services to Customers	74,643.02	50-R3	2.00%	1,492.86
380.4	Treatment & Disposal Equipment	229,645.26	40-R3	2.50%	5,741.13
381	Plant Sewers	1,536.55	50-R3	2.00%	30.73
382	Outfall Sewer Lines	1,536.55	50-R3	2.00%	30.73
390.1	Office Furniture	274.98	25-L1	4.00%	11.00
393	Tools, Shop and Garage Equipment	4,449.14	15-R3	4.18%	185.97
394	Laboratory Equipment	1,362.82	20-R3	5.00%	68.14
	Total Contributions in Aid of Construction	$2,385,004.29			$37,452.65
	Total Plant in Service (Net)	$5,023,101.50			$102,728.11

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TOTAL ENVIRONMENTAL SOLUTIONS, INC.

Pennsylvania Water and Sewer Utilities
Treasure Lake Sewer System

Development of the Accrued Book Depreciation Reserve
for Ratemaking Purposes as of December 31, 2007

Description	Calendar Year December31,	Amount Reserved
Plant In Service		
Beginning Balance	1998	$2,065,693.79
Annual Depreciation Expense	1999	123,342.97
Annual Depreciation Expense	2000	123,342.97
Annual Depreciation Expense	2001	123,747.84
Annual Depreciation Expense	2002	124,703.29
Annual Depreciation Expense	2003	127,128.28
Annual Depreciation Expense	2004	130,661.67
Annual Depreciation Expense	2005	132,747.98
Annual Depreciation Expense	2006	134,489.25
Annual Depreciation Expense	2007	140,180.76
Total Plant In Service Reserve		$3,226,038.80
Contributions In Aid of Construction		
Beginning Balance	1998	$762,872.80
Annual Depreciation Expense	1999	37,443.34
Annual Depreciation Expense	2000	37,443.34
Annual Depreciation Expense	2001	37,452.65
Annual Depreciation Expense	2002	37,452.65
Annual Depreciation Expense	2003	37,452.65
Annual Depreciation Expense	2004	37,452.65
Annual Depreciation Expense	2005	37,452.65
Annual Depreciation Expense	2006	37,452.65
Annual Depreciation Expense	2007	37,452.65
Total Contributions Reserve		$1,099,928.03

TESI-SEWER STATEMENT NO. 3
WITNESS: PAULINE M. AHERN

4/17/08 TES
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TOTAL ENVIRONMENTAL SOLUTIONS, INC. – TREASURE LAKE SEWER DIVISION

DOCKET NO. R-00072495

DIRECT TESTIMONY

OF

PAULINE M. AHERN, CRRA
PRINCIPAL
AUS CONSULTANTS

CONCERNING

FAIR RATE OF RETURN

FEBRUARY 2008

TABLE OF CONTENTS

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

A. My name is Pauline M. Ahern and I am a Principal of AUS Consultants. My business address is 155 Gaither Drive, Suite A, Mt. Laurel, New Jersey 08054.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE.

A. I am a graduate of Clark University, Worcester, MA, where I received a Bachelor of Arts degree with honors in Economics in 1973. In 1991, I received a Master of Business Administration with high honors from Rutgers University.

In June 1988, I joined AUS Consultants as a Financial Analyst and am now a Principal. I am responsible for the preparation of all fair rate of return and capital structure exhibits for AUS Consultants. I have offered expert testimony on behalf of investor-owned utilities before twenty-four state regulatory commissions. The details of these appearances, as well as details of my educational background, are shown in Appendix A supplementing this testimony.

I also calculate and maintain the A.G.A. Index under contract with the American Gas Association (A.G.A.). The A.G.A. Index is a market capitalization weighted index of the common stocks of about 70 corporate members of the A.G.A.

I have co-authored an article with Frank J. Hanley, a Principal & Director of AUS Consultants entitled "Comparable Earnings: New Life for an Old Precept" which was published in the American Gas Association's Financial

Quarterly Review, Summer 1994. I also assisted in the preparation of an article authored by Frank J. Hanley and A. Gerald Harris entitled "Does Diversification Increase the Cost of Equity Capital?" published in the July 15, 1991 issue of Public Utilities Fortnightly.

I am a member of the Society of Utility and Regulatory Financial Analysts (formerly the National Society of Rate of Return Analysts) serving as President for 2006-2008 and Secretary/Treasurer for 2004-2006. In 1992, I was awarded the professional designation "Certified Rate of Return Analyst" (CRRA) by the National Society of Rate of Return Analysts. This designation is based upon education, experience and the successful completion of a comprehensive written examination.

I am an associate member of the National Association of Water Companies, serving on its Finance Committee, a member of the Energy Association of Pennsylvania, formerly the Pennsylvania Gas Association, and a member of the American Finance and Financial Management Associations.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose is to provide testimony on behalf of Total Environmental Solutions, Inc. – Treasure Lake Sewer Division (TESI-Sewer or the Company) as to the fair rate of return, including common equity cost rate, senior capital cost rate, and capital structure which it should be afforded the opportunity to earn on its jurisdictional rate base

Q. WHAT IS YOUR RECOMMENDED COMMON EQUITY COST RATE?

A. I recommend that the Pennsylvania Public Utility Commission (PA PUC or the

Commission) authorize the Company the opportunity to earn an overall rate of return based upon a hypothetical ratemaking capital structure at December 31, 2007 consisting of 45.00% long-term debt and 55.00% common equity at cost rates of 6.41% and 11.40%, respectively, as summarized in Table 1 below:

Table 1

	Capital Structure Ratios	Cost Rate	Weighted Return
Long-Term Debt	45.00%	6.41%	2.88%
Common Equity	55.00	11.40	6.27
Total	100.00%		9.15%

Q. HAVE YOU PREPARED AN EXHIBIT WHICH SUPPORTS YOUR RECOMMENDED COMMON EQUITY COST RATE?

A. Yes, I have. It has been marked for identification as TESI-SEWER EXHIBIT NO. 1 and consists of Schedules PMA-1 through PMA-14.

II. SUMMARY

Q. PLEASE SUMMARIZE YOUR RECOMMENDED COMMON EQUITY COST RATE RANGE.

A. My recommended common equity cost rate of 11.40% is summarized on Schedule PMA-1, page 2. Because TESI-Sewer's common stock is not publicly traded, a market-based common equity cost rate cannot be determined directly for TESI-Sewer. Therefore, in arriving at my recommended common equity cost rate of 11.40%, I assessed the market-based cost rates of companies of relatively similar risk, i.e., proxy group(s), for insight into a recommended common equity cost rate applicable to TESI-Sewer and suitable

for cost of capital purposes. Using other utilities of relatively comparable risk as proxies is consistent with the principles of fair rate of return established in the Hope[1] and Bluefield[2] cases and adds reliability to the informed expert judgment used in arriving at a recommended common equity cost rate. However, no proxy group can be selected to be identical in risk to TESI-Sewer and therefore, the proxy groups' results must be adjusted to reflect the greater relative business risk of TESI-Sewer as will be subsequently discussed in detail. The bases of selection of the two proxy groups will also be discussed subsequently.

As explained in more detail below, my analysis reflects current capital market conditions and results from the application of four well-tested market-based cost of common equity models, the Discounted Cash Flow (DCF) approach, the Risk Premium Model (RPM), the Capital Asset Pricing Model (CAPM), and the Comparable Earnings Model (CEM).

The results derived from each are as follows:

[1] Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944).

[2] Bluefield Water Works Improvement Co. v. Public Serv. Comm'n, 262 U.S. 679 (1922).

Table 2

	Proxy Group of Six AUS Utility Reports Water Cos.		Proxy Group of Four Value Line (Std. Ed.) Water Cos.
Discounted Cash Flow Model	10.36%		10.49%
Risk Premium Model	10.94		11.34
Capital Asset Pricing Model	10.40		10.89
Comparable Earnings Model	13.88		13.60
Indicated Common Equity Cost Rate Before Business Risk Adjustment	10.80%	--	11.00%
Business Risk Adjustment	0.50		0.50
Indicated Common Equity Cost Rate After Adjustment for Business Risk	11.30%	--	11.50%
Recommended Common Equity Cost Rate	11.40%		

After reviewing the cost rates based upon the four models, I conclude that a range of common equity cost rate, before adjustment for business risk, of 10.80% to 11.00%, is indicated based upon the application of all four models to the market data of the proxy groups of six AUS Utility Reports water companies and four Value Line (Standard Edition) water companies. Due to TESI-Sewer's smaller size relative to the two proxy groups an upward business risk adjustment is warranted. After applying a business risk adjustment of 50 basis points (0.50%), an indicated risk adjusted range of common equity cost rate of 11.30% to 11.50% is applicable to the Company's proposed common equity ratio of 55.00%. My recommended common equity cost rate of 11.40% is based upon the midpoint of this range and is applicable to the common equity financed portion of the Company's jurisdictional rate base.

III. GENERAL PRINCIPLES

Q. WHAT GENERAL PRINCIPLES HAVE YOU CONSIDERED IN ARRIVING AT YOUR RECOMMENDED COMMON EQUITY COST RATE OF 11.40%?

A. In unregulated industries, the competition of the marketplace is the principal determinant of the price of a product or service. In the case of regulated public utilities, regulation must act as a substitute for such marketplace competition. Consequently, marketplace data must be relied upon to assure that the utility can fulfill its obligations to the public and provide adequate service at all times. This requires a level of earnings sufficient to maintain the integrity of presently invested capital and permit the attraction of needed new capital at a reasonable cost in competition with other firms of comparable risk, consistent with the fair rate of return standards established by the U.S. Supreme Court in the Hope and Bluefield cases cited previously. Consequently, in my determination of common equity cost rate, I have evaluated data gathered from the marketplace for utilities as similar in risk as possible to TESI-Sewer.

IV. BUSINESS RISK

Q. PLEASE DEFINE BUSINESS RISK AND EXPLAIN WHY IT IS IMPORTANT TO THE DETERMINATION OF A FAIR RATE OF RETURN.

A. Business risk incorporates all of the risks of a firm other than financial risk, which will be discussed subsequently. Examples of business risk include the quality of management, the regulatory environment, customer mix, service territory growth and the like, which have a direct bearing on earnings.

Business risk is important to the determination of a fair rate of return

because the greater the level of risk, the greater the rate of return investors demand, consistent with the basic financial precept of risk and return.

Q. PLEASE DISCUSS THE BUSINESS RISKS FACING THE SEWER INDUSTRY IN GENERAL.

A. The water and wastewater utility industry faces significant risks related to replacing aging transmission and distribution systems. Although Value Line Investment Survey[3] observes the following about the water utility industry, it applies equally to the wastewater utility industry as many of the water companies followed by Value Line also have wastewater operations:

> After a brief spurt late last year, water utility stocks, as a group, have recently given back most of the gains. Therefore, the industry ranks in the bottom rungs of our Survey for Timeliness. Although broad-market weakness, the result of a plunging housing market and lofty commodity prices, played a role, weaker-than-expected third-quarter results, due to industry-specific woes, namely unfavorable weather conditions and a hiccup in the regulatory process, was the primary reason for the decline. And, although conditions probably got a little better in the fourth quarter, we suspect that earnings growth remained weak for most of these stocks in the fourth-quarter 2007. (Results are likely to be released for most in the coming weeks.)
>
> Earnings growth ought to get back on track this year, as more-normalized weather patterns and recent company initiatives (discussed further below) boost usage rates and act as a catalysts [sic]. However, long term, we worry that many water utilities lack the finances to keep up with the elevated infrastructure costs that should persist for years to come.
>
> * * * * *
>
> Water providers have seen maintenance costs jump considerably in recent years as aging infrastructures required repairs and, in many cases, even rebuilding. However, we suspect that many systems are still outdated and require additional renovations.

[3] Value Line Investment Survey, January 25, 2008.

> That, coupled, with more stringent water purification standards, due to greater fears of bioterrorism, ought to result in high costs for the foreseeable future. Unfortunately, many companies here do not have the finances to fund these endeavors and will be forced to look to fund these endeavors and will be forced to look to outside financiers to help meet the costs.
>
> Appealing investment options are difficult to find here. Not a single stock in the group is ranged favorably for Timeliness or the 3- to 5-year pull, due to the capital constraints of the industry. Indeed, any gains we envision stemming from an improving regulatory landscape and/or penetration into new markets, will likely be offset by rising interest costs and higher share count. This affects the income component as well. The once lofty dividend yields are a thing of the past, and income-oriented investors have better investments options. That said, as always, we caution all potential investors to take a careful look at the individual reports on the following pages before making any financial commitments.

In addition, because the water and wastewater industry is much more capital-intensive than the electric, natural gas or telephone industries, the investment required to produce a dollar of revenue is greater. And, because investor-owned water and wastewater utilities typically do not receive federal funds for infrastructure replacement, the challenge to investor-owned water and wastewater utilities is exacerbated and their access to financing is restricted, thus increasing risk.

The National Association of Regulatory Commissioners (NARUC) has also highlighted the challenges facing the water and wastewater industry stemming from its capital intensity. NARUC's Board of Directors adopted a resolution in July 2006, taking the position that[4]:

> WHEREAS, To meet the challenges of the water and wastewater industry which may face a combined capital investment

[4] "Resolution Supporting Consideration of Regulatory Policies Deemed as 'Best Practices'", Sponsored by the Committee on Water. Adopted by the NARUC Board of Directors, July 27, 2006.

requirement nearing one trillion dollars over a 20-year period, the following policies and mechanisms were identified to help ensure sustainable practices in promoting needed capital investment and cost-effective rates: a) the use of prospectively relevant test years; b) the distribution system improvement charge; c) construction work in progress; d) pass-through adjustments; e) staff-assisted rate cases; f) consolidation to achieve economies of scale; g) acquisition adjustment policies to promote consolidation and elimination of non-viable systems; h) a streamlined rate case process; i) mediation and settlement procedures; j) defined timeframes for rate cases; k) integrated water resource management; l) a fair return on capital investment; *and* m) improved communications with ratepayers and stakeholders; *and*

WHEREAS, Due to the massive capital investment required to meet current and future water quality and infrastructure requirements, adequately adjusting allowed equity returns to recognize industry risk in order to provide a fair return on invested capital was recognized as crucial...

RESOLVED, That the National Association of Regulatory Utility Commissions (NARUC), convened in its July 2006 Summer Meetings in Austin, Texas, conceptually supports review and consideration of the innovative regulatory policies and practices identified herein as "best practices;" *and be it further*

RESOLVED, That NARUC recommends that economic regulators consider and adopt as many as appropriate of the regulatory mechanisms identified herein as best practices...

The water and wastewater utility industry also experiences lower relative depreciation rates. Lower depreciation rates, as one of the principal sources of internal cash flows for all utilities, mean that water and wastewater utility depreciation as a source of internally-generated cash is far less than for electric, natural gas or telephone utilities. Water and wastewater utilities' assets have longer lives and, hence, longer capital recovery periods. As such, water and wastewater utilities face greater risk due to inflation which results in a higher replacement cost per dollar of net plant than for other types of utilities.

Water utilities experienced an average depreciation rate of 2.5% for 2006 with TESI-Sewer expected to experience a similar depreciation rate of 1.4% on a pro forma basis at December 31, 2007, assuming the requested rate request is granted. In contrast, in 2006 the electric, combination electric and gas, natural gas or telephone industries, experienced average depreciation rates of 4.2%, 4.4%, 4.3% and 6.5%, respectively.

