BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application Of a Rate Increase For Indian Hills Utility Operating Company, Inc.	))))	**Case No. WR-2017-0259**

INDIAN HILLS' BRIEF

COMES NOW Indian Hills Utility Operating Company, Inc. ("Indian Hills" or "Company"), and, as its Brief, respectfully states as follows to the Missouri Public Service Commission ("Commission"):

The following sections will provide an introduction and then address the *Non-Unanimous Stipulation and Agreement* filed by the Staff of the Commission (Staff) and Indian Hills on November 22, 2017. Thereafter, it will specifically address the issues contained in the *List of Issues, Order of Witnesses, Order of Cross-Examination and Order of Opening* filed on November 21, 2017.

Because the procedural schedule does not provide for reply briefs (and no agreement could be reached among the parties to provide for such), to the extent issues are raised in parties' briefs that are not addressed herein, Indian Hills asks that the Commission refer to its filed and live testimony for its response.

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1. Introduction

Indian Hills Utility Operating Company, Inc. is a subsidiary of First Round CSWR, LLC. (Exh. 1NP, Cox Dir., p. 9)

First Round is also the ultimate parent of public utilities Hillcrest Utility Operating Company, Inc.; Raccoon Creek Utility Operating Company, Inc.; and, Elm Hills Utility Operating Company, Inc.; as well as, Confluence Rivers Utility Operating Company, Inc., which is currently an applicant to become a public utility.

Organization Background

On the wastewater side of the business, First Round's subsidiaries have purchased seven wastewater treatment plants with associated sewer pumping stations, gravity force mains, and gravity conveyance lines. The companies have designed, permitted, and completed construction, with Missouri Department of Natural Resources approval, of approximately $2.4 million of sanitary sewer systems since March of 2015. (Exh. 1NP, Cox Dir., p. 4; plus systems acquired pursuant to MoPSC Case No. SM-2017-0150 (Missouri Utilities Company and State Park Village)

On the drinking water side of the business, the companies have designed, permitted, and have completed construction ,with Missouri Department of Natural Resources approval, approximately $2.6 million of drinking water systems since March of 2015. (Exh. 1NP, Cox Dir., p. 5)

Most recently, Elm Hills Utility Operating Company, Inc. closed on the purchase of two wastewater systems, and one water system. One water system and one sewer system (Missouri Utilities Company) had been in Missouri state-appointed receivership for about ten years and had AG enforcement actions pending. Improvements will soon be underway. (MoPSC Case No. SM-2017-0150)

Confluence Rivers Utility Operating Company, Inc. has filed with this Commission an application to acquire approximately fifteen water and wastewater systems, which contain four wastewater systems currently in state appointed receivership, one water system in receivership (with an active attorney general enforcement action), and two non-regulated wastewater systems in attorney general enforcement actions, to include one with a current building moratorium in the area it serves. (MoPSC Cases Nos. WM-2018-0116 and SM-2018-0117)

Indian Hills acquired its water system from I.H. Utilities, Inc., which was a public utility regulated by the Commission. The Company sought approval of the proposed transaction in its File No. WO-2016-0045. (Exh. 1NP, Cox Dir., p. 10)

Ultimately, a Stipulation was reached and the Commission approved the transactions by its *Order Regarding Stipulation and Agreement and Certificate of Convenience and Necessity* issued February 3, 2016, effective March 4, 2016. Closing took place on March 31, 2016. (Exh. 1NP, Cox Dir., p. 11)

The original Indian Hills drinking water system was constructed approximately fifty years ago. Indian Hills does not believe any major capital improvements were completed after the initial construction. The original system was in a state of significant disrepair that centered around six major enforcement issues or schedules of compliance associated with the system’s operations at the time Indian Hills bought the water assets. (Exh. 1NP, Cox Dir., p. 11)

- There was only one well in service. For drinking water systems serving over 500 individuals, MDNR's design guides require two or more active sources of water.[1] Missouri DNR considers Indian Hills to serve approximately 2,500 individuals. Exh. 1NP, Cox Dir., Sched. JC-01, p. 4 of 11)
- There was no backup power or backup pumping system. (Exh. 1NP, Cox Dir., p. 12)
- There was significant water loss inside the system. I.H. Utilities was losing about 75% of all the water pumped to leakage from the existing water conveyance lines. (Exh. 1NP, Cox Dir., p. 12-13)
- There was a lack of sufficient pressure. MDNR current design guides require a minimum of 21 psi of water pressure, with a guideline of 35 psi for residential drinking water systems. At the time of acquisition, Indian Hills registered a maximum of 20 psi at the back of the lake community and, during peak usage, no water pressure at all in that area. (Exh. 1NP, Cox Dir., p. 14)
- There was a lack of redundant pumps to ensure system reliability. (Exh. 1NP, Cox Dir., p. 14) And,
- A lack of sufficient storage. It previously had 20,000 gallons of storage for a system that can average around 180,000 per day during the summer months. (Exh. 1NP, Cox Dir., p. 114-15)

Indian Hills had a list of twenty-seven (27) MDNR compliance issues at the time of acquisition that dated back to at least 2014. (Exh. 1NP, Cox Dir., p. 15-17)

[1] Indian Hills erroneously made this comparison based upon homes in opening statement and in Exh. 1NP, Cox Dir., p.12, and apologizes for this error and any confusion it may have caused.