In addition, as noted by S&P[5]:

> Environmental regulations, which can be particularly stringent for water utilities, impact credit quality. Mandatory compliance with environmental legislation is often quite capital intensive. This is particularly so in the areas of wastewater discharge and drinking water quality. In most jurisdictions observed by Standard & Poor's, pressures from environmental standards is likely to increase. High compliance costs can impact a water utility's creditworthiness if their financing is up-front and their recovery is over a long period, potentially putting stress on the financial profile in the short term.
>
> A key rating consideration is the extent of the link between a water utility's legislated environmental standards and its rate-setting mechanism. Stringent environmental rules requiring expensive upgrade and compliance costs are not necessarily a negative rating factor, so long as the utility has a flexible and transparent process for passing the costs through to consumers, and these consumers are willing and able to bear these costs. Standard & Poor's considers whether the environmental and economic regulators are acting in isolation, or perhaps have different constituencies.

Moody's[6] also notes that:

> We expect that the credit quality of the investor-owned U.S. water utilities will likely deteriorate over the next several years, due to

[5] Standard & Poor's, Criteria: Infrastructure Finance, Water and Wastewater Utilities, Projects and Concessions, September 1998, p. 47.

[6] Moody's Investors Service, Global Credit Research, "Credit Risks and Increasing for U.S. Investor Owned Water Utilities", Special Comment, January 2004, p. 5.

ongoing large capital spending requirements in the industry. Larger capital expenditures facing the water utility industry result from the following factors:

- Continued federal and state environmental compliance requirements;
- Higher capital investments for constructing modern water treatment and filtration facilities;
- Ongoing improvement of maturing distribution and delivery infrastructure; and
- Heightened security measures for emergency preparedness designed to prevent potential terrorist acts.

Given the overwhelming importance of protecting the public health, the water utility industry remains regulated by the federal and state regulatory agencies. As a result of this importance, the level of state regulators' responsiveness is critical in enabling the water utilities to maintain their financial integrity. In addition, when utilities are permitted a fair rate of return and timely rate adjustments to reflect the costs of providing this essential service, they will be more able to implement the necessary safeguards to protect the public health.

In addition, the water utility industry, as well as the electric and natural gas utility industries, faces the need for increased funds to finance the increasing security costs required to protect the water supply and infrastructure from potential terrorist attacks in the post-September 11, 2001 world.

In view of the foregoing, it is clear that the water and wastewater utility industry's high degree of capital intensity coupled with the need for substantial infrastructure capital spending and increased anti-terrorism and anti-bioterrorism security spending, requires regulatory support in the form of adequate and timely rate relief, as recognized by NARUC, so water and wastewater utilities will be able to successfully meet the challenges they face.

Q. DOES TESI-SEWER FACE ADDITIONAL EXTRAORDINARY BUSINESS RISK?

A. Yes. TESI-Sewer's smaller size as shown on page 3 of Schedule 1, i.e., total capital of $1.701 million pro forma at December 31, 2007 relative to average total capital of $626.006 million in 2006 for the proxy group of six AUS Utility Reports water companies and $895.381 million for the proxy group of four Value Line (Std. Ed.) water companies indicates greater relative business risk because all else equal, size has a bearing on risk.

Q. PLEASE EXPLAIN WHY SIZE HAS A BEARING ON BUSINESS RISK.

A. Smaller companies are simply less able to cope with significant events which affect sales, revenues and earnings. In general, as will be discussed in detail subsequently, the loss of revenues from a few larger customers, for example, would have a greater effect on a small company than on a much larger company with a larger customer base. In addition, the effect of extreme weather conditions, i.e., prolonged droughts or extremely wet weather will have a greater effect upon a small operating water and wastewater utility than upon the much larger, more geographically diverse, publicly-traded holding companies.

Another factor contributing to the risk effects of size include the fact that investors demand greater returns to compensate for a lack of marketability and liquidity. Because TESI-Sewer is the regulated utility to whose rate base the Commission's ultimately allowed overall cost of capital and fair rate of return will be applied, the relevant risk reflected in the cost of capital must be that of TESI-Sewer, including the impact of its small size on common equity cost rate. Size is an important factor which affects common equity cost rate, and TESI-

Sewer is significantly smaller than the average company in each proxy group based upon total investor-provided capital as shown below:

Table 3

	2006 Total Capital (1) ($ millions)	Times Greater than The Company	Market Capitalization(1) ($ Millions)	Times Greater than the Company
Proxy Group of Six AUS Utility Reports Water Companies	$626.006	368.0x	$745.405	459.0x
Proxy Group of Four Value Line (Std. Ed.) *Water Companies*	*895.381*	*526.4x*	*1,058.678*	*681.3x*
TESI-Sewer	1.701		1.624 (2) 1.554 (3)	

(1) From Schedule PMA-1, page 3.
(2) Based upon the average market-to-book ratio of the proxy group of six AUS Utility Reports water companies.
(3) Based upon the average market-to-book ratio of the proxy group of four Value Line (Std. Ed.) water companies.

Table 3 above also shows the results of my study of the market capitalization of the proxy groups of six AUS Utility Reports water companies and four Value Line (Std. Ed.) water companies. The results are shown on page 5 of Schedule PMA-1 which summarizes the market capitalizations as of February 8, 2008.

TESI-Sewer's common stock is not publicly traded. Consequently, I have assumed that if it were publicly traded, the common shares would be selling at the same market-to-book ratio as the average market-to-book ratio for each proxy group, or 212.3% (six water companies) and 203.2% (four water companies) on February 8, 2008. Hence, TESI-Sewer's market capitalization is estimated at $1.624 million and $1.554 million based upon the average market-to-book ratios of each proxy group, respectively, as of February 8,

2008. In contrast, the market capitalization of the average AUS Utility Reports water company was $745.405 million on February 8, 2008, or 459.0 times larger than TESI-Sewer's estimated market capitalization. In addition, the market capitalization of the average Value Line (Std. Ed.) water company was $1.059 billion on February 8, 2008 or 681.3 times larger than TESI-Sewer. It is conventional wisdom, supported by actual returns over time, and a general premise contained in basic finance textbooks, that smaller companies tend to be more risky causing investors to expect greater returns as compensation for that risk.

Q. DOES THE FINANCIAL LITERATURE AFFIRM A RELATIONSHIP BETWEEN SIZE AND COMMON EQUITY COST RATE?

A. Yes. Brigham[7] states:

> A number of researchers have observed that portfolios of small-firms have earned consistently higher average returns than those of large-firms stocks; this is called "small-firm effect." On the surface, it would seem to be advantageous to the small firms to provide average returns in a stock market that are higher than those of larger firms. In reality, it is bad news for the small firm; what *the small-firm effect means is that the capital market demands higher returns on stocks of small firms than on otherwise similar stocks of the large firms.* (italics added)

V. FINANCIAL RISK

Q. PLEASE DEFINE FINANCIAL RISK AND EXPLAIN WHY IT IS IMPORTANT TO THE DETERMINATION OF A FAIR RATE OF RETURN.

A. Financial risk is the additional risk created by the introduction of senior capital, i.e., debt and preferred stock, into the capital structure. In other words, the

[7] Eugene F. Brigham, Fundamentals of Financial Management, Fifth Edition, The Dryden Press, 1989, p. 623.

higher the proportion of senior capital in the capital structure, the higher the financial risk.

Utilities formerly were considered to have much less business risk in comparison to unregulated enterprises, and, as a result, a larger percentage of debt capital was acceptable to investors.

In November 2007, S&P published its electric, gas, and water utility ratings rankings lists in a framework consistent with the manner in which it presents is rating conclusions across all other corporate sectors. As S&P stated[8]:

> Incorporating utility ratings into a shared framework to communicate the fundamental credit analysis of a company furthers the goals of transparency and comparability in the ratings process.
>
> * * *
>
> The utilities rating methodology remains unchanged, and the use of the corporate risk matrix has not resulted in any changes to ratings or outlooks. The same five factors that we analyzed to produce a business risk score in the familiar 10-point scale are used in determining whether a utility possesses an "Excellent," "Strong," "Satisfactory," "Weak," or "Vulnerable" business risk profile.

Pages 1 through 9 of Exhibit PMA-2 describe the utility bond rating process. S&P's new business risk/financial risk matrix is shown in Table 1 on page 11 of Exhibit PMA-1, while financial risk indicative ratios for utilities are shown in Table 2 on page 12. Notwithstanding the metrics published in Table 2, S&P states:

[8] Standard & Poor's – Ratings Direct – "U.S. Utilities Ratings Analysis Now Portrayed In The S&P Corporate Ratings Matrix", November, 30, 2007, p. 2.

> Note that even after we assign a company a business risk and a financial risk, the committee does not arrive by rote at a rating based on the matrix. The matrix is a guide – it is not intended to convey precision in the ratings process or reduce the decision to plotting intersections on a graph.

As shown on Schedule PMA-10, page 2, the average S&P bond rating (issuer credit rating), business risk profile and financial risk profile of the six AUS Utility Reports water companies is AA-/A+(A), Excellent and Intermediate and for the four Value Line (Std. Ed.) water companies, A+ (A), Excellent and Intermediate, respectively.

Q. NEVERTHELESS, CAN ONE STILL MEASURE THE COMBINED BUSINESS RISKS, I.E., INVESTMENT RISK OF AN ENTERPRISE USING BOND RATINGS AND CREDIT RATINGS?

A. Yes, similar bond ratings/issue credit ratings reflect similar combined business risks, i.e., total risk. Although the specific business or financial risks may differ between companies, the same bond rating indicates that the combined risks are similar as the bond rating process reflects acknowledgment of all diversifiable business and financial risks in order to assess credit quality or credit risk. For example, S&P expressly indicates that the bond rating process encompasses a qualitative analysis of business and financial risks (see pages 3 through 9 of Schedule PMA-2). While not a means by which one can specifically quantify the differential in common equity risk between companies, the bond (credit) rating provides a useful means to compare/differentiate investment risk between companies because it is the result of a thorough and comprehensive analysis of all diversifiable business risks, i.e., investment risk.

VI. TOTAL ENVIRONMENTAL SOLUTIONS, INC. - TREASURE LAKE SEWER DIVISION

Q. HAVE YOU REVIEWED THE FINANCIAL DATA FOR TESI-SEWER?

A. Yes. TESI-Sewer provides sewer service to approximately 5,500 customers in Sandy Township, Clearfield County. TESI-Sewer is a wholly-owned subsidiary of Total Environmental Solutions, Inc. Thus, the Company's common stock is not publicly traded.

VII. PROXY GROUPS

Q. PLEASE EXPLAIN HOW YOU CHOSE THE PROXY GROUP OF SIX AUS UTILITY REPORTS WATER COMPANIES.

A. The basis of selection for the proxy group of six AUS Utility Reports water companies were those companies that meet the following criteria: 1) they are included in the Water Company Group of AUS Utility Reports (February 2008); they have Value Line or Reuters consensus five-year EPS growth projections; and 3) they have more than 70% of their 2006 operating revenues derived from water operations. Six companies met all of these criteria. BIW Ltd., Middlesex Water Co., Pennichuck Corp. and SJW Corp. were eliminated because Reuters was not reporting a consensus five-year EPS growth rate projection for the companies at the time of the selection of the proxy group. Southwest Water Company was eliminated because it did not derive more than 70% of its 2006 operating revenues from water operations.

Q. PLEASE DESCRIBE SCHEDULE PMA-3.

A. Schedule PMA-3 contains comparative capitalization and financial statistics for the six AUS Utility Reports water companies for the years 2002 through 2006.

Page 1 contains a summary of the comparative data for the years 2002-2006. Page 2 contains notes relevant to page 1, as well as the basis of selection and names of the individual companies in the proxy group.

During the five-year period ending 2006, the historically achieved average earnings rate on book common equity for this group averaged 9.88%. The average common equity ratio based upon total capital was 46.27% for the five-years ending 2006, while the five-year average dividend payout ratio was 74.73%.

Coverage of interest charges, excluding all AFUDC from funds from operations for the years 2002-2006 ranged between 3.46 and 4.10 times and averaging 3.75 times, while funds from operations relative to total debt ranged from 16.10% to 18.62% averaging 16.79%.

Q. PLEASE EXPLAIN HOW YOU CHOSE THE PROXY GROUP OF FOUR VALUE LINE WATER COMPANIES.

A. The basis of selection for the proxy group of four Value Line (Std. Ed.) water companies was to include those companies which are part of Value Line's (Std. Ed.) Water Utility Industry Group.

Q. PLEASE DESCRIBE SCHEDULE PMA-4.

A. Schedule PMA-4 contains comparative capitalization and financial statistics for the four Value Line (Std. Ed.) water companies for the years 2002 through 2006. Page 1 contains a summary of the comparative data for the years 2002-2006. Page 2 contains notes relevant to page 1, as well as the basis of selection and names of the individual companies in the proxy group.

During the five-year period ending 2006, the historically achieved average earnings rate on book common equity for this group averaged 9.16%. The average common equity ratio based upon total capital was 46.98% for the five-year period ending 2006, while the five-year average dividend payout ratio was 67.20%.

Coverage of interest charges, excluding all AFUDC from funds from operations for the years 2002-2006 ranged between 3.66 and 4.34 times, averaging 3.99 times, while funds from operations relative to total debt ranged from 14.97% to 19.78%, averaging 18.34%.

VIII. CAPITAL STRUCTURE RATIOS

Q. WHAT CAPITAL STRUCTURE RATIOS DO YOU RECOMMEND FOR USE IN DETERMINING THE OVERALL COST OF CAPITAL FOR TESI-SEWER?

A. I recommend the use of a ratemaking capital structure consisting of 45.00% total debt and 55.00% common equity. TESI-Sewer's debt ratio based upon total capital at December 31, 2006 adjusted per books and pro forma on December 31, 2007 was and will be 100.00% as shown in the Balance Sheet provided on page 1-17 of Supporting Data for Supplement No. 3 to Tariff Water – Pa. PUC No. 4 in the instant docket. In my opinion, a debt ratio of 100% is inappropriate to use for ratemaking because with 100% debt capital, it contains much more debt than is necessary if TESI-Sewer's capital structure were market-based, i.e., if it raised debt capital directly in the marketplace.

Q. HOW DID YOU ARRIVE AT YOUR RECOMMENDED HYPOTHETICAL CAPITAL STRUCTURE RATIOS CONSISTING OF 45.00% TOTAL DEBT AND

55.00% COMMON EQUITY?

A. S&P has assigned the long-term debt of the proxy group of six AUS Utility Reports water companies an average 'AA-/A+' bond rating, an 'Excellent' business risk profile and an 'Intermediate' financial risk profile. The proxy group of four Value Line (Std. Ed.) water companies has an average 'A+' bond rating, an 'Excellent' business risk profile and an 'Intermediate' financial risk profile. As shown on page 12 of Schedule PMA-2, S&P's financial risk indicative total debt / total capital ratios range from 35% - 50%, with a midpoint of 42.5%, for a utility with an 'Intermediate' financial risk profile, like the two proxy groups of companies. This range implies a range of total equity / total capital ratios of 50% - 65%, with a midpoint of 57.5%. Since my recommended common equity cost rate of 11.40%, after adjustment for TESI-Sewer's greater business risk, is based upon the market data of both of these proxy groups, it is reasonable to base my recommended hypothetical capital structure on the midpoints of the range of S&P's Indicative financial risk total debt ratio, 42.5% (42.5% = (35% + 50%) / 2) and implied total equity ratio of 57.5% (57.5% = (50% + 60.0%) / 2). Hence my recommended hypothetical capital structure applicable to TESI-Sewer consisting of 45.0% total debt and 55.0% total equity is reasonable and conservative.