Indian Hills began construction on the wastewater improvements approximately 30 days after it acquired systems. (Exh. 1NP, Cox Dir., p. 18) Those violations were addressed by November of 2016. The remaining improvements were completed by February of 2017. (Exh. 1NP, Cox Dir., p. 18-21)

Indian Hills invested approximately $1.84MM in the facilities. (Exh. 1NP, Cox Dir., p. 21)

Indian Hills Customers

Indian Hills provides water service to about 715 residential customers. (Exh. 1NP, Cox Dir., p. 9) About half of those are part-time residents -- People for whom their Indian Hills residence is a second home (or vacation home). (Exh. 101, Gateley Dir., p. 2; Exh. 107, Gateley Reb., p. 3-4)

Current Rates

Indian Hills current rates became effective in October of 2009, and include a $10.81 base rate, which includes 4,000 gallons of water use; and, a volumetric rate of $1.89 for every 1,000 gallons used over the original 4,000 gallons. (Exh. 1NP, Cox Dir., p. 21-22)

Unfortunately, whether the Commission follows the OPC, Staff, or Company recommendation as to rates, a substantial rate increase will result.

The water system required a substantial rebuild (which is still underway, to some extent) to: (1) to be operational for the provision of service to the customers; and, (2) to comply with federal and state regulations related to those services. (Exh. 1NP, Cox Dir., p. 22)

This rebuilding will continue even after this case is over, as the distribution system itself was largely constructed in a haphazard manner with insufficient materials. (Exh. 7, Thomas Dir., p. 5-6) Eventually, much of that distribution system will need to be rebuilt. (Exh. 7, Thomas Dir., p. 7)

2. <u>Non-Unanimous Stipulation and Agreement</u>

Indian Hills has presented testimony in this case to support its positions as represented in its position statement. However, on November 22, 2017, Indian Hills, along with the Staff of the Commission, filed a *Non-Unanimous Stipulation and Agreement* (Non-Unanimous Stipulation) that represents a compromise of these positions as part of a proposed, comprehensive determination of the positions before the Commission.

The Office of the Public Counsel (OPC) objected to the Non-Unanimous Stipulation in a timely manner. Thus, by Commission Rule, the Non-Unanimous Stipulation became a "joint position statement" of Indian Hills and Staff. (Commission Rule 4 CSR 240-2.115(2)(D)) Further, in accordance with *State ex rel. Fischer v. Public Service Commission*, 645 S.W.2d 39 (Mo.App.W.D. 1982), the Commission must conduct a full and contested hearing that provides parties with a fair and meaningful opportunity to be heard. The Commission has conducted such a hearing in this case and has evidence before it that will allow the Commission to reach findings of fact and conclusions of law that will support an order consistent with the Non-Unanimous Stipulation.

Key points in that Non-Unanimous Stipulation and Agreement are as follows:

- **An incremental increase to Indian Hills' annual revenue requirement in the amount of $630,911, based on a cost of debt of 14%, a return on**

equity (ROE) of 12%, and a hypothetical capital structure of 35% equity to 65% debt. (Non-Unanimous Stip., p. 4-6, 9)

The cost of money elements specified by the Non-Unanimous Stipulation are supported by the record in this case.

Debt

The debt cost specified in the Non-Unanimous Stipulation (14%) is the actual debt of the Company as addressed in Commission Case No. WO-2016-0045.

Indian Hills witness Thaman, who has represented more than 100 client companies in raising debt and/or equity financing in both local and national markets, testified that "lenders to companies with risk profiles similar to that of Indian Hills could expect returns in the range of fifteen (15%) to twenty-one percent (21%) for such loans." (Exh. 13, Thaman Dir., p. 2, 5) Based on the risk profile of Indian Hills and the very few alternatives available for financing, Mr. Thaman testified that the fourteen percent (14% inertest rate associated with Indian Hill's financing is reasonable. (*Id.* at p. 5)

The debt cost rate is addressed in more detail below.

Return On Equity

The Non-Unanimous Stipulation specifies a return on equity of twelve percent (12%).