Q. **HOW DOES THE COMPANY'S RATEMAKING HYPOTHETICAL COMMON EQUITY RATIO OF 55.0% COMPARE WITH THE COMMON EQUITY RATIOS MAINTAINED BY THE COMPANIES IN THE PROXY GROUPS?**

A. The Company's ratemaking common equity ratio of 55.0% is reasonable, if not

conservative, relative to the common equity ratios maintained on average by the companies in both the proxy group of six AUS Utility Reports water companies and the proxy group of four Value Line (Std. Ed.) water companies upon whose market data I base my 11.40% common equity cost rate. The common equity ratios of the six AUS Utility Reports water companies averaged 48.74% for the year 2006 ranging from 37.67% to 56.01% and averaging 46.27% for the five years ended 2006 as shown on page 1 of Schedule PMA-5. Likewise, the common equity ratios of the four Value Line (Std. Ed.) water companies averaged 51.52% for the year 2005, ranging from 45.50% to 56.01% and averaging 46.98% for the five years ended 2005 as shown on page 2 of Schedule PMA-5. Hence, a 55.0% common equity ratio is reasonable, if not conservative relative to the capital structure ratios maintained on average by the water companies in both proxy groups, for ratemaking purposes in determining overall rate of return for TESI-Sewer, given the Company's small size.

IX. LONG-TERM DEBT COST RATE

Q. **PLEASE EXPLAIN THE BASIS OF THE LONG-TERM DEBT COST RATES ASSOCIATED WITH THE COMPANY'S PROPOSED LONG-TERM DEBT RATIO OF 45.0%.**

A. The basis of my long-term debt cost rate of 6.41% is contained in Schedule PMA-6. Page 1 contains a summary of the basis of the composite cost rate while page 2 contains a summary of the basis of the cost rate applicable to the pro forma debt at December 31, 2007 and pages 3 through 9 contain the basis of the composite long-term debt interest cost rate for each company in the two

proxy groups based upon information contained in the 2006 annual Forms 10K for each company. As shown on page 2, the composite interest cost rate of the proxy group of six AUS Utility Reports water companies was 6.07%, while that of the proxy group of four Value Line (Std. Ed.) water companies was 6.45%. Because I rely upon both proxy groups in formulating my recommended hypothetical capital structure and common equity cost rate, I utilize the midpoint of these long-term composite interest cost rates, or 6.26% as a starting point in developing a long-term debt cost rate applicable to TESI-Sewer. By definition, the composite interest cost rates do not represent the full cost of raising long-term debt capital as they do not reflect issuance costs associated with debt financings. To allow for a reasonable provision for issuance expenses, I have added a modest 15 basis points to the average long-term composite interest cost rate of 6.26%. It has been my experience in calculating effective cost rates to maturity for long-term debt, which take issuance costs into account, that 15 basis points is reasonable, if not conservative for a utility of TESI-Sewer's small size. Therefore, I have added 15 basis points to the average composite interest cost rate of 6.26% to arrive at a long-term debt cost rate applicable to TESI-Sewer's pro forma long-term debt at December 31, 2007 of 6.41% as shown on page 2 of Schedule PMA-6 which results in a composite long-term debt cost rate of 6.41% shown on page 1 and which is reasonable relative to a long-term debt ratio of 45.00%.

VIII. COMMON EQUITY COST RATE MODELS

A. The Efficient Market Hypothesis (EMH)

Q. ARE THE COST OF COMMON EQUITY MODELS YOU USE MARKET-BASED MODELS, AND HENCE BASED UPON THE EMH?

A. Yes. The DCF model is market-based in that market prices are utilized in developing the dividend yield component of the model. The RPM is market-based in that the bond ratings and expected bond yields used in the application of the RPM reflect the market's assessment of risk. In addition, the use of betas to determine the equity risk premium also reflects the market's assessment of risk as betas are derived from regression analyses of market prices. The CAPM is market-based for many of the same reasons that the RPM is market-based i.e., the use of expected bond (Treasury bond) yields and betas. The CEM is market-based in that the process of selecting the comparable risk non-utility companies is based upon statistics which result from regression analyses of market prices. Therefore, all the cost of common equity models I utilize are market-based models, and hence based upon the EMH.

Q. PLEASE DESCRIBE THE CONCEPTUAL BASIS OF THE EMH.

A. The Efficient Market Hypothesis (EMH), which is the foundation of modern investment theory, was pioneered by Eugene F. Fama[9] in 1970. An efficient market is one in which security prices reflect all relevant information all the time. This implies that prices adjust instantaneously to new information, thus reflecting

[9] Fama, Eugene F., "Efficient Capital Markets: A Review of Theory and Empirical Work". Journal of Finance, May 1970, pp. 383-417.

the intrinsic fundamental economic value of a security.[10]

The essential components of the EMH are:

A. Investors are rational and invest in assets providing the highest expected return given a particular level of risk.

B. Current market prices reflect all publicly available information.

C. Returns are independent i.e., today's market returns are unrelated to yesterday's returns.

D. Capital markets follow a random walk i.e., the probability distribution of expected returns approximates a normal distribution.

Brealey and Myers state:[11]

> When economists say that the security market is 'efficient', they are not talking about whether the filing is up to date or whether desktops are tidy. They mean that information is widely and cheaply available to investors and that all relevant and ascertainable information is already reflected in security prices.

The three forms of the EMH are:

A. The "weak" form which asserts that all past market prices and data are fully reflected in securities prices i.e., technical analysis cannot enable an investor to "outperform the market".

B. The "semistrong" form which asserts that all publicly available information is fully reflected in securities prices i.e., fundamental analysis cannot enable an investor to "outperform the market".

C. The "strong" form which asserts that all information, both public and private, is fully reflected in securities prices i.e., even insider information cannot enable an investor to "outperform the market".

The "semistrong" form of the EMH is generally held to be true because the use of insider information often enables investors to "outperform the market" and

[10] Morin, Roger A., New Regulatory Finance, Public Utility Reports, Inc., Arlington, VA, 2006, pp. 279-281.

[11] Brealey, R.A. and Myers, S.C., Principles of Corporate Finance, McGraw-Hill Publications, Inc., 1996, pp. 323-324.

earn excessive returns. The generally-accepted "semistrong" form of the EMH means that all perceived risks are taken into account by investors in the prices they pay for securities. Investors are aware of all publicly-available information, including bond ratings, discussions about companies by bond rating agencies and investment analysts as well as the various cost of common equity methodologies (models) discussed in the financial literature. In an attempt to emulate investor behavior, this means that no single common equity cost rate model should be relied upon in determining a cost rate of common equity and that the results of multiple cost of common equity models should be taken into account.

Q. IS THERE SUPPORT IN THE ACADEMIC LITERATURE FOR THE NEED TO RELY UPON MORE THAN ONE COST OF COMMON EQUITY MODEL IN ARRIVING AT A RECOMMENDED COMMON EQUITY COST RATE?

A. Yes. For example, Phillips[12] states:

> Since regulation establishes a level of authorized earnings which, in turn, implicitly influences dividends per share, *estimation of the growth rate from such data is an inherently circular process. For these reasons, the DCF model "suggests a degree of precision which is in fact not present" and leaves "wide room for controversy and argument about the level of k" [investors' capitalization or discount rate, i.e., the cost of capital].* (italics added) (p. 396)
>
> * * *
>
> Despite the difficulty of measuring relative risk, the comparable earnings standard is no harder to apply than is the market-determined standard. The DCF method, to illustrate, requires a subjective determination of the growth rate the market is contemplating. Moreover, as Leventhal has argued: *'Unless the*

[12] Charles F. Phillips, Jr., The Regulation of Public Utilities-Theory and Practice, 1993, Public Utility Reports, Inc., Arlington, VA, p. 396, 398.

utility is permitted to earn a return comparable to that available elsewhere on similar risk, it will not be able in the long run to attract capital.' (italics added) (p. 398)

Also, Morin[13] states:

> Each methodology requires the exercise of considerable judgment on the reasonableness of the assumptions underlying the methodology and on the reasonableness of the proxies used to validate a theory. *The inability of the DCF model to account for changes in relative market valuation, discussed below, is a vivid example of the potential shortcomings of the DCF model when applied to a given company.* Similarly, the inability of the CAPM to account for variables that affect security returns other than beta tarnishes its use. (italics added)
>
> No one individual method provides the necessary level of precision for determining a fair return, but each method provides useful evidence to facilitate the exercise of an informed judgment. Reliance on any single method or preset formula is inappropriate when dealing with investor expectations because of possible measurement difficulties and vagaries in individual companies' market data. (Morin, p. 428)

* * *

The financial literature supports the use of multiple methods. Professor Eugene Brigham, a widely respected scholar and finance academician, asserts:[1](footnote omitted)

> Three methods typically are used: (1) the Capital Asset Pricing Model (CAPM), (2) the discounted cash flow (DCF) method, and (3) the bond-yield-plus-risk-premium approach. These methods are not mutually exclusive – no method dominates the others, and all are subject to error when used in practice. Therefore, when faced with the task of estimating a company's cost of equity, we generally use all three methods and then choose among them on the basis of our confidence in the data used for each in the specific case at hand.

Another prominent finance scholar, Professor Stewart Myers, in an early pioneering article on regulatory finance, stated:[2](footnote omitted)

> Use more than one model when you can. Because estimating

[13] Id, at pp. 428 and 430 - 431.

> the opportunity cost of capital is difficult, only a fool throws away useful information. That means you should not use any one model or measure mechanically and exclusively. Beta is helpful as one tool in a kit, to be used in parallel with DCF models or other techniques for interpreting capital market data.
>
> Reliance on multiple tests recognizes that no single methodology produces a precise definitive estimate of the cost of equity. As stated in Bonbright, Danielsen, and Kamerschen (1988), '*no single or group test or technique is conclusive.*' Only a fool discards relevant evidence. (italics in original) (Morin, p. 430)
>
> * * *
>
> While it is certainly appropriate to use the DCF methodology to estimate the cost of equity, there is no proof that the DCF produces a more accurate estimate of the cost of equity than other methodologies. Sole reliance on the DCF model ignores the capital market evidence and financial theory formalized in the CAPM and other risk premium methods. The DCF model is one of many tools to be employed in conjunction with other methods to estimate the cost of equity. *It is not a superior methodology that supplants other financial theory and market evidence. The broad usage of the DCF methodology in regulatory proceedings in contrast to its virtual disappearance in academic textbooks does not make it superior to other methods. The same is true of the Risk Premium and CAPM methodologies.* (italics added) (Morin, p. 431)

In view of the foregoing, it is clear that investors are or should be aware of all of the models available for use in determining a common equity cost rate. The EMH requires the assumption that, collectively, investors consider them all.

B. Discounted Cash Flow Model (DCF)

Q. WHAT IS THE THEORETICAL BASIS OF THE DCF MODEL?

A. The theory of the DCF model is that the present value of an expected future stream of net cash flows during the investment holding period can be determined by discounting the cash flows at the cost of capital, or the capitalization rate. DCF theory suggests that an investor buys a stock for an expected total return

rate which is derived from cash flows received in the form of dividends plus appreciation in market price (the expected growth rate). Thus, the dividend yield on market price plus a growth rate equals the capitalization rate, i.e., the total return rate expected by investors.

Q. PLEASE COMMENT ON THE APPLICABILITY OF THE DCF MODEL IN ESTABLISHING A COST OF COMMON EQUITY FOR TESI-Sewer.

A. The extent to which the DCF is relied upon should depend upon the extent to which the cost rate results differ from those resulting from the use of other cost of common equity models because the DCF model has a tendency to mis-specify investors' required return rate when the market value of common stock differs significantly from its book value. Mathematically, because the "simplified" DCF model traditionally used in rate regulation assumes a market-to-book ratio of one, it understates/overstates investors' required return rate when market value exceeds/is less than book value. It does so because, in many instances, market prices reflect investors' assessments of long-range market price growth potentials (consistent with the infinite investment horizon implicit in the standard regulatory version of the DCF model) not fully reflected in analysts' shorter range forecasts of future growth for earnings per share (EPS) and dividends per share (DPS) accounting proxies. Thus, the market-based DCF model will result in a total annual dollar return on book common equity equal to the total annual dollar return expected by investors only when market and book values are equal, a rare and unlikely situation. In recent years, the market values of utilities' common stocks have been well in excess of their book values as shown on page 1 of

Schedule PMA-3 ranging between 226.95% and 264.27% for the proxy group of six AUS Utility Reports water companies and between 220.49% and 262.50% for the proxy group of four Value Line (Std. Ed.) water companies as shown on page 1 of Schedule PMA-4.

Roger A. Morin has confirmed this tendency of the DCF by stating[14]:

> The third and perhaps most important reason for caution and skepticism is that application of the DCF model produces estimates of common equity cost that are consistent with investors' expected return only when stock price and book value are reasonably similar, that is when the M/B is close to unity. As shown below, application of the standard DCF model to utility stocks understates the investor's expected return when the market-to-book (M/B) ratio of a given stock exceeds unity. This is particularly relevant in the capital market environment of the 1990s and 2000s, where utility stocks are trading at M/B ratios well above unity and have been for nearly two decades. The converse is also true, that is, the DCF model overstates that investor's return when the stock's M/B ratio is less than unity. The reason for the distortion is that the DCF market return is applied to a book value rate base by the regulator, that is, a utility's earnings are limited to earnings on a book value rate base. (emphasis supplied)

Under the DCF model, the rate of return investors require is related to the price paid for a security. Thus, market prices form the basis of investment decisions and investors' expected rates of return. In contrast, a regulated utility is limited to earning on its net book value (depreciated original cost) rate base. Market values can diverge from book values for a myriad of reasons including, but not limited to, earnings per share (EPS) and dividends per share (DPS) expectations, merger / acquisition expectations, interest rates, etc. Thus, when market values are grossly disparate from their book values, a market-based DCF cost rate applied to the book value of common equity will not reflect investors'

[14] Id., at p. 434.

expected common equity cost rate. It will either overstate the common equity cost rate (without regard to any adjustment for flotation costs which may, at times, be appropriate) when market value is less than book value or understate the cost rate when market value is, as here, above book value.

This indicates the need to better match market prices with investors' longer range growth expectations embedded in those prices. However, the understatement/overstatement of investors' required return rate associated with the application of the market price-based DCF model to the book value of common equity clearly illustrates why reliance upon a single common equity cost rate model should be avoided.

Q. IS IT REASONABLE TO EXPECT THE MARKET VALUES OF UTILITIES' COMMON STOCKS TO CONTINUE TO SELL WELL ABOVE THEIR BOOK VALUES?

A. Yes. I believe that the common stocks of utilities will continue to sell substantially above their book values, because many investors, especially individuals who traditionally committed less capital to the equity markets, will likely continue to commit a greater percentage of their available capital to common stocks in view of lower interest rate alternative investment opportunities and to provide for retirement. The recent past and current capital market environment is in stark contrast to the late 1970's and early 1980's when very high (by historical standards) yields on secured debt instruments in public utilities were available. Despite the fact that the market declined significantly during late 2001 through 2003, following the September 11, 2001 tragedy and despite

recent and continuing market volatility due to volatile energy prices, the stressed housing market and the credit crunch in the currently fragile U.S. economy, utility stocks have continued to sell at market prices well above their book values. The significant recent increases in market-to-book ratios have been influenced by factors other than fundamentals such as actual and reported growth in earnings per share (EPS) and dividends per share (DPS).

Traditional rate base/rate of return regulation, where a market-based common equity cost rate is applied to a book value rate base, presumes that market-to-book ratios are one. However, there is ample empirical evidence over sustained periods which demonstrate that this is an incorrect presumption. Market-to-book ratios of one are rarely the case as there are many factors affecting the market price of common stocks, in addition to earnings. Moreover, allowed ROEs have a limited effect on utilities' market/book ratios as market prices of common stocks are influenced by a number of other factors beyond the direct influence of the regulatory process.

For example, Phillips[15] states:

> Many question the assumption that market price should equal book value, believing that 'the earnings of utilities should be sufficiently high to achieve market-to-book ratios which are consistent with those prevailing for stocks of unregulated companies.'

In addition, Bonbright[16] states:

> In the first place, commissions cannot forecast, except within wide limits, the effect their rate orders will have on the market prices of the stocks of the companies they regulate. In the second place,

[15] Id., at p. 395.

[16] James C. Bonbright, Albert L. Danielsen and David R. Kamerschen, Principles of Public Utility Rates, 1988, Public Utilities Reports, Inc., Arlington, VA, p. 334.

> *whatever the initial market prices may be, they are sure to change not only with the changing prospects for earnings, but with the changing outlook of an inherently volatile stock market.* In short, market prices are beyond the control, though not beyond the influence of rate regulation. Moreover, even if a commission did possess the power of control, any attempt to exercise it ... would result in harmful, uneconomic shifts in public utility rate levels. (italics added)

In view of the foregoing, a mismatch results in the application of the DCF model as market prices reflect long range expectations of growth in market prices (consistent with the presumed infinite investment horizon of the standard DCF model), while the short range forecasts of growth in accounting proxies, i.e., EPS and DPS, *do not* reflect the full measure of growth (market price appreciation) expected in per share market value.

Q. HAVE ANY COMMISSIONS RECOGNIZED THIS TENDENCY OF THE DCF MODEL TO UNDERSTATE/OVERSTATE INVESTORS' REQUIRED RETURN RATE WHEN MARKET-TO-BOOK RATIOS ARE GREATER/LESS THAN UNITY?

A. Yes. The Pennsylvania Public Utility Commission recognized this tendency in its order of August 26, 2006 in Docket No. R-00049862, et al re: The City of Lancaster – Sewer Fund when it stated:

> The ALJ recommended a market-to-book adjustment (MTB) of 65 basis points (.65%) to her recommended equity return. The ALJ reasoned that this adjustment had been adopted by the Commission in three major rate cases in the past 18 months. *See Pa. P.U.C. v. PPL Electric Utilities Corporation,* 2004 Pa. P.U.C. LEXIS 40; *Pa. P.U.C. (PPL) Pa. PUC v. Aqua Pennsylvania, Inc.,* R-00038805, (Order entered August 5, 1004) (*Aqua)*; and *Pa. P.U.C.V. Pennsylvania-American Water Company*, Docket No. R-00038304 (Order entered January 29, 204) (*PAWC*)

* * * *

> As discussed previously herein, the ALJ recommended a MTB adjustment of 65 basis points to her unadjusted DCF starting point of 10.1 percent. We shall adopt this adjustment. First, this adjustment is consistent with our recent orders in *PAWC, Aqua,* and *PPL*. Next, we note that *Aqua* and *PAWC* are subsidiaries of corporate parents which are publicly traded. The actual utilities operating in Pennsylvania are not publicly traded. Nevertheless, we applied the adjustment to the entities which are providing service in Pennsylvania. Thus, we reject the argument advanced by the OTS in its Exceptions that this adjustment is inappropriate because the City's operation is not an investor-owned utility. As in *PPL*, we find that adjustment is necessary because the DCF method produces the investor required return based on the current market price, not the return on the book value capitalization. With the MTB adjustment, the equity return allowance is 10.75 percent. (emphasis added)

Q. PLEASE EXPLAIN WHY A DCF-DERIVED COMMON EQUITY COST RATE MIS-SPECIFIES INVESTORS' EXPECTED COMMON EQUITY COST RATE WHEN THE MARKET/BOOK RATIO IS GREATER OR LESS THAN UNITY (100%).

A. Under the DCF model, the rate of return investors require is related to the price paid for a stock i.e., market price is the basis upon which they formulate the required rate of return. A regulated utility is limited to earning on its net book value (depreciated original cost) rate base. As discussed previously, market values differ from book values for many reasons unrelated to earnings. Thus, when market values differ significantly from book values, a market-based DCF cost rate applied to the book value of common equity will not accurately reflect investors' expected common equity cost rate. It will either overstate or understate investors' expected common equity cost rate (without regard to any adjustment for flotation costs which may, at times, be appropriate on an ad hoc basis) depending upon whether market value is less than or greater than book

value.

Schedule PMA-7 demonstrates how a market-based DCF cost rate applied to a book value which is either below or above market value will either understate or overstate investors' expectations because these expectations are based on a required return on market value. As shown, there is no realistic opportunity to earn the market-based rate of return on book value. Note that in Column 1, investors expect a 10.00% return on a market price of $24.00. Moreover, as shown in Column 2, when the 10.00% return rate on market value is applied to book value which is approximately 55.5% of market value, the total annual return opportunity is just $1.333 on book value. With an annual dividend of $0.840, there is an opportunity for growth of $0.493 which translates to just 2.05% in contrast to the 6.50% growth in market price expected by investors. There is no way to possibly achieve the expected growth of $1.560 or 6.50% absent a huge cut in the annual dividend, an unreasonable expectation which would result in an extremely adverse reaction by investors because it would be a sign of extreme financial distress.

Conversely, in Column 3, where the market-to-book ratio is 80%, when the 10.00% return rate on market value is applied to a book value which is approximately 25.0% greater than market value, the total annual return opportunity is $3.000 on book value with an annual dividend of $0.840, there is an opportunity for growth of $2.160 which translates to 9.00% in contrast to the 6.50% growth in market price expected by investors.

In view of the foregoing, it is clear that the DCF model either understates

or overstates investors' required cost of common equity capital when market values exceed or are less than their underlying book values and thus multiple cost of common equity models should be relied upon when estimating investors' expectations.

Q. HAVE ANY COMMISSIONS EXPLICITLY STATED THAT THE DCF MODEL SHOULD NOT BE RELIED UPON EXCLUSIVELY?

A. Yes. As stated previously, the majority of regulatory commissions rely upon a combination of the various cost of common equity models available.

Specifically, the Iowa Utilities Board (IUB) has recognized the tendency of the DCF model to understate investors' expected cost of common equity capital when market values are significantly above their book values. In its June 17, 1994 Final Decision and Order in Re U.S. West Communications, Docket No. RPU-93-9 the IUB stated:[17]

> While the Board has relied in the past on the DCF model, in *Iowa Electric Light and Power Company*, Docket No. RPU-89-9, "Final Decision and Order" (October 15, 1990), the Board stated: '[T]he DCF model may understate the return on equity in some circumstances. This is particularly true when the market is relatively volatile and the company in question has a market-to-book ratio in excess of one." Those conditions exist in this case and the Board will not rely on the DCF return. (Consumer Advocate Ex. 367, See Tr. 2208, 2250, 2277, 2283-2284). *The DCF approach underestimates the cost of equity needed to assure capital attraction during this time of market uncertainty and volatility. The board will, therefore, give preference to the risk premium approach.* (italics added)

Similarly, in 1994, the Indiana Utility Regulatory Commission (IURC), for example, recognized the tendency of the DCF model to understate the cost of

[17] Re: U.S. West Communications, Inc., Docket No. RPU-93-9, 152 PUR4th at 459.

equity when market value exceeds book value[18]:

> In determining a common equity cost rate, we must again recognize the tendency of the traditional DCF model, . . . to understate the cost of common equity. As the Commission stated in Indiana-Mich. Power Co. (IURC 8/24/90), Cause No. 38728, 116 PUR 4th 1, 17-18, *"the unadjusted DCF result is almost always well below what any informed financial analyst would regard as defensible, and therefore, requires an upward adjustment based largely on the expert witness's judgement."* (italics added)
>
> * * *
>
> [u]nder the traditional DCF model . . . the appropriate earnings level of the utility would not be derived by applying the DCF result to the market price of the Company's stock . . . it would be applied to the utility's net original cost rate base. *If the market price of the stock exceeds its book value, . . . the investor will not achieve the return which the model finds is necessary.* (italics added)

Also, the Hawaii Public Utilities Commission (HPUC) recognized this phenomenon in a decision dated June 30, 1992[19] in a case regarding Hawaiian Electric Company, Inc., when it stated:

> In this docket, as in other rate proceedings, experts disagree on the relative merits of the various methods of determining the cost of common equity. In this docket, HECO is particularly critical of the use of the constant growth DCF methodology. It asserts that method is imbued with downward bias and, thus, its use will understate common equity cost. *We are cognizant of the shortcomings of the DCF method.* There are, however, shortcomings to be found with the use of CAPM and the RP methods as well. We reiterate that, despite the problems with the use of any methodology, *all methods should be considered and that the DCF method and the combined CAPM and RP methods should be given equal weight.* (italics added)

Q. DO OTHER COST OF COMMON EQUITY MODELS ALSO CONTAIN

[18] Re: Indiana-American Water Company, Inc., Cause No. 39595, 150 PUR4th at 167-168.

[19] Re: Hawaiian Electric Company, Inc., Docket No. 6998, 134 PUR4th at 479.

UNREALISTIC ASSUMPTIONS AND HAVE SHORTCOMINGS?

A. Yes. That is why I am not recommending that any of the models be relied upon exclusively. I have focused on the shortcomings of the DCF model because some regulatory commissions still place excessive or exclusive reliance upon it. Although the DCF model is useful, it is not a superior methodology that supplants financial theory and market evidence based upon other valid cost of common equity models. For these reasons, no model, including the DCF, should be relied upon exclusively.

Q. PLEASE DESCRIBE THE DIVIDEND YIELD YOU USED IN YOUR APPLICATION OF THE DCF MODEL.

A. The unadjusted dividend yields are based upon an average of a recent spot date (February 8, 2008) as well as an average of the three months ended January 31, 2008, respectively, which are derived on Schedule PMA-9. The average unadjusted yield is 3.17% for the six AUS Utility Reports water companies and 2.66% for the four Value Line (Std. Ed.) water companies.

Q. PLEASE EXPLAIN THE DIVIDEND GROWTH COMPONENT SHOWN ON SCHEDULE PMA-6, PAGE 1, COLUMN 2.

A. Because dividends are paid quarterly, or periodically, as opposed to continuously (daily), an adjustment to the dividend yield must be made. This is often referred to as the discrete, or the Gordon Periodic, version of the DCF model.

Since the various companies in the proxy groups increase their quarterly dividend at various times during the year, a reasonable assumption is to reflect one-half the annual dividend growth rate in the D_1 expression, or $D_{1/2}$. This is a

conservative approach which does not overstate the dividend yield which should be representative of the next twelve-month period. Therefore, the actual average dividend yields in Column 1 on Schedule PMA-8 have been adjusted upward to reflect one-half the growth rates shown in Column 4.

Q. PLEASE EXPLAIN THE BASIS OF THE GROWTH RATES OF THE PROXY GROUP OF SIX AUS UTILITY REPORTS WATER COMPANIES AND THE PROXY GROUP OF FOUR VALUE LINE (STD. ED.) WATER COMPANIES WHICH YOU USE IN YOUR APPLICATION OF THE DCF MODEL.

A. Schedule PMA-10 indicates that approximately 65% of the common shares of the proxy group of six AUS Utility Reports water companies and 49% of the common shares of the proxy group of four Value Line (Std. Ed.) water companies are held by individuals as opposed to institutional investors. Individual investors are particularly likely to place great significance on the opinions expressed by financial information services, such as Value Line and Reuters, which are easily accessible and/or available on the Internet.

Forecasts by analysts, including Value Line, are typically limited to five years. In my opinion, investors in water utilities would have little interest in historical growth rates beyond the most recent five years because an historical five-year period balances the five-year period for projected growth rates. Consequently, the use of five-year historical and five-year projected growth rates in earnings per share (EPS) and dividends per share (DPS) as well as the sum of internal and external growth in per share value (BR + SV) is appropriate to consider in the determination of a growth rate for use in this application of the

DCF model. In addition, investors realize that analysts have significant insight into the dynamics of the industries and they analyze individual companies as well as companies' abilities to effectively manage the effects of changing laws and regulations. Consequently, I have reviewed analysts' projected growth in EPS, as well as historical and projected five-year compound growth rates in EPS, DPS and (BR + SV) for each company in each proxy group. The historical growth rates are from Value Line or are calculated in a manner similar to Value Line, while the projected growth rates in earnings are from Value Line and Reuters forecasts. Reuters growth rate estimates are not available for DPS and internal growth, and they do not include the Value Line projections.

In addition to evaluating EPS and DPS growth rates, it is reasonable to assume that investors also assess (BR + SV). The concept is based on well documented financial theory that future dividend growth is a function of the portion of the overall return to investors which is reinvested in the firm plus the sales of new common stock. Consequently, the growth component as proxied by internal and external growth is defined as follows:

$$g = BR + SV$$

Where:

B = the fraction of earnings retained by the firm, i.e., retention ratio

R = the return on common equity

S = the growth in common shares outstanding

V = the premium/discount of a company's stock price relative to its book value, i.e., one minus the complement of the market/book ratio.

Consistent with the use of five-year historical and five-year projected growth rates in EPS and DPS, I have derived five-year historical and five-year projected (BR + SV) growth. Projected EPS growth rate averages are shown in Column 4 on the lower half of Schedule PMA-8, while historical and projected growth rates in DPS, EPS, and BR + SV are shown in Column 4 on the upper half of Schedule PMA-8. The bases of these growth rates are summarized for the companies in each proxy group on page 1, Schedule PMA-11. Supporting growth rate data are detailed on pages 2 through 7 of Schedule PMA-11, while pages 8 through 13 contain all of the most current Value Line Investment Survey data for the companies in both proxy groups.

Q. PLEASE SUMMARIZE THE DCF MODEL RESULTS.

A. As shown on Schedule PMA-8, the results of the applications of the single-stage DCF model are 9.76% for the proxy group of six AUS Utility Reports water companies and 9.89% for the proxy group of four Value Line (Std. Ed.) water companies before any adjustment to reflect the application of a market-based cost of common equity to a book value common equity ratio. In arriving at conclusions of indicated common equity cost rates for the two proxy groups, I included only those single-stage DCF results which are 7.95% or greater, i.e., 200 basis points above and less than 11.45%, i.e., 550 basis points above the average prospective yield on Moody's A rated public utility bonds of 5.95% based upon Blue Chip Financial Forecasts' February 1, 2008 consensus forecast of about 50 economists of the expected yield on Aaa rated corporate bonds as discussed subsequently and derived in Note 3 on page 6 of Schedule

PMA-12. As will also be discussed subsequently, it is necessary to adjust the average Aaa rated corporate bond yield to be equivalent to a Moody's A2 rated public utility bond. Thus, an adjustment to the average prospective 5.32% yield on Aaa rated corporate bonds of 0.63% was required, as detailed in Note 2 on page 1 of Schedule PMA-12, resulting in an average prospective yield on Moody's A rated public utility bonds of 5.95%.