In their testimony, Staff and OPC both recommended a return on equity of 9.34%. Indian Hills provided the testimony of witness D'Ascendis, who supported a return on equity of 15.20%, based upon his assessment of "the market-based common equity cost rates of companies of relatively similar, but not necessarily identical risk to Indian Hills." (Exh. 10, D'Ascendis Dir., p. 6) Mr. D'Ascendis further observed that the 9.34% cited by Staff and OPC is lower than the mid-point range of 9.625% cited by this

Commission in regard to Missouri-American Water Company's last rate case (Case No. WR-2015-0301). (Exh. 11, D'Ascendis Reb., p. 9) Moreover, in Cases Nos. GR-2017-0215 and GR-2017-0216, Staff recommended a range of ROEs between 9.00% and 9.50% for Spire Missouri, an A rated public utility. (Exh. 12, D'Ascendis Sur., p. 4)

In addition to the identified 12% being the approximate half way point between the 9.34% and 15.2% recommendation, Indian Hills witness D'Ascendis explained on the witness stand how the Commission could support a 12% return on equity using his analysis. (Tr. 400-403, D'Ascendis)

To do this, one would start with the Indicated Common Equity Cost Rate Before Adjustments of 10.35%. (Tr. 402, D'Ascendis; Exh. 10, D'Ascendis Dir., p. 7 and Subschedule DWD-1) Utilizing the capital structure specified by the Non-Unanimous Stipulation (65/35) would reduce considerably the Financial Risk Adjustment identified by Mr. D'Ascendis based on Indian Hills actual capital structure. (Tr. 402, D'Ascendis)

The Commission could then focus only on the Size Risk Adjustment. Mr. D'Ascendis' identifies a Size Risk Adjustment range of 1.34 to 3.94 percent. (Tr. 402, D'Ascendis; Exh. 10, D'Ascendis Dir., Subschedule DWD-9) He believes that any adjustment within that range would be reasonable. (Tr. 402, D'Ascendis) Choosing a Size Risk Adjustment of 1.65%, and adding it to the Indicated Common Equity Cost Rate Before Adjustment of 10.35%, will result in the 12% return on equity identified by the Non-Unanimous Stipulation.

Capital Structure

The capital structure of 65% debt and 35% equity is the structure proposed by Staff and is bracketed on one side by the 50/50 capital structure recommended by the

OPC and the 21.2% equity and 78.8% debt structure Indian Hills identifies as its actual structure.

Staff witness Barnes explained that the Staff recommended 65/35 capital structure is a hypothetical structure Staff deemed to be reasonable given:

1) Indian Hills is not rated by a credit rating agency;
2) Indian Hills is not publicly traded;
3) Staff's familiarity with the structure of other companies;
4) Indian Hills' heavy use of debt; and,
5) A desire that the company work toward achieving the capital structure approved by the Commission.

(Tr. 545-546, Barnes)

The EMS (Exhibit Modeling System) run incorporated by the Non-Unanimous Stipulation (Attachment B) reflects to provide detail in regard to the agreed-to revenue requirement. (Non-Unanimous Stip., p. 4-6, 9) Attachment B to the Non-Unanimous Stipulation represents resolution of the remaining contested revenue requirement issues as follows:

a. **Salaries**: The signatories agree to the annual salary amounts of $51,722.
b. **Auditing Expense**: The signatories agree to the auditing expense of $11,078.
c. **Tax Preparation Expense**: The signatories agree to the tax preparation expense of $2,915.
d. **Management Consulting Fees**: The signatories include management consulting fees in the cost of service for Indian Hills.

e. **Bank Fees**: The signatories agree $4,714 should be included in the Company's cost of service.

f. **Rate Case Expense**: The signatories agree to a normalized rate case expense of $5,722 (includes a five year amortization and a 50/50 sharing of expert witness fees (Tr. 260-261, Cox)).

g. **Extension of Electric Service**: The signatories agree to the capitalization of electric line extension in the amount of $23,000, booked to account 325.

These resolutions are consistent with the Staff's position in its filed testimony. (Tr. 393, Bolin)

- **Prior to the effective date of any rate change tariff sheets, the Company agrees to submit a modification of loan agreement to reduce the prepayment penalty term from 20 years to 10 years**. (Non-Unanimous Stip., p. 6)

This is something that is a unique feature of the Non-Unanimous Stipulation. It seeks to address a concern that has been expressed by the Staff, OPC, and Commission, and an issue to which Indian Hills and its parent are sensitive. It would require a change to a financing agreement that was previously approved by the Commission in Case No. WO-2016-0045 - something that Indian Hills would argue could not be accomplished at this point in the absence of its agreement.