Based upon a review of recent authorized returns on common equity (ROE) throughout the United States relative to concurrent estimates of the forecasted average yield on A rated public utility bonds, I determined that the equity risk premium implicit in authorized ROEs for the twelve months ended December 31, 2007 is between 278 and 548 basis points, averaging 407 basis points. In accordance with the EMH, investors are aware of these implicit equity risk premia and, in my opinion, would not consider returns providing an equity risk premium of only 200 basis points or more than 550 basis points either reasonable or credible. Therefore, it is reasonable, if not conservative, to eliminate any single-stage DCF results which are no more than 200 basis points above, which exceed 550 basis points above the current prospective average yield on A rated public utility bonds of 5.95%.

To the indicated DCF cost rates of 9.76% and 9.89% for each proxy group, I have made a conservative upward financial risk adjustment to reflect the application of a market based cost of common equity to a book value common equity ratio consistent with PA PUC precedent in recent utility base rate cases. As explained in Note 7 on pages 2 through 4 of Schedule PMA-8,

adjustments of 100 basis points (1.00%) and 87 basis points (0.87%) are indicated based upon the market value capital structure ratios of each proxy group as shown in pages 5 through 7 of Schedule PMA-8. However, I have limited my adjustments to only 60 basis points (0.60%) consistent with the adjustments authorized by the PA PUC to reflect the added financial risk attributable to the application of a market based cost of common equity to a book value common equity ratio in Docket Nos. R-00016339 re: Pennsylvania-American Water Company entered January 25, 2002, R-00038304 re: Pennsylvania-American Water Company entered January 16, 2004, R-00038805 re: Aqua Pennsylvania, Inc. entered August 5, 2004 and R-00049255 re: PPL Electric Utilities Corp. entered December 22, 2004. Consequently, the resultant DCF-based cost rates of 10.6% and 10.8%, which reflect only the 60 basis points financial risk adjustment, are conservatively reasonable.

In view of the foregoing, as shown on Schedule PMA-8, the results of the applications of the DCF model are 10.36% for the proxy group of six AUS Utility Reports water companies and 10.49% for the proxy group of four Value Line (Std. Ed.) water companies.

C. The Risk Premium Model (RPM)

Q. PLEASE DESCRIBE THE THEORETICAL BASIS OF THE RPM.

A. Risk Premium theory indicates that the cost of common equity capital is greater than the prospective company-specific cost rate for long-term debt capital. In other words, the cost of common equity equals the expected cost rate for long-

term debt capital plus a risk premium to compensate common shareholders for the added risk of being unsecured and last-in-line for any claim on the corporation's assets and earnings.

Q. SOME ANALYSTS STATE THAT THE RPM IS ANOTHER FORM OF THE CAPM. DO YOU AGREE?

A. While there are some similarities, there is a very significant distinction between the two models. The RPM and CAPM both add a "risk premium" to an interest rate. However, the beta approach to the determination of an equity risk premium in the RPM should not be confused with the CAPM. Beta is a measure of systematic, or market, risk, a relatively small percentage of total risk (the sum of both non-diversifiable systematic and diversifiable unsystematic risk). Unsystematic risk is fully captured in the RPM through the use of the prospective long-term bond yield as can be shown by reference to pages 3 through 9 of Schedule PMA-2, which confirm that the bond rating process involves an assessment of all business risks. In contrast, the use of a risk-free rate of return in the CAPM does not, and by definition cannot, reflect a company's specific i.e., unsystematic risk. Consequently, a much larger portion of the total common equity cost rate is reflected in the company-specific bond yield (a product of the bond rating) than is reflected in the risk-free rate in the CAPM, or indeed even by the dividend yield employed in the DCF model. Moreover, the financial literature recognizes the RPM and CAPM as two separate and distinct cost of common equity models as discussed previously.

Q. HAVE YOU PERFORMED RPM ANALYSES OF COMMON EQUITY COST

RATE FOR THE TWO PROXY GROUPS?

A. Yes. The results of my application of the RPM are summarized on page 1 of Schedule PMA-12. The first step is to determine the expected bond yield.

Q. PLEASE EXPLAIN THE BASIS OF THE EXPECTED BOND YIELD OF 6.13% APPLICABLE TO THE AVERAGE COMPANY IN BOTH PROXY GROUPS.

A. Because the cost of common equity is prospective, a prospective yield on similarly-rated long-term debt is essential. As shown on Schedule PMA-12, page 2, although based upon only one water company, the average Moody's bond rating of both proxy groups is A2. I relied upon a consensus forecast of about 50 economists of the expected yield on Aaa rated corporate bonds for the six calendar quarters ending with the second calendar quarter of 2009 as derived from the February 1, 2008 Blue Chip Financial Forecasts (shown on page 7 of Schedule PMA-12). As shown on Line No. 1 of page 1 of Schedule PMA-12, the average expected yield on Moody's Aaa rated corporate bonds is 5.32%. It is necessary to adjust that average yield to be equivalent to a Moody's A2 rated public utility bond. Consequently, an adjustment to the average prospective yield on Aaa rated corporate bonds of 0.63% was required. It is shown on Line No. 2, page 1 of Schedule PMA-12 and explained in Note 2 at the bottom of the page. After adjustment, the expected bond yield applicable to a Moody's A rated public utility bond is 5.95% as shown on Line No. 3, page 1 of Schedule PMA-12.

Because both the proxy group of six AUS Utility Reports water companies' and the proxy group of four Value Line (Std. Ed.) water companies'

average Moody's bond rating is A2, no adjustment is necessary to make the prospective bond yield applicable to an A2 public utility bond. Therefore, the expected specific bond yield is 5.95% for both proxy groups of water companies.

Q. PLEASE EXPLAIN THE METHOD UTILIZED TO ESTIMATE THE EQUITY RISK PREMIUM.

A. I evaluated the results of two different historical equity risk premium studies, as well as Value Line's forecasted total annual market return in excess of the prospective yield on high grade corporate bonds, as detailed on pages 5, 6 and 8 of Schedule PMA-12. As shown on Line No. 3, page 5, the mean equity risk premium based on both of the studies is 4.99% applicable to the proxy group of six AUS Utility Reports water companies and 5.39% applicable to the proxy group of four Value Line (Std. Ed.) water companies. These estimates are the result of an average of a beta-derived historical equity risk premium and a forecasted total market equity risk premium as well as the mean historical equity risk premium applicable to public utilities with bonds rated A based upon holding period returns.

The basis of the beta-derived equity risk premia applicable to the proxy groups is shown on page 6 of Schedule PMA-12. Beta-determined equity risk premia should receive substantial weight because betas are derived from the market prices of common stocks over a recent five-year period. Beta is a meaningful measure of prospective relative risk to the market as a whole and is a logical means by which to allocate a relative share of the market's total equity

risk premium.

The total market equity risk premium utilized is 6.20% and is based upon an average of both the long-term historical and forecasted market risk premium of 6.20%, only because it is my opinion that the current and recent substantial decline in the stock market is extraordinary and not representative of the expected long-term, as shown on page 6 of Schedule PMA-12. To derive the historical market equity risk premium, I used the most recent Morningstar[20] data on holding period returns for the S&P 500 Composite Index and the average historical yield on Moody's Aaa and A rated corporate bonds for the period 1926-2007. The use of holding period returns over a very long period of time is useful in the beta approach. As the 2007 Yearkbook - Valuation Edition states[21]:

> The estimate of the equity risk premium depends on the length of the data series studied. A proper estimate of the equity risk premium requires a data series long enough to give a reliable average without being unduly influenced by very good and very poor short-term returns. When calculated using a long data series, the historical equity risk premium is relatively stable.[5] Furthermore, because an average of the realized equity risk premium is quite volatile when calculated using a short history, using a long series makes it less likely that the analyst can justify any number he or she wants. The magnitude of how shorter periods can affect the result will be explored later in this chapter.
>
> Some analysts estimate the expected equity risk premium using a shorter, more recent time period on the basis that recent events are more likely to be repeated in the near future; furthermore, they believe that the 1920s, 1930s and 1940s contain too many unusual events. This view is suspect because all periods contain "unusual" events. Some of the most unusual

[20] Morningstar, Inc. acquired Ibbotson Associates in 2006.
[21] 2007 Yearbook – Valuation Edition, Morningstar, Inc., 2007, pp. 82-83. Morningstar, Inc. acquired Ibbotson Associates in 2006.

> events this century took place quite recently, including the inflation of the late 1970s and early 1980s, the October 1987 stock market crash, the collapse of the high-yield bond market, the major contraction and consolidation of the thrift industry, the collapse of the Soviet Union, the development of the European Economic Community, and the attacks of September 11, 2001.
>
> It is even difficult for economists to predict the economic environment of the future. For example, if one were analyzing the stock market in 1987 before the crash, it would be statistically improbable to predict the impending short-term volatility *without considering the* stock market crash and market volatility of the 1929-1931 period.
>
> Without an appreciation of the 1920s and 1930s, no one would believe that such events could happen. The 81-year period starting with 1926 is representative of what can happen: it includes high and low returns, volatile and quiet markets, war and peace, inflation and deflation, and prosperity and depression. Restricting attention to a shorter historical period underestimates the amount of change that could occur in a long future period. Finally, because historical event-types (not specific events) tend to repeat themselves, long-run capital *market return* studies can reveal a great deal about the future. Investors probably expect "unusual" events to occur from time to time, and their return expectations reflect this. (footnote omitted)

In addition, the use of long-term data in a RPM model is consistent with the long-term investment horizon presumed by the DCF model. Consequently, the long-term arithmetic mean total return rates on the market as a whole of 12.30% and the long-term arithmetic mean yield on corporate bonds of 6.10% were used, as shown at Line Nos. 1 and 2 of page 6 of Schedule PMA-12. As shown on Line No. 3 of page 6, the resultant long-term historical equity risk premium on the market as a whole is 6.20%.

I used arithmetic mean return rates because they are appropriate for

cost of capital purposes. As stated in the 2007 Yearbook - Valuation Edition[22]:

> The equity risk premium data presented in this book are arithmetic average risk premia as opposed to geometric average risk premia. The arithmetic average equity risk premium can be demonstrated to be most appropriate when *discounting future* cash flows. For use as the expected equity risk premium in either the CAPM or the building block approach, the arithmetic mean or the simple difference of the arithmetic means of stock market returns and riskless rates is the relevant number. This is because both the CAPM and the building block approach are additive models, in which the cost of capital is the sum of its parts. The geometric average is more appropriate for reporting past performance, since it represents the compound average return.
>
> The argument for using the arithmetic average is quite straightforward. In looking at projected cash flows, the equity risk premium that should be employed is the equity risk premium that is expected to actually be incurred over the future time periods. Graph 5-3 shows the realized equity risk premium for each year based on the returns of the S&P 500 and the income return on long-term government bonds. (The actual, observed difference between the return on the stock market and the riskless rate is known as the realized equity risk premium.) There is considerable volatility in the year-by-year statistics. At times the realized equity risk premium is even negative.

As Ibbotson Associates[23] states in their 1999 Yearbook:

> The expected equity risk premium should always be calculated using the arithmetic mean. The arithmetic mean is the rate of return which, when compounded over multiple periods, gives the mean of the probability distribution of ending wealth values....Stated another way, the arithmetic mean is correct because an investment with uncertain returns will have a higher expected ending wealth value than an investment which earns, with certainty, its compound or geometric rate of return every year....*Therefore, in the investment markets, where returns are described by a probability distribution, the arithmetic mean is the measure that accounts for uncertainty, and is the appropriate one for estimating discount rates and the cost of capital.* (italics added)

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[22] Id., p. 77.

[23] Ibbotson Associates, Stocks, Bonds, Bills and Inflation - 1999 Yearbook, pp. 157-158.

Ex-post (historical) total returns and equity risk premium spreads differ in size and direction over time. This is precisely why the arithmetic mean is important as it provides insight into the variance and standard deviation of returns. This prospect for variance, as captured in the arithmetic mean, provides the valuable insight needed by investors to estimate future risk when making a current investment. Absent such valuable insight into the potential variance of returns, investors cannot meaningfully evaluate prospective risk. As discussed previously, all of the cost of common equity models, including the DCF, are premised upon the EMH, that all publicly available information is reflected in the market prices paid. If investors relied upon the geometric mean of ex-post spreads, they would have no insight into the potential variance of future returns because the geometric mean relates the change over many periods to a constant rate of change, thereby obviating the year-to-year fluctuations, or variance, *critical to risk analysis*.

The basis of the forecasted market equity risk premium can be found on Line Nos. 4 through 6 on page 6 of Schedule PMA-12. It is derived from an average of the most recent 3-month (using the months of November 2007 through January 2008) and a recent spot (February 8, 2008) median market price appreciation potentials by Value Line as explained in detail in Note 1 on page 3 of Schedule PMA-13.

The average expected price appreciation is 63% which translates to 12.99% per annum and, when added to the average (similarly calculated) dividend yield of 2.07% equates to a forecasted annual total return rate on the

market as a whole of 15.06%. Thus, this methodology is consistent with the use of the 3-month and spot dividend yields in my application of the DCF model. To derive the forecasted total market equity risk premium of 9.74% shown on Schedule PMA-12, page 6, Line No. 6, the February 1, 2008 forecast of about 50 economists of the expected yield on Moody's Aaa rated corporate bonds for the six calendar quarters ending with the second calendar quarter 2009 of 5.32% from Blue Chip Financial Forecasts was deducted from the Value Line total market return of 15.06%. The calculation resulted in an expected market risk premium of 9.74%.

Because I believe the current and recent substantial decline in the stock market is extraordinary and not representative of the expected long-term in this instance, I will not rely upon the forecasted market equity risk premium but rather, will rely upon this historical long-term arithmetic market equity risk premium of 6.20%.

On page 9 of Schedule PMA-12, the most current Value Line (Standard Edition) betas for the companies in the two proxy groups are shown. Applying the average beta of each proxy group to the market equity risk premium of 6.20% results in a beta adjusted equity risk premium of 5.46% for the proxy group of six AUS Utility Reports water companies and 6.26% for the proxy group of four Value Line (Std. Ed.) water companies as shown on Schedule PMA-12, page 6, Line No. 9.

A mean equity risk premium of 4.51% applicable to companies with A rated public utility bonds was calculated based upon holding period returns

from a study using public utilities, as shown on Line No. 2, page 5 of Schedule PMA-12, and detailed on page 8 of the same Exhibit.

The equity risk premia applicable to the proxy group of six AUS Utility Reports water companies and the proxy group of four Value Line (Std. Ed.) water companies are the averages of the beta-derived premia and that based upon the holding period returns of public utilities with A rated bonds, as summarized on Schedule PMA-12, page 5, i.e., 4.99% and 5.39%.

Q. WHAT ARE THE RPM CALCULATED COMMON EQUITY COST RATES?

A. They are 10.94% for the six AUS Utility Reports water companies and 11.34% for the four Value Line (Std. Ed.) water companies as shown on Schedule PMA-12, page 1.

Q. SOME CRITICS OF THE RPM MODEL CLAIM THAT ITS WEAKNESS IS THAT IT PRESUMES A CONSTANT EQUITY RISK PREMIUM. IS SUCH A CLAIM VALID?

A. No. The equity risk premium varies inversely with interest rate changes, although not in tandem with those changes. This presumption of a constant equity risk premium is no different than the presumption of a constant "g", or growth component, in the DCF model. If one calculates a DCF cost rate today, the absolute result "k", as well as the growth component "g", would invariably differ from a calculation made just one or several months earlier. This implies that the "g" does change, although in the application of the standard DCF model, the "g" is presumed to be constant. Hence, there is no difference between the RPM and DCF models in that both models assume a constant

component, but in reality, these components, the "g" and the equity risk premium both change.