- **A two-way tracker for repair expenses related to water main repair and service line repair expense, with a $90,000 base amount**. (Non-Unanimous Stip., p. 5)

The tracker is a mechanism that "tracks" the actual amount of these expenses and provide for an opportunity for adjustment in a future rate case, whether the expenses are greater or lesser than the base amount. (*See* Tr. 388, 391-392, Bolin) Trackers have been used in the past for pensions and OPEBs, where the expenses fluctuate year to ear, and they have also been used in vegetation management trackers where there is not much history of the expense to determine a normal level. (Tr. 391, Bolin)

In this case, the tracker attempts to address the repair expenses on an on-going basis as Indian Hills repair expense is similar to the vegetation management trackers where there is not a lot of history. While all parties agree repair expenses will continue to be incurred by the Company, they do not agree on what amount of repair expenses would be a reasonable amount. OPC witness Robinett acknowledged that there was a difference of opinion among the parties as to what the expense will be in the future years, and a lack of historical information for this expense. (Tr. 355, Robinett ("We don't even know historically what its been other than the test year."))

Missing low may not provide the revenues necessary for the Company to provide safe and adequate service. Missing high may result in revenues greater than what the customers might otherwise have paid.

In the Non-Unanimous Stipulation, the base amount matches Staff's analyzed repair expense and then the amount Staff called "initial repair leaks" was added to that. This came to roughly $89,000, and it was rounded to $90,000. (Tr. 386, Bolin) The $90,000 is assumed to be in the revenue requirement on an annual basis. (Tr. 391, Bolin)

Indian Hills would begin to track its repair expenses on the date rates become effective as a result of this case and would continue to track those expenses until its next rate case. (Tr. 387, Bolin) In that next rate case, ratemaking treatment, if any, would be determined. (Tr. 388, 394, Bolin)

- **A rate design containing a moderate seasonal commodity charge**. (Non-Unanimous Stip., p. 6)

The reasons for this provision are discussed in the Rate Design Section below.

- **An engineering study to be performed by Indian Hills to outline the water system areas that should be scheduled for main replacement, based on historical repair data and current distribution line plans, to be submitted with its next annual report**. (Non-Unanimous Stip., p. 6)

The purpose of this provision is to develop a plan for main replacements on a going-forward basis in order to address the known deficiencies of the Indian Hills system. (Exh. 113, Spratt Sur., p. 1-2; Exh. 206, Robinett Reb., p. 4) A similar provision was included in the Partial Disposition Agreement between Staff and Indian Hills filed on September 1, 2017.

OPC witness Robinett recommended that Indian Hills "create a systemic replacement program for system mains and service connections to address the leak issue caused by increases in pressure from the plant upgrades." (Exh. 206, Robinett Reb., p. 4) At a high level, Mr. Robinett indicated that the study contemplated by Indian Hills and Staff was the sort of study he was looking for. (Tr. 355, Robinett)

During the hearing, questions were raised as to the relationship of the provisions found in the Partial Disposition Agreement and the Non-Unanimous Stipulation. After discussion with Staff counsel, Indian Hills recommends that if the Non-Unanimous Stipulation is generally adopted by the Commission, the Commission further order Indian Hills to comply with the following requirement in place of paragraph 12 of the Non-Unanimous Stipulation and paragraph 7 of the Partial Disposition Agreement:

> Indian Hills agrees to develop a five-year Distribution System Improvement Plan (DSIP) for replacement of mains and service connections, where such replacement is necessary and prudent. The goal of the DSIP will be to continue current efforts to reduce the frequency of significant leaks and water

> loss, and provide a predictable construction schedule for its customers. To develop the DSIP, Indian Hills will perform an engineering study to outline the water system areas based on historical repair data and current distribution line plans that should be scheduled for main replacement, and submit the DSIP to OPC and the PSC Water and Sewer Department by April 15, 2018. The DSIP will include the engineering study and the five-year schedule proposal to address the most problematic portions of the system. Thereafter, Indian Hills shall submit progress reports as to the replacement program developed in the DSIP with its annual reports. The progress reports will update the DSIP, with explanations of any adjustments to the five-year schedule. The progress reports will continue for a five year period (until April 15, 2023), unless sooner modified by Commission order.

This proposed paragraph is encompasses both the actions to be taken by Indian Hills and the timing of those actions in a comprehensive manner.

- **The submission of monthly usage data, inclusive of water loss, on a quarterly basis**. (Non-Unanimous Stip., p. 6)

Historic water sales data is not available because prior to Indian Hills installation of meters, the only meters in place were largely beyond their useful life and not providing accurate data. (Exh. 101, Gately Dir., p. 2; Tr. 512, Gateley) Accordingly, "Staff was forced to develop an assumed water sales volume" for purposes of this case. (*Id.*) This provision will allow the parties to monitor and analyze actual sales data on a going-forward basis to assess these assumptions.

- **Schedule of depreciation rates attached to the Non-Unanimous Stipulation as Attachment A.** (Non-Unanimous Stip., p. 7)

This provision merely incorporates the depreciation rates found in the Partial Disposition Agreement. It does not concern any contested issue in the case.

The Non-Unanimous Stipulation represents a package of items that Indian Hills believes would represent a just and reasonable resolution of this case and one that would be supported by the evidence before the Commission.

If the Commission should decide to not adopt the positions found in the Non-Unanimous Stipulation in its order, Indian Hills' positions as to the contested issues are found below.

3. Payroll

- **a.** What are the appropriate job titles to be used in MERIC to compare and determine labor expense associated with Mr. Josiah Cox and Mr. Todd Thomas?
- b. What are the appropriate MERIC salary wages?
- c. Should the Employment Cost Index inflation rate be applied in setting such amounts?
- d. What allocation factor (actual or assumed) should be used to determine payroll?
- e. What level of experience should be used to set the labor expense associated with each employee?

Job Titles

Mr. Cox and Mr. Thomas' job titles for MERIC salary data should be 11-1011 Chief Executive – Experienced, and 11-1021 General and Operations Manager – Experienced, respectively.

Smaller water utilities, especially distressed small water utilities, are particularly difficult to permit, build, and operate. (Exh. 8, Thomas Reb., p. 7) In fact, based on the current state of small regulated utilities in Missouri, I think you could argue that small distressed regulated water utilities require more expertise and executive level skills than larger utilities because every employee needs to have expertise in multiple areas. (*Id.*)

OPC alleges that Mr. Cox' job title under MERIC should be "General and Operations Manager," rather than Chief Executive, as is utilized by Staff and the Company. The Commission has addressed this issue previously as to Mr. Cox. In Case No. WR-2016-0064, the Commission found and concluded that President (or Chief Executive within MERIC) was appropriate for Mr. Cox as follows:

> Hillcrest's parent company has already acquired three water and sewer systems and is planning to purchase more troubled systems, which will require the hiring of more employees to maintain the operations of Hillcrest and the other acquired utilities.
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> **
>
> The appropriate job titles to use in MERIC to determine labor expense for Mr. Cox and Mr. Chalfant are President and Chief Financial Officer, respectively. These are the titles presently used by Hillcrest to describe those two employees, and Staff's comparison of their job duties to MERIC found that these titles should continue to be used for ratemaking purposes. Since Hillcrest is part of a group of commonly-owned regulated utilities and has plans to acquire additional utilities, it is appropriate to assign employee titles similar to larger utilities rather than single utility companies.

In re Hillcrest Utility Operating Company, Inc., *Report and Order*, MoPSC Case No. WR-2016-0064, 14, 16 (July 12, 2016).

What has happened in regard to this family of companies since the issue of this Report and Order is consistent with the Commission' stated reasoning. Indian Hills parent First Round CSWR, LLC is also the ultimate parent of public utilities Hillcrest Utility Operating Company, Inc.; Raccoon Creek Utility Operating Company, Inc.; and, Elm Hills Utility Operating Company, Inc.; as well as, Confluence Rivers Utility Operating Company, Inc., which is currently an applicant to become a public utility.

Confluence Rivers Utility Operating Company, Inc. alone is attempting to acquire approximately fifteen water and wastewater systems, which contain four wastewater systems currently in state appointed receivership, one water system in receivership (with an active attorney general enforcement action), and two non-regulated wastewater systems in attorney general enforcement actions, to include one with a current building moratorium in the area it serves. (MoPSC Cases Nos. WM-2018-0116 and SM-2018-0117)

Mr. Thomas' main responsibilities include utility operations along with the acquisition, development, and rate stabilization of CSWR utilities. (Exh. 7, Thomas Dir., p. 3) These duties include operations, maintenance, capital planning, and regulatory compliance for all CSWR facilities. (*Id.*) He is responsible for the management of all operations and maintenance service providers, customer service and billing service providers, and engineering firms. (*Id.*)

The job title of General and Operations Manager on the other hand specifically references the management of operations.

> Occupational Employment and Wages, May 2016
>
> 11-1021 General and Operations Managers
>
> *Plan, direct, or coordinate the operations of public or private sector organizations*. Duties and responsibilities include formulating policies, managing daily operations, and planning the use of materials and human resources, but are too diverse and general in nature to be classified in any one functional area of management or administration, such as personnel, purchasing, or administrative services. Excludes First-Line Supervisors.