As Morin[24] states with respect to the DCF model:

> It is not necessary that *g* be constant year after year to make the model valid. *The growth rate may vary randomly around some average expected value. Random variations around trend are perfectly acceptable, as long as the mean expected growth is constant.* The growth rate must be 'expectationally constant' to use formal statistical jargon. (italics added)

The foregoing confirms that the RPM is similar to the DCF model. Both assume an "expectationally constant" risk premium and growth rate, respectively, but in reality both vary (change) randomly around an arithmetic mean. Consequently, the use of the arithmetic mean, and not the geometric mean is confirmed as appropriate in the determination of an equity risk premium as discussed previously.

D. The Capital Asset Pricing Model (CAPM)

Q. PLEASE EXPLAIN THE THEORETICAL BASIS OF THE CAPM.

A. CAPM theory defines risk as the covariability of a security's returns with the market's returns. This covariability is measured by beta ("β"), an index measure of an individual security's variability relative to the market. A beta less than 1.0 indicates lower variability while a beta greater than 1.0 indicates greater variability than the market.

The CAPM assumes that all other risk, i.e., all non-market or unsystematic risk, can be eliminated through diversification. The risk that cannot be eliminated through diversification is called market, or systematic,

[24] Id., p. 256.

risk. The CAPM presumes that investors require compensation for risks that cannot be eliminated through diversification. Systematic risks are caused by macroeconomic and other events that affect the returns on all assets. Essentially, the model is applied by adding a risk-free rate of return to a market risk premium. This market risk premium is adjusted proportionately to reflect the systematic risk of the individual security relative to the market as measured by beta. The traditional CAPM model is expressed as:

$$R_s = R_f + \beta(R_m - R_f)$$

Where:

R_s	=	Return rate on the common stock
R_f	=	Risk-free rate of return
R_m	=	Return rate on the market as a whole
β	=	Adjusted beta (volatility of the security relative to the market as a whole)

Numerous tests of the CAPM have confirmed its validity. These tests have measured the extent to which security returns and betas are related as predicted by the CAPM. However, Morin observes that while the results support the notion that beta is related to security returns, it has been determined that the empirical Security Market Line (SML) described by the CAPM formula is not as steeply sloped as the predicted SML. Morin[25] states:

> With few exceptions, the empirical studies agree that ... low-beta securities earn returns somewhat higher than the CAPM would predict, and high-beta securities earn less than predicted.
>
> * * *
>
> Therefore, the empirical evidence suggests that the expected

[25] Id., at p. 175.

return on a security is related to its risk by the following approximation:

$$K = R_F + x\,\beta(R_M - R_F) + (1-x)\,\beta(R_M - R_F)$$

where x is a fraction to be determined empirically. The value of x that best explains the observed relationship Return = 0.0829 + 0.0520 β is between 0.25 and 0.30. If x = 0.25, the equation becomes:

$$K = R_F + 0.25(R_M - R_F) + 0.75\,\beta(R_M - R_F)^{26}$

In view of theory and practical research, I have applied both the traditional CAPM and the empirical CAPM to the companies in the proxy groups and averaged the results.

Q. PLEASE DESCRIBE YOUR SELECTION OF A RISK-FREE RATE OF RETURN.

A. As shown at the top of column 3 on page 2 of Schedule PMA-13, the risk-free rate adopted for both applications of the CAPM is 4.32%. It is based upon the average consensus forecast of the reporting economists in the February 1, 2008 Blue Chip Financial Forecasts as shown in Note 2, page 3, of the expected yields on 30-year U.S. Treasury bonds for the six quarters ending with the second calendar quarter 2009.

Q. WHY IS THE PROSPECTIVE YIELD ON LONG-TERM U.S. TREASURY BONDS APPROPRIATE FOR USE AS THE RISK-FREE RATE?

A. The yield on long-term T-Bonds is almost risk-free and its term is consistent with the long-term cost of capital to public utilities measured by the yields on A rated public utility bonds, and is consistent with the long-term investment

[26] Id., at p. 190.

horizon inherent in utilities' common stocks. Therefore, it is consistent with the long-term investment horizon presumed in the standard DCF model employed in regulatory ratemaking. As Morin[27] states:

> As a proxy for the risk-free rate, long-term rates are the relevant benchmarks when determining the cost of common equity rather than short-term or intermediate-term interest rates.[4(footnote omitted)] There are several reasons for this, both conceptual and practical.
>
> At the conceptual level, because common stock is a long-term investment and because the cash flows to investors in the form of dividends last indefinitely, the yield on very long-term government bonds, namely, the yield on 30-year Treasury bonds, is the best measure of the risk-free rate for use in the CAPM[5(footnote omitted)] . . . . The expected common stock return is based on long-term cash flows, regardless of an individual's holding time period.
>
> On the grounds of stability and consistency, the yields on long-term Treasury bonds match more closely with expected commons tock returns. Finally, yields on 90-day Treasury Bills typically do not match the investor's planning horizons. Equity investors generally have an investment horizon far in excess of 90 days.
>
> At the practical level, short-term rates are volatile, fluctuate widely, and are subject to more random disturbances than are long-term rates, leading to volatile and unreliable equity return estimates. Short-term rates are also largely administered rates. For example, Treasury Bills are used by the Federal Reserve as a policy vehicle to stimulate the economy and to control the money supply, and are used by foreign governments, companies, and individuals as a temporary safe harbor for money.

In addition, as noted in the 2007 Yearbook - Valuation Edition[28]:

> The horizon of the chosen Treasury security should match the horizon of whatever is being valued. When valuing a business

[27] Id., at p. 151.

[28] Id., p. 59.

that is being treated as a going concern, the appropriate Treasury yield should be that of a long-term Treasury bond. Note that the horizon is a function of the investment, not the investor. If an investor plans to hold stock in a company for only five years, the yield on a five-year Treasury Note would not be appropriate since the Company will continue to exist beyond those five years.

In conclusion, the average expected yield on 30-year Treasury Bonds is the appropriate proxy for the risk-free rate in the CAPM because it is less volatile than yields on Treasury Bills, is almost risk-free as noted by Morin above and is consistent with the long-term investment horizon implicit in common stocks.

Q. PLEASE EXPLAIN THE ESTIMATION OF THE EXPECTED EQUITY RISK PREMIUM FOR THE MARKET.

A. First, I estimate investors' expected total return rate for the market. Then I estimate the expected risk-free rate which I subtract from the expected total return rate for the market. The result is an expected equity risk premium for the market, some proportion of which must be allocated to the companies in the proxy group through the use of beta. As a measure of risk relative to the market as a whole, the beta is an appropriate means by which to apportion the market risk premium to a specific company or group. The total market equity risk premium utilized was 7.20% and, in this instance, is based upon the long-term historical market risk premia because, in my opinion, the current and recent substantial decline in the stock market is extraordinary and not representative of the expected long-term.

The basis of the projected median market equity risk premium is

explained in detail in Note 1 on page 3 of Schedule PMA-13. As previously discussed, it is derived from an average of the most recent 3-month (using the months of November 2007 through January 2008) and a recent spot (February 8, 2008) 3 - 5 year median total market price appreciation projections from Value Line, and the long-term historical average from Morningstar. The appreciation projections by Value Line plus average dividend yield equate to a forecasted annual total return rate on the market of 15.06%. The long-term historical return rate of 12.30% on the market as a whole is from the 2007 Yearbook - Valuation Edition. In each instance, the relevant risk-free rate was deducted from the total market return rate. For example, from the Value Line projected total market return of 15.06%, the forecasted average risk-free rate of 4.32% was deducted indicating a forecasted market risk premium of 10.74%. From the Ibbotson Associates' long-term historical total return rate of 12.30%, the long-term historical income return rate on long-term U.S. Government Securities of 5.20% was deducted indicating an historical equity risk premium of 7.10%. Thus, the average of the projected and historical total market risk premia of 10.74% and 7.10%, respectively, is 8.92%. However, as stated previously, I will rely upon the historical market equity risk premium of 7.10%.

Q. WHAT ARE THE RESULTS OF YOUR APPLICATIONS OF THE TRADITIONAL AND EMPIRICAL CAPM TO THE PROXY GROUPS?

A. As shown on Schedule PMA-13, Line No. 1 of page 1, the traditional CAPM cost rate is 10.62% for the proxy group of six AUS Utility Reports water companies and 10.80% for the proxy group of four Value Line (Std. Ed.) water

companies. And, as shown on Line No. 2 of page 1, the empirical CAPM cost rate is 10.17% for the six water companies and 10.98% for the four Value Line (Std. Ed.) water companies. The traditional and empirical CAPM cost rates are shown individually by company on pages 2 and 3 of Schedule PMA-13. As shown on Line No. 3, the CAPM cost rate applicable to the proxy groups of six AUS Utility Reports water companies is 10.40% and to the proxy group of four Value Line (Std. Ed.) water companies is 10.89%, based upon the traditional and empirical CAPM results.

Q. SOME CRITICS OF THE ECAPM MODEL CLAIM THAT USING ADJUSTED BETAS IN A TRADITIONAL CAPM AMOUNTS TO USING AN ECAPM. IS SUCH A CLAIM VALID?

A. No. Using adjusted betas in a CAPM analysis is not equivalent to the ECAPM. Betas are adjusted because of the regression tendency of betas to converge toward 1.0 over time, i.e., over successive calculations of beta. As discussed previously, numerous studies have determined that the Security Market Line (SML) described by the CAPM formula at any given moment in time is not as steeply sloped as the predicted SML. Morin[29] states:

> Some have argued that the use of the ECAPM is inconsistent with the use of adjusted betas, such as those supplied by Value Line and Bloomberg. This is because the reason for using the ECAPM is to allow for the tendency of betas to regress toward the mean value of 1.00 over time, and, since Value Line betas are already adjusted for such trend [sic], an ECAPM analysis results in double-counting. This argument is erroneous. Fundamentally, the ECAPM is not an adjustment, increase or decrease, in beta. This is obvious from the fact that the expected return on high beta securities is actually lower than

[29] Id., at p. 191.

that produced by the CAPM estimate. The ECAPM is a formal recognition that the observed risk-return tradeoff is flatter than predicted by the CAPM based on myriad empirical evidence. The ECAPM and the use of adjusted betas comprised two separate features of asset pricing. Even if a company's beta is estimated accurately, the CAPM still understates the return for low-beta stocks. Even if the ECAPM is used, the return for low-beta securities is understated if the betas are understated. Referring back to Figure 6-1, the ECAPM is a return (vertical axis) adjustment and not a beta (horizontal axis) adjustment. Both adjustments are necessary.

Moreover, the slope of the Security Market Line (SML) should not be confused with beta. As Eugene F. Brigham, finance professor emeritus and the author of many financial textbooks states[30] :

> The slope of the SML reflects the degree of risk aversion in the economy – the greater the average investor's aversion to risk, then (1) the steeper is the slope of the line, (2) the greater is the risk premium for any risky asset, and (3) the higher is the required rate of return on risky assets.[12]
>
> [12]Students sometimes confuse beta with the slope of the SML. This is a mistake. As we saw earlier in connection with Figure 6-8, and as is developed further in Appendix 6A, beta does represent the slope of a line, but *not* the Security Market Line. This confusion arises partly because the SML equation is generally written, in this book and throughout the finance literature, as $k_i = R_F + b_i(k_M - R_F)$, and in this form b_i looks like the slope coefficient and $(k_M - R_F)$ the variable. It would perhaps be less confusing if the second term were written $(k_M - R_F)b_i$, but this is not generally done.

In addition, regulatory support for the ECAPM can be found in the New York Public Service Commission's Generic Financing Docket, Case 91-M-0509. In addition, the Regulatory Commission of Alaska (RCA) in its Order No. 151 in Docket No. P-97-4 re: In the Matter of the Correct Calculation and Use of Acceptable Input Data to Calculate the 1997, 1998, 1999, 2000, 2001 and

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30 Eugene F. Brigham, Financial Management – Theory and Practice, 4th Ed., The Dryden Press, 1985, p. 203.

2002 Tariff Rates for the Intrastate Transportation of Petroleum over the TransAlaska Pipeline System noted:

> Although we primarily rely upon Tesoro's recommendation, we are concerned, however, about Tesoro's CAPM analysis. Tesoro averaged the results it obtained from CAPM and ECAPM while at the same time providing empirical testimony[604] (footnote omitted) that the ECAPM results are more accurate then [sic] traditional CAPM results. The reasonable investor would be aware of these empirical results. Therefore, we adjust Tesoro's recommendation to reflect only the ECAPM result.

In view of the foregoing, using adjusted betas in an ECAPM analysis is not incorrect, nor inconsistent with the financial literature. Rather, the use of the traditional CAPM results in an understated estimate of the cost of common equity capital for a utility with an adjusted beta below 1.00. And notwithstanding regulatory support for the use of only the ECAPM, my CAPM analysis, which includes both the traditional CAPM and the ECAPM, is a conservative approach resulting in a reasonable estimate of the cost of common equity.

E. Comparable Earnings Model (CEM)

Q. PLEASE DESCRIBE YOUR APPLICATION OF THE COMPARABLE EARNINGS MODEL AND HOW IT IS USED TO DETERMINE COMMON EQUITY COST RATE.

A. My application of the CEM is summarized on Schedule PMA-14 which consists of sixteen pages. Pages 1 through 7 show the CEM results for the proxy groups of six AUS Utility Reports water companies and four Value Line (Std. Ed.) water companies. Supporting data are shown on pages 8 through 14 and pages 15 and 16 contain notes related to pages 1 through 14.

The comparable earnings approach is derived from the "corresponding risk" standard of the landmark cases of the U.S. Supreme Court. Therefore, it is consistent with the Hope doctrine that the return to the equity investor should be commensurate with returns on investments in other firms having corresponding risks.

The CEM is based upon the fundamental economic concept of opportunity cost which maintains that the true cost of an investment is equal to the cost of the best available alternative use of the funds to be invested. The opportunity cost principle is also consistent with one of the fundamental principles upon which regulation rests: that regulation is intended to act as a surrogate for competition and to provide a fair rate of return to investors.

The CEM is designed to measure the returns expected to be earned on the book common equity, in this case net worth, of similar risk enterprises. Thus, it provides a direct measure of return, since it translates into practice the competitive principle upon which regulation rests. In my opinion, it is inappropriate to use the achieved returns of regulated utilities of similar risk because to do so would be circular and inconsistent with the principle of equality of risk with non-price regulated firms.

The difficulty in application of the CEM is to select a proxy group of companies which are similar in risk, but are not price regulated utilities. Consequently, the first step in determining a cost of common equity using the comparable earnings model is to choose an appropriate proxy group of non-price regulated firms. The proxy group should be broad-based in order to

obviate any company-specific aberrations. As stated previously, utilities need to be eliminated to avoid circularity since the returns on book common equity of utilities are substantially influenced by regulatory awards and are therefore not representative of the returns that could be earned in a truly competitive market.

Q. PLEASE DESCRIBE YOUR APPLICATION OF THE CEM.

A. My application of the CEM is market-based in that the selection of non-price regulated firms of comparable risk is based upon statistics derived from the market prices paid by investors.