(Exh. 9, Thomas Sur., p. 4) Mr. Thomas' duties are consistent with that of the General and Operations Manager. (*Id.* at p. 5)

Allocated Total

Only an allocated portion of the salaries discussed above is assigned to Indian Hills. An allocated total of $56,705, should be included in Indian Hills' revenue requirement for salaries. (*See Reconciliation* (filed November 17, 2017)

MERIC Data

The most currently available MERIC data (MERIC 2016) should be used for all employees, with adjustment for the consumer price index to reflect current trends.

Staff used 2013 employment wages for the President and Customer Service Manager, while 2015 employment wages were used for the four remaining employees. Consistent, reliable and accurate results require the use of a consistent analytical methodology. (Exh. 5NP, Macias Reb., p. 10) In addition to using different data years, Staff used out-of-date data for all employees. (*Id.*) The fundamental purpose for the MERIC is to continuously research and assess labor market conditions to provide policy makers and the public with accurate, up-to-date and useful information. (*Id.*) Staff witness Sarver states on page 5 of her Direct Testimony that the MERIC data used for the President and Customer Service Manager has been updated 3 times since 2013. (*Id.*) Data for each of the remaining positions has been updated once. (*Id.*)

MERIC studies occupational groups by region in Missouri bi-annually, using actual job responsibilities, using actual wages page to create a benchmark for experience and salary levels. (*Id.*) The most currently available (MERIC 2016) data should be used and it should be used uniformly for all employees. (*Id.*)

Allocation Method

Indian Hills has no employees. (Exh. 4, Macias Dir., p. 11) Several functions related to its operation are provided by six employees of Central States --, a financial manager, chief executive, operations manager, senior accountant, accountant and a customer service manager. (*Id.*) A portion of the costs associated with those employees is then allocated to Indian Hills. (*Id.*)

The Commission should use a “per customer” allocation, which would result in an 18% allocation of payroll for Indian Hills. A per customer basis is a more consistent measurement for the allocation of payroll than hours worked in regard to particular subsidiaries over the long term as hours worked for a particular subsidiary can vary by a greater amount than customer count. (*See* Tr. 198-199, Macias)

This per-customer allocation was derived as follows:

- During the test year, CSWR provided water service to 1,064 water customers (238 at Hillcrest, 725 at Indian Hills, 101 at Smithview) and CSWR had another 121 in the acquisition process associated with Elm Hills (the current water customers at Missouri Utilities), for a total of 1,185 water customers. During the test year CSWR provided sewer service to 736 sewer customers (237 at Hillcrest and 499 at Raccoon Creek) and CSWR had another 299 in the acquisition process associated with Elm Hills (the sewer customers at Missouri Utilities and State Park Village), for a total of 1,035 sewer customers. (Exh. 4, Macias Dir., p. 8)
- If Indian Hills only used the resulting 2,220 water and sewer customer count present in the test year, Indian Hills' customers would have amounted to 32.66% of the CSWR customer base. (Exh. 4, Macias Dir., p. 9)
- Thus, in order to account for its potential acquisitions, CSWR also included the potential water and sewer customers of Alpine Village (161 water and sewer PSC regulated system under contract), Confluence Rivers (the 727 water customers and 643 sewer customers that are the subject of Commission Cases Nos. WM-2018-0116 and SM-2018-0117; and 185 other sewer customers CSWR planned on acquiring. Of the 3,998 current and planned water and sewer customers, Indian Hills customers represent 18.13% of the customer base, and was rounded down to 18%. (*Id.*)

Staff's allocation model is designed around five basic steps/calculations with each step being used as input for subsequent calculations. (Exh. 6, Macias Sur., p. 7) Indian Hills witness Macias described in detail the disputes Indian Hills has with the "assumed" data used by Staff (Ignoring that additional required work at Indian Hills drove an increase in parent company staff) and the compounding errors contained in Staff's execution of its allocation methodology. (Exh. 6, Macias Sur., p. 7-11)

With its errors, Staff derived an allocation factor of 16.61%. (Exh. 6, Macias Sur., p. 12) The corrected rate (using Staff's model and actual recorded hours) is 17.52%, which is very close to the 18% used by Indian Hills. (*Id.*)

Experience Level

Within MERIC, an employee is either in the bottom one third for a given position or the upper two thirds for experience designation purposes. (Exh. 5NP, Macias Reb., p. 9) The CSWR employees providing services to Indian Hills should be identified as experienced for purposes of MERIC salary data.