I have chosen two proxy groups of domestic, non-price regulated firms to reflect both the systematic and unsystematic risks of the proxy group of six AUS Utility Reports water companies and the proxy group of four Value Line (Std. Ed.) water companies, respectively. The proxy group of one hundred fifty-one non-utility companies similar in risk to the proxy group of six AUS Utility Reports water companies and two hundred three non-utility companies similar in risk to the proxy group of four Value Line (Std. Ed.) water companies are listed on pages 1 through 7, Schedule PMA-14. The criteria used in the selection of these proxy companies were that they be domestic non-utility companies and have a meaningful rate of return on net worth, common equity or partners' capital reported in Value Line (Std. Ed.) for each of the five years ended 2006, or projected for 2010-2012. Value Line betas were used as a measure of systematic risk. The standard error of the regression was used as a measure of each firm's unsystematic or specific risk. The standard error of the regression reflects the extent to which events specific to a company's

operations will affect its stock price and, therefore, is a measure of diversifiable, unsystematic, company-specific risk. *In essence, companies which have similar betas and standard errors of the regressions, have similar investment risk, i.e., the sum of systematic (market) risk as reflected by beta and unsystematic (business and financial) risk, as reflected by the standard error of the regression, respectively. Those statistics are derived from regression analyses using market prices which, under the EMH reflect all relevant risks. The application of these criteria results in proxy groups of non-price regulated firms similar in risk to the average company in each proxy group.*

Using a Value Line, Inc. proprietary database dated January 9, 2008, the proxy group of one hundred fifty-one non-price regulated companies were chosen based upon ranges of unadjusted beta and standard error of the regression. The ranges were based upon the average standard deviations of the unadjusted beta and the average standard error of the regression for the proxy group of six AUS Utility Reports water companies.

The six AUS Utility Reports water companies in the proxy group have an average unadjusted beta of 0.77 whose standard deviation is 0.1122 as of January 9, 2008, as shown on page 3, Schedule PMA-12. The average standard error of the regression is 2.9385 as also shown on page 3 of Schedule PMA-14, with a standard deviation of 0.1291 as derived in Note 5, page 15. Ranges of unadjusted betas from 0.43 to 1.11 and of standard errors of the regression from 2.5512 to 3.3258 were used to select the proxy group of

one hundred fifty-one domestic non-utility companies comparable to the profile of the proxy group of six AUS Utility Reports water companies as can be gleaned from pages 1 through 3 and explained in Note 1 on page 15 of Schedule PMA-14. These ranges are based upon the proxy group's average unadjusted beta of 0.77 and average standard error of the regression of 2.9385 plus or minus three standard deviations of beta (0.1122 x 3 = 0.3366) and standard error of the regressions (0.1291 x 3 = 0.3873). The use of three standard deviations assures capturing 99.73% of the distribution of unadjusted betas and standard errors, assuring comparability.

Likewise, using the same Value Line, Inc. proprietary database dated January 9, 2008, the proxy group of two hundred three non-price regulated companies were chosen based upon ranges of unadjusted beta and standard error of the regression. The ranges were based upon the average standard deviations of the unadjusted beta and the average standard error of the regression for the proxy group of four Value Line (Std. Ed.) water companies.

The four Value Line (Std. Ed.) water companies in the proxy group have an average unadjusted beta of 0.97 whose standard deviation is 0.1173 as of January 9, 2008, as shown on page 7, Schedule PMA-12. The average standard error of the regression is 3.0719 as also shown on Schedule PMA-14, page 7 with a standard deviation of 0.1350 as derived in Note 10, page 16. Ranges of unadjusted betas from 0.62 to 1.32 and of standard errors of the regression from 2.6669 to 3.4769 were used to select the proxy group of two hundred three domestic non-utility companies comparable to the profile of the

proxy group of four Value Line (Std. Ed.) water companies as can be gleaned from pages 4 through 7 and explained in Note 9 on pages 15 and 16 of Schedule PMA-14. These ranges are based upon the proxy group's average unadjusted beta of 0.97 and average standard error of the regression of 3.0719 plus or minus three standard deviations of beta (0.1173 x 3 = 0.3519) and standard error of the regressions (0.1350 x 3 = 0.4050). The use of three standard deviations assures capturing 99.73% of the distribution of unadjusted betas and standard errors, assuring comparability.

I believe that this methodology for selecting non-price regulated firms of similar total risk (i.e., non-diversifiable systematic and diversifiable non-systematic risk) is meaningful and effectively responds to the criticisms normally associated with the selection of firms presumed to be comparable in total risk. This is because the selection of non-price regulated companies comparable in total risk is based upon regression analyses of market prices which reflect investors' assessment of all risks, diversifiable and non-diversifiable. Thus, the empirical selection process results in companies comparable in both systematic and unsystematic risks, i.e., total risk.

Once proxy groups of non-price regulated companies are selected, it is then necessary to derive returns on book common equity, net worth or partners' capital for the companies in the groups. I have measured these returns using the rate of return on net worth, common equity or partners' capital reported by Value Line (Standard Edition). It is reasonable to measure these returns over both the most recent historical five-year period as well as those projected over

the ensuing five-year period.

Q. WHAT ARE YOUR CONCLUSIONS OF CEM COST RATE?

A. Conclusions of CEM cost rates are 15.46% for the proxy group of six AUS Utility Reports water companies as shown on page 3 of Schedule PMA-14 and 15.10%, for the proxy group of four Value Line (Std. Ed.) water companies as shown on page 7. Note that I have applied a test of significance (Student's t-statistic) to determine whether any of the historical or projected returns are significantly different from their respective means at the 95% confidence level. As a result, the historical and the projected means of several companies have been excluded.

I have also eliminated from the groups of non-price regulated companies, all those rates of return which are 20.0% or greater and 7.95% and below, i.e., 200 basis points above the current prospective yield of 5.95% on Moody's A rated public utility bonds (see page 1 of Schedule PMA-12) for reasons discussed previously. Such an elimination results in an arithmetic mean return rate of 13.87% on an historical five-year basis and 13.89% on a projected five-year basis for the six AUS Utility Reports water companies and 13.49% on an historical five-year basis and 13.71% on a projected five-year basis for the four Value Line (Std. Ed.) water companies as shown on pages 3 and 7 of Schedule PMA-14, respectively. I rely upon the midpoint of the arithmetic mean historical five-year and projected five-year rates of return of 13.88% for the proxy group of six AUS Utility Reports water companies and 13.60% for the proxy group of four Value Line (Std. Ed.) water companies as

my CEM conclusions.

IX. CONCLUSION OF COMMON EQUITY COST RATE

Q. WHAT IS YOUR RECOMMENDED COMMON EQUITY COST RATE?

A. It is 11.40% based upon the common equity cost rates resulting from all four cost of common equity models consistent with the EMH which logically mandates the use of multiple cost of common equity models as adjusted for TESI-Sewer's greater business risk.

In formulating my recommended common equity cost rate of 11.40%, I reviewed the results of the application of four different cost of common equity models, namely, the DCF, RPM, CAPM, and CEM for the two proxy groups. I employ all four cost of common equity models as primary tools in arriving at my recommended common equity cost rate range because no single model is so inherently precise that it can be relied upon solely, to the exclusion of other theoretically sound models. As discussed above, all four models are based upon the Efficient Market Hypothesis (EMH), and therefore, have application problems associated with them. The EMH, as also previously discussed, requires the assumption that investors rely upon multiple cost of common equity models. Moreover, as demonstrated in this testimony, the prudence of using multiple cost of common equity models is supported in the financial literature. Therefore, none should be relied upon exclusively to estimate investors' required rate of return on common equity.

In a market environment where market value deviates significantly from book value (lower or higher), sole reliance on the simplified DCF model is

particularly problematic for a regulated utility because its application results in both a practical and theoretical overstatement or understatement, respectively, of investors' required rate of return. Investors expect to achieve their required rate of return based upon dividends received and appreciation in market price. This testimony has shown that market prices are significantly influenced by factors other than earnings per share (EPS) and dividends per share (DPS). Thus, because it is necessary to use accounting proxies for growth in the DCF model (such as EPS, DPS, or their derivative, internal growth), that model does not reflect the full extent of market price growth expected by investors. Market prices reflect other factors affecting growth not accounted for in the standard regulatory version of the DCF model such as an increase in the market value per share due to expected increases in price/earnings multiples and less obvious factors included in the long-range goals of investors. For these reasons, sole reliance on the DCF model should be avoided. In fact, as discussed in detail above, state commissions in Iowa, Indiana and Hawaii have questioned their previous primary reliance upon the DCF, having explicitly recognized this tendency of the DCF model to understate the common equity cost rate when, as now, market prices significantly exceed book values.

The results of the four cost of common equity models applied to the proxy groups of six AUS Utility Reports water companies and four Value Line (Std. Ed.) water companies are shown on Schedule PMA-1, page 2 and summarized below:

Table 4

	Proxy Group of Six AUS Utility Reports Water Cos.		Proxy Group of Four Value Line (Std. Ed.) Water Cos.
Discounted Cash Flow Model	10.36%		10.49%
Risk Premium Model	10.94		11.34
Capital Asset Pricing Model	10.40		10.89
Comparable Earnings Model	13.88		13.60
Indicated Common Equity Cost Rate Before Business Risk Adjustment	10.80%	--	11.00%
Business Risk Adjustment	0.50		0.50
Indicated Common Equity Cost Rate After Adjustment for Business Risk	11.30%	--	11.50%
Recommended Common Equity Cost Rate	11.40%		

Based upon these common equity cost rate results, I conclude that a common equity cost rate in the range of 10.80% to 11.00% is indicated based upon the use of multiple common equity cost rate models applied to the market data of both proxy groups and before any adjustment for TESI-Sewer's greater relative business risk as shown on Line No. 5, page 2 of Schedule PMA-1.

Q. IS THERE A WAY TO QUANTIFY A BUSINESS RISK ADJUSTMENT DUE TO TESI-SEWER'S SMALL SIZE RELATIVE TO THE TWO PROXY GROUPS?

A. Yes. As discussed previously, TESI-Sewer has greater business risk than the average proxy group company because of its smaller size relative to each proxy group, whether measured by book capitalization or the market capitalization of common equity (estimated market value for TESI-Sewer,

whose common stock is not traded). Therefore, it is necessary to upwardly adjust the common equity cost rate range of 10.80% to 11.00% based upon the two proxy groups. Based upon TESI-Sewer's small relative size, an adjustment to reflect its smaller relative size of 3.44% (344 basis points) relative to the conclusion of common equity cost rate of the six AUS Utility Reports water companies and 3.97% (397 basis points) relative to the conclusion of common equity cost rate of the four Value Line (Std. Ed.) water companies are indicated. These adjustments are based upon data contained in the 2008 Ibbotson Risk Premia Over Time Report – Estimates for 1926-2007. The determinations are based on the size premia for decile portfolios of New York Stock Exchange (NYSE), American Stock Exchange (AMEX) and NASDAQ listed companies for the 1926-2007 period and related data shown on pages 3 through 20 of Schedule PMA-1. The average size premia for the deciles in which the proxy groups fall have been compared to the average size premia for the 10th decile in which TESI-Sewer would fall if its stock were traded and sold at the February 8, 2008 average market/book ratio of either 212.3% or 203.2% experienced by each proxy group, respectively. As shown on page 3 of Schedule PMA-1, the size premium spread between TESI-Sewer and the six water companies is 3.44% and 3.97% between TESI-Sewer and the four Value Line (Std. Ed.) water companies. Page 4 contains notes relative to page 3. Page 5 contains data in support of page 3 while pages 6 through 20 of Schedule PMA-1 contain relevant information from the 2008 Ibbotson Risk Premia Over Time Report – Estimates for 1926-2007 discussed previously.

Consequently, business risk adjustments of 3.44% and 3.97% are indicated for the six water companies and the four Value Line (Std. Ed.) water companies, respectively. Although an upward risk adjustment of 3.44% - 3.97% is warranted, I will make a conservatively reasonable business risk adjustment of 0.50% (50 basis points) as shown on Line No. 6 on page 2 of Schedule PMA-1 to the indicated common equity cost rate range of 10.80% to 11.00%. This results in a range of business risk adjusted common equity cost rate of 11.30% to 11.50% shown on Line No. 7. While the business risk profile of TESI-Sewer indicates an even larger adjustment, to be both reasonable and conservative, I have restricted this adjustment to only 50 basis points.

This results in a range of business risk adjusted common equity cost rates of 11.30% to 11.50% as shown on Line No. 9, the midpoint of which is 11.40%, is my recommended common equity cost rate and, in my opinion, is both reasonable and conservative. A common equity cost rate range of 11.40% will provide TESI-Sewer with sufficient earnings to enable it to attract necessary new capital.

Q. DOES THAT CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

APPENDIX A

PROFESSIONAL QUALIFICATIONS

OF

PAULINE M. AHERN, CRRA
PRINCIPAL

AUS CONSULTANTS

PROFESSIONAL QUALIFICATIONS
OF
PAULINE M. AHERN, CRRA
PRINCIPAL
AUS CONSULTANTS

PROFESSIONAL EXPERIENCE

1996-2006

As a Principal (Vice President – 1996-2006), I offer testimony as an expert witness on the subjects of fair rate of return and cost of capital before state public utility commissions. I provide assistance and support to clients throughout the entire ratemaking litigation process.

1994-1996

As an Assistant Vice President, I prepared fair rate of return and cost of capital exhibits which are filed along with expert testimony before various state and federal public utility regulatory bodies. These supporting exhibits include the determination of an appropriate ratemaking capital structure and the development of embedded cost rates of senior capital. The exhibits also support the determination of a recommended return on common equity through the use of various market models, such as, but not limited to, Discounted Cash Flow analysis, Capital Asset Pricing Model and Risk Premium Methodology, as well as an assessment of the risk characteristics of the client utility. I also assisted in the preparation of responses to any interrogatories received regarding such testimonies filed on behalf of client utilities. Following the filing of fair rate of return testimonies, I assisted in the evaluation of opposition testimony in order to prepare interrogatory questions, areas of cross-examination, and rebuttal testimony. I also evaluated and assisted in the preparation of briefs and exceptions following the hearing process. I have submitted testimony before state public utility commissions regarding appropriate capital structure ratios and fixed capital cost rates.

1990-1994

As a Senior Financial Analyst, I supervised two analysts in the preparation of fair rate of return and cost of capital exhibits which are filed along with expert testimony before various state and federal public utility regulatory bodies. The team also assisted in the preparation of interrogatory responses.

I evaluated the final orders and decisions of various commissions to determine whether further actions are warranted and to gain insight which may assist in the preparation of future rate of return studies.

I assisted in the preparation of an article authored by Frank J. Hanley and A. Gerald Harris entitled "Does Diversification Increase the Cost of Equity Capital?" published in the July 15, 1991 issue of Public Utilities Fortnightly.

I co-authored an article with Frank J. Hanley entitled "Comparable Earnings: New Life for an Old Precept" which was published in the American Gas Association's Financial Quarterly Review, Summer 1994.

I was awarded the professional designation "Certified Rate of Return Analyst" (CRRA) by the National Society of Rate of Return Analysts (now the Society of Utility and Regulatory Financial Analysts (SURFA)). This designation is based upon education, experience and the successful completion of a comprehensive examination.

As Administrator of Financial Analysis for AUS Utility Reports, which reports financial data for over 200 utility companies and has approximately 1,000 subscribers, I oversee the preparation of this monthly publication, as well as the annual publication, Financial Statistics - Public Utilities.

1988-1990

As a Financial Analyst, I assisted in the preparation of fair rate of return studies including capital structure determination, development of senior capital cost rates, as well as the determination of an appropriate rate of return on equity. I also assisted in the preparation of interrogatory responses, interrogatory questions of the opposition, areas of cross-examination and rebuttal testimony. I also assisted in the preparation of the annual publication C. A. Turner Utility Reports - Financial Statistics - Public Utilities.

1973-1975

As a research assistant in the Research Department of the Regional Economics Division of the Federal Reserve Bank of Boston, I was involved in the development and maintenance of econometric models to simulate regional economic conditions in New England in order to study the effects of, among other things, the energy crisis of the early 1970's and property tax revaluations on the economy of New England. I was also involved in the statistical analysis and preparation of articles for the New England Economic Review. Also, I acted as assistant editor for New England Business Indicators.

1972

As a research assistant in the Office of the Assistant Secretary for International Affairs, U.S. Treasury Department, Washington, D.C., I developed and maintained econometric models which simulated the economy of the United States in order to study the results of various alternate foreign trade policies so that national trade policy could be formulated and recommended.

I am also a member of the Society of Utility and Regulatory Financial Analysts (formerly the National Society of Rate of Return Analysts).

Clients Served

I have offered expert testimony before the following commissions:

Arkansas
California
Connecticut
Delaware
Florida
Hawaii
Idaho
Illinois
Indiana
Kentucky
Maine
Maryland
Michigan
Missouri
Nevada
New Jersey
New York
North Carolina
Ohio
Pennsylvania
South Carolina
Virginia
Washington

I have sponsored testimony on the rate of return and capital structure effects of merger and acquisition issues for:

California-American Water Company

New Jersey-American Water Company

I have sponsored testimony on fair rate of return and related issues for:

Aqua Illinois, Inc.
Aqua New Jersey, Inc.
Aqua Virginia, Inc.
Audubon Water Company
The Atlantic City Sewerage Company
Carolina Pines Utilities, Inc.
Carolina Water Service, Inc.
Consumers Illinois Water Company
Consumers Maine Water Company
Consumers New Jersey Water Company
City of DuBois, Pennsylvania
Elizabethtown Water Company
Emporium Water Company
GTE Hawaiian Telephone Inc.
Greenridge Utilities, Inc.
Borough of Hanover, Pennsylvania
Illinois American Water Company
Iowa American Water Company
Land'Or Utility Company
Long Neck Water Company
Massanutten Public Service Company
Middlesex Water Company
Missouri-American Water Company
Mt. Holly Water Company
Nero Utility Services, Inc.
New Jersey-American Water Company
NRG Energy Center Pittsburgh LLC
Ohio-American Water Company
Penn Estates
Pinelands Waste Water Company
Pittsburgh Thermal
Southland Utilities, Inc.
Spring Creek Utilities, Inc.
Sussex Shores Water Company
Tega Cay Water Service, Inc.
Twin Lakes Water Service, Inc.
Thames Water Americas
Tidewater Utilities, Inc.
Transylvania Utilities, Inc.
Twin Lakes Utilities, Inc.
United Utility Companies
United Water Arkansas, Inc.
United Water Connecticut, Inc.
United Water Delaware, Inc.
United Water Idaho, Inc.
United Water Indiana, Inc.
United Water New Jersey, Inc.
United Water New Rochelle, Inc.
United Water New York, Inc.
United Water Owego / Nichols, Inc.
United Water Pennsylvania, Inc.
United Water Virginia, Inc.
United Water West Lafayette, Inc.
Utilities Inc. of Central Nevada
Utilities, Inc. of Florida
Utilities Services of South Carolina
Utility Center, Inc.
Valley Energy, Inc.
Water Service Corp. of Kentucky
Wellsboro Electric Company
Western Utilities, Inc.

I have sponsored testimony on capital structure and senior capital cost rates for the following clients:

Alpena Power Company
Arkansas-Western Gas Company
Associated Natural Gas Company
PG Energy Inc.
United Water Delaware, Inc.
Washington Natural Gas Company

I have assisted in the preparation of rate of return studies on behalf of the following clients:

Algonquin Gas Transmission Company
Arkansas-Louisiana Gas Company
Arkansas Western Gas Company
Artesian Water Company
Associated Natural Gas Company
Atlantic City Electric Company
Bridgeport-Hydraulic Company
Cambridge Electric Light Company
Carolina Power & Light Company
Citizens Gas and Coke Utility
City of Vernon, CA
Columbia Gas/Gulf Transmission Cos.
Commonwealth Electric Company
Commonwealth Telephone Company
Conestoga Telephone & Telegraph Co.
Connecticut Natural Gas Corporation
Consolidated Gas Transmission Company
Consumers Power Company
CWS Systems, Inc.
Delmarva Power & Light Company
East Honolulu Community Services, Inc.
Equitable Gas Company
Equitrans, Inc.
Florida Power & Light Company
Gary Hobart Water Company
Gasco, Inc.
GTE Arkansas, Inc.
GTE California, Inc.
GTE Florida, Inc.
GTE Hawaiian Telephone
GTE North, Inc.
GTE Northwest, Inc.
GTE Southwest, Inc.
Great Lakes Gas Transmission L.P.

Rate of Return Study Clients, Continued

Hawaiian Electric Company
Hawaiian Electric Light Company
IES Utilities Inc.
Illinois Power Company
Interstate Power Company
Iowa Electric Light and Power Company
Iowa Southern Utilities Company
Kentucky-West Virginia Gas Company
Lockhart Power Company
Middlesex Water Company
Milwaukee Metropolitan Sewer District
Mountaineer Gas Company
National Fuel Gas Distribution Corp.
National Fuel Gas Supply Corp.
National Fuel Gas Distribution Corp.
National Fuel Gas Supply Corp.
Newco Waste Systems of NJ, Inc.
New Jersey Natural Gas Company
New Jersey-American Water Company
New York-American Water Company
North Carolina Natural Gas Corp.
Northumbrian Water Company
Ohio-American Water Company
Oklahoma Natural Gas Company
Orange and Rockland Utilities
Paiute Pipeline Company
PECO Energy Company
Penn-York Energy Corporation
Pennsylvania-American Water Co.
PG Energy Inc.
Philadelphia Electric Company
South Carolina Pipeline Company
Southwest Gas Corporation
Stamford Water Company
Tesoro Alaska Petroleum Company
United Telephone of New Jersey
United Utility Companies
United Water Arkansas, Inc.
United Water Delaware, Inc.
United Water Idaho, Inc.
United Water Indiana, Inc.
United Water New Jersey, Inc.
United Water New York, Inc.
United Water Pennsylvania, Inc.
United Water Virginia, Inc.
United Water West Lafayette, Inc.
Vista-United Telecommunications Corp.
Washington Natural Gas Company
Washington Water Power Corporation
Waste Management of New Jersey – Transfer Station A
Wellsboro Electric Company
Western Reserve Telephone Company
Western Utilities, Inc

EDUCATION:

1973 – Clark University – B.A. – Honors in Economics
1991 – Rutgers University – M.B.A. – High Honors

PROFESSIONAL AFFILIATIONS:

American Finance Association
Financial Management Association
Society of Utility and Regulatory Financial Analysts
President – 2006-2008
Secretary/Treasurer – 2004-2006
Energy Association of Pennsylvania
National Association of Water Companies – Member of the Finance Committee

TESI-Sewer Exhibit No. 2

4-17-08 TG HBC

R-00072495

JOINT STIPULATION

Total Environmental Solutions, Inc. and the Office of Consumer Advocate stipulate that the 2007 salaries and wages for the Treasure Lake Sewer Division contained in TESI-Sewer Statement No. 1R, SDF Exhibit No. 3, Attachment 2 was not submitted as part of discovery.

TESI-Sewer Exhibit No. 3

4-17-08 JES
KBL

R-00072495

DOCUMENT FOLDER

Total Environmental Solutions, Inc.
Treasure Lake Sewer Division

Rate Case Costs

Company	Invoice Date	Amount	
AUS Consultants	08/06/07	$3,185.00	Previously supplied.
AUS Consultants	09/07/07	6,232.50	Previously supplied.
AUS Consultants	10/12/07	5,290.00	Previously supplied.
AUS Consultants	11/07/07	11,669.50	Previously supplied.
AUS Consultants	12/05/07	2,292.50	Previously supplied.
AUS Consultants	01/09/08	4,629.75	Previously supplied.
AUS Consultants	02/06/08	2,525.00	Previously supplied.
AUS Consultants	03/06/08	2,678.29	Previously supplied.
AUS Consultants	03/06/08	6,315.00 *	Previously supplied.
AUS Consultants	04/08/08	8,354.50	
AUS Consultants	04/08/08	4,070.75 *	
Hawke McKeon & Sniscak LLP	11/28/07	5,308.25	Previously supplied.
Hawke McKeon & Sniscak LLP	12/31/07	1,138.35	Previously supplied.
Hawke McKeon & Sniscak LLP	01/28/08	3,812.90	Previously supplied.
Hawke McKeon & Sniscak LLP	02/29/08	8,130.63	Previously supplied.
Hawke McKeon & Sniscak LLP	03/31/08	10,004.39	
Hawke McKeon & Sniscak LLP	04/30/08 (Est.)	7,380.00	
Faulk & Winkler LLC	08/11/07	915.00 *	Previously supplied.
Faulk & Winkler LLC	10/01/07	795.00 *	Previously supplied.
Faulk & Winkler LLC	10/19/07	1,192.50 *	Previously supplied.
Total		$95,919.81	

* Charges split 50% to water and 50% to sewer.

GARY D. SHAMBAUGH
Principal & Director

AUS CONSULTANTS

375 Grandview Avenue Suite 100
Camp Hill PA 17011
717.763.7680 - Tel
717.762.8931 - Fax
gshambaugh@ausinc.com

April 8, 2008

Mr. William Schoening, CEO
TOTAL ENVIRONMENTAL SOLUTIONS
1824 Ryder Drive
Post Office Box 14056
Baton Rouge, LA 70898

RE: NEW Ref. No. 12-0189
Treasure Lake (Sewer) Rate Filing

Dear Mr. Schoening:

Please find enclosed our invoice in the amount of $8,354.50 for professional services and/or expenses incurred and rendered from February 25, 2008 through March 30, 2008 relative to the above referenced project.

Charges included in this invoice are outlined on the attached billing summary.

Upon your approval, I would appreciate you placing this invoice in line for payment at your convenience.

Sincerely,

Gary D. Shambaugh

GDS:sm
enclosure

PAULINE M. AHERN
Principal

AUS CONSULTANTS

155 Gaither Drive, Suite A
Mt. Laurel, NJ 08054
856 234.9200, ext. 204 • Tel
856.234.8371 • Fax
pahern@ausinc.com

April 7, 2008

Mr. William Schoening
Chief Executive Officer
Total Environmental Solutions, Inc.
1824 Ryder Drive
P.O. Box 14056
Baton Rouge, LA 70898

Re: Total Environmental Solutions, Inc. – Treasure Lake Water Division
Total Environmental Solutions, Inc. – Treasure Lake Sewer Division

Dear Mr. Schoening:

Enclosed please find our billing for services rendered through March 31, 2008 in connection with the above-mentioned cases.

I believe the invoice is self-explanatory and would appreciate it if you would place the enclosed in line for payment.

Best personal regards.

Sincerely,

Pauline M. Ahern

PMA/s
enc.

AUS

Invoice Number	107273
Invoice Date	April 07, 2008
PO Number	
Contract	ROR
Project	13-0173
Page	1

AUS Consultants, Inc.
155 Gaither Drive, Suite A
Mt. Laurel, NJ 08054
856 234 9200

Incorporated FID# 22-1943906
www.ausinc.com
Consultant:
PAULINE M. AHERN
PAHERN@AUSINC.COM

William Schoening
Total Environ. Solutions, Inc.
1824 Ryder Drive
PO Box 14056
Baton Rouge, LA 70898

Professional Services	7,849.00
Administrative Support	292.50
Invoice Total	**8,141.50**

Please make check payable to:
AUS Consultants
155 Gaither Drive, Suite A
Mt. Laurel, NJ 08054

Invoice due upon presentation

70TES01

AUS CONSULTANTS

185 Gaither Drive, Suite A
Mt. Laurel, NJ 08054
856.234.9200 • Tel
856 234.8371 • Fax
www.ausinc.com

Employer I.D. #22-1943906 Incorporated

April 7, 2008
Job No. 13-0173

TOTAL ENVIRONMENTAL SOLUTIONS, INC. –
TREASURE LAKE WATER DIVISION
TREASURE LAKE SEWER DIVISION

For professional services rendered in connection with the review of OTS Staff Witness Robert Plonski's direct testimonies, preparation of data requests on same and preparation of rebuttal testimonies in response. (Aggregate time spent was 41.75 hours at a composite rate of $188.00 per hour)	$7,849.00
Administrative support charges (4.5 hours @ $65 per hour)	292.50
TOTAL	$8,141.50

P.O. Box 1778
Harrisburg, PA 17105
Phone: (717) 236-1300
Fax (717) 236-4841
EIN: 23-2194794

March 31, 2008

Invoice # 41033
Matter # 720-0000013

Total Environmental Solutions, Inc. (TESI)
ATTN: William Schoening
487 Treasure Lake Mini Mall #4
DuBois, PA 15801

RE: TESI Treasure Lakes Sewer Rate Case

For Services Rendered Through February 29, 2008

Previous Balance - PLEASE DISREGARD IF PAID	11,943.53	
Payments Received	<11,943.53>	
Current Amount Due		10,004.39
Total Balance Due		10,004.39

PAYMENT DUE WITHIN 20 DAYS FROM RECEIPT OF BILL
PLEASE RETURN THIS PAGE WITH YOUR PAYMENT

TESI-Sewer Statement No. 20R

4-170 STS
HSL

PENNSYLVANIA PUBLIC UTILITY COMMISSION

v.

TOTAL ENVIRONMENTAL SOLUTIONS, INC.
Treasure Lake Sewer Division

Docket No. R-00072495

DOCUMENT FOLDER

Rejoinder Testimony

of

Gary D. Shambaugh, Principal & Director
AUS Consultants

Materials and Supplies

Q. MR. SHAMBAUGH WHAT IS THE NATURE OF YOUR ADDITIONAL TESTIMONY IN THIS PROCEEDING?

A. My additional testimony will provide clarification to OTS Witness Maceo's belief that the Company does not account for materials and supplies properly.

Q. WILL YOU PLEASE EXPLAIN?

A. Several years ago, the Company began to account for materials and supplies by following the NARUC Uniform System of Accounts guidelines. Physical inventory counts are performed twice a year and the inventory is priced based upon the Company's purchase records. The 2006 materials and supplies inventory was provided in response to OTS-RB-12-D in Docket No. R-00072493.

OFFICE OF TRIAL STAFF DATA REQUESTS

TOTAL ENVIRONMENTAL SOLUTIONS
TREASURE LAKE WATER DIVISION

Docket No. R-00072493

Engineer: Jeremy B. Hubert

OTS-RB-12-D Provide the actual monthly value for the inventory of materials and supplies by month for 2006. Supply as of the end of the test year, a 13 month average, by month, for the materials and supplies amount. If this is not possible, provide 5 years work of data for materials and supplies.

Response:

January 2006	$26,452.24
February 2006	$25,896.47
March 2006	$28,525.52
April 2006	$27,790.13
May 2006	$27,790.13
June 2006	$24,323.50
July 2006	$22,117.92
August 2006	$19,865.24
September 2006	$21,191.95
October 2006	$20,860.02
November 2006	$21,326.56
December 2006	$18,618.45
2006 Average	$23,729.84

Also, see the physical inventory counts as of June 2006 and December 2006 attached.

Responsible Party: Wayne Owens