The appropriate SOC codes and Titles for Indian Hills are:

11-1011 - Chief Executive – Experienced

11-3031 - Financial Manager – Experienced

11-1021 – General and Operations Manager – Experienced

11-9199 – Customer Service Manager - Experienced

The Financial Manager has a BS in Business Administration from St. Louis University and is a CPA; teaches colligate level accounting; worked inside one of the big four accounting firms; has worked on hundreds of millions of dollars of telecommunications infrastructure projects; has run a private accounting practice;

managed multiple types of federal government audits; managed third party audits on overseas foreign subsidiaries; managed audits by the governments of Mexico and China; and had to manage the materiality of internal financial reporting of not to exceed 0.01 cents on a $37MM budget. (Exh. 4, Macias Dir., p. 13)

Indian Hills Chief Executive has completed significant utility acquisition work, including evaluation of the existing utility assets for acquisition, determination of existing net book value of acquisition targets, engineering design/technology selection for new improvements, construction contractor selection, construction management (since 2015 Central States has completed approximately $6MM in new plant investment with an additional $1.5MM currently part of an approved acquisition case); and, been responsible for ongoing O&M management, including monitoring all plant remote operations and emergency responses, new utility rate design/pro-forma financial models, and overall companywide management across multiple states. (*Id*. at p. 13-14)

Indian Hills Senior Vice President (General and Operations Manager), is responsible for running the operations and some development, and was previously President of Brotcke Well and Pump (the 2nd largest well driller and service provider in the Midwest); Vice President of Operations and Business Development of the Midwest for American Water Contract Operations; and, General Manager of Midwest operations for Environmental Management Corporation. (*Id*. at p. 14) At one time, as an operations manager, he was responsible for the operations and maintenance of water and wastewater systems servicing 64,000 households across multiple states and systems. (*Id*.) He currently serves on the Technical Advisory Team for the Public Water Supply District 2 of St. Charles County, MO, the largest water district in MO. (*Id*.)

Indian Hills Customer Service Manager has over 30 years of director experience managing large financial institution offices and most recently managed the office of the largest drinking water well services company in Missouri before coming to Central States for the last two and a half years. (*Id.* at p. 14-15)

The Commission should find that salaries, for purposes of establishing the revenue requirement in this case, be adjusted to reflect MERIC "Experienced" employees for the St. Louis area.

4. **<u>Auditing and Tax Preparation Fees</u>**
   a. What is the appropriate amount of Indian Hill's auditing and tax preparation (accounting) costs to include in Indian Hill's cost of service?
   b. Should accounting costs paid outside the test year be included in Indian Hill's cost of service?

The Commission should order that Indian Hills' tax fees, Indian Hills' audit fees, and Indian Hills' corporate allocation of the actual audit and tax preparation fees of First Round CSWR, LLC and Central States Water Resources, Inc. be included in Indian Hills' revenue requirement. (Exh. 5NP, Macias Reb., p. 6) These expenses are known, measurable, and part of best practices for a utility company. (*Id.*)

One of the major problems facing failing water and sewer companies is a lack of professional management and attention to regulatory and statutory compliance. (Exh. 1NP, Cox Dir., p. 23) The former owner of these systems did not correctly file tax forms (resulting in federal tax liens at the time of acquisition), nor did they develop and maintain accurate financial records. (*Id.*) Further, every major government funding source for water and wastewater improvements (and in some cases, private funding sources) require audited financials. (*Id.*) These government funding groups include USDA Rural Development, The Missouri Clean Water State Revolving Fund, and

Missouri Community Development Block Grants. (*Id.*) In addition, CSWR has had recent experience where it was denied equipment financing based on a lack of audited financials for the target utility. (*Id.*) Tax preparation and audit fees are a normal course of business for a professionally managed utility. (*Id.* at p. 24) This is particularly important for a utility, or group of utilities, that is actively engaged in attempting to raise capital. (*Id.*)

The Company issued requests for proposals (RFP) and circulated those RFP's to a variety of accountants and accounting firms in order to determine the least expensive qualified firm for rate making purposes. (Exh. 1NP, Cox Dir., p. 23) The lowest priced bid was selected. (*Id.*)

OPC witness Roth suggests that the audit and tax issue was determined by the Commission in the Hillcrest case (Case No. WR-2016-0064). However, the issue at that time was "estimated" costs. (Tr. 228, Roth) In this case, there are invoices associated with the audit and tax preparation fees and the invoices have been paid (while not paid prior to March 31, 2017, they were paid in 2017). (*Id.*)

The 2016 Financial Audit and the 2016 Income Tax Returns are an integral component of the 2016 Indian Hills financial year, tax year, and test year. (Exh. 6, Macias Sur., p. 6) The audit and tax expenses are for the test year, the expense is known, measurable, and recurring, thus they should be part of Indian Hill's revenue requirement. (Id.) Costs related to the preparation of those items should be included in Indian Hills' revenue requirement at the level identified by Staff witness Sarver (Exh. 112, Sarver Sur., p. 4). (*Id.*)

5. **<u>Management Consulting Fees</u>**
   a. Should a management consulting fee be included in the cost of service for Indian Hills?

The "management consulting fees" in question are amounts paid pursuant to contract by Indian Hills to Lois Stanley, the previous Owner of I.H. Utilities. (Exh. 2NP, Cox Reb., p. 17) Indian Hills has a contract with Ms. Stanley requiring payment of $500 per month to her in exchange for her consultation on an as-needed basis. (*Id.*; Exh. 3, Cox Sur., p. 3)

The Indian Hills system is approximately 50 years old and there are no known engineering plans or system mapping showing the location and type of infrastructure services the Indian Hills community or how the original system operated. (Exh. 2NP, Cox Reb., p. 18) Moreover, there are no tracer wires that aid in location. (Tr. 238, Cox) In the absence of such information, and Ms. Stanley's input, Indian Hills must dig up lines or "pothole" to find mains. (*Id.*)

Ms. Stanley has been utilized to help locate elements of the water system that were not documented in drawings or plans, clarify existing connection points, and to explain the system-specific nuances of operating the 50-year-old system that she developed as a result of her owning the system. (Exh. 2NP, Cox Reb., p. 18) This includes where lines would be and where specific improvements would be, such as connections and cross corrections. (Tr. 232, Cox)

Because the payments are a fixed fee, time sheets are not kept. (Exh. 3, Cox Sur., p. 3; Tr. 231, Cox) The primary persons that interact with Ms. Stanley are Indian Hills' engineering firm and its operation and maintenance company. (Tr. 232, 237, Cox)

An example of where Ms. Stanley has been helpful was the avoidance of the installation of some isolation valves, and certain capital investment, in the system because of Ms. Stanley's identification of the location of some existing valves that had been buried prior to Indian Hills' ownership. (Tr. 233, Cox) Additionally, has been specifically helpful with the size of lines in certain locations (line sizes vary so randomly that there is no logic to it) and to locate lines in areas where they would not be expected to exist. (Tr. 238, Cox)

OPC suggested that Missouri One Call could do line locates for Indian Hills. (Tr. 245-246, Roth) This is not the function of Missouri One Call. In fact, Indian Hills must locate its own lines for Missouri One Call as it requires each utility to locate its own lines. (Tr. 236, Cox)

The Company plans to continue to utilize Ms. Stanley as an aid in locating lines where work will be required. Because there are over 16 miles of water main in the Indian Hills system, even at the end of 3 years, Indian Hills will still have areas that have yet to be worked on. (Exh. 2NP, Cox Reb., p. 18)

6. **<u>Bank Fees</u>**
   a. What is the appropriate level of bank fees to include in the cost of service for Indian Hills?

The phrase "bank analysis fee" is a (banking) industry term for what is essentially an invoice detailing the charges incurred during the month. (Exh. 5NP, Macias Reb., p. 11) For Indian Hills, the largest portion of the monthly bill is for lockbox services. (*Id.*; Tr. 250, Macias) The Company maintains "lockbox" accounts at Enterprise Bank and Trust. (*Id.*) The bank analysis fees included by the Staff for rate making purposes are $4,932 or $411 per month. (*Id.*)

A lockbox account is a commonly used business and banking service where the bank directly receives payments from a company's customers and records the cash receipts on behalf of the company. (*Id.* at p. 12) In Indian Hills witness Macias' experience as an accountant; the use of such services is very common. (Tr. 252, Macias) The use of lockboxes has been a part of the Indian Hills, and all of its sister operating utilities, from the beginning of the business. (*Id.*)

There are several advantages to the lockbox: 1) by having payments sent directly to the Company's bank, the payments are processed much faster which increases the pace of cash flow; and, 2) banks typically employ ridged process controls which reduces the inherent risks associated with cash receipts. (*Id.*; Tr. 251-252, Macias) For example, in the month of September 2017, the lockbox for Indian Hills processed 449 transactions and the lockboxes for all CSWR companies processed 1,165 transactions. (*Id.* at p. 13) There were no errors in the deposits. (*Id.*) That level of accuracy has been our standard experience over the last 2.5 years of using this system. (*Id.*)

The lockbox is also a valuable to Indian Hills because it receives a high quantity of low dollar payments the processing of which is a time consuming and labor-intensive process. (*Id.* at p. 12) By contracting for only the exact amount of (labor related) expense required to complete this function, the Company avoids any additional costs not directly associated with servicing Indian Hills customers.[2] (*Id.*)

Staff has included the cost, in part, because it is the process the Company actually used for its payments process. (Tr. 254, Sarver) In the absence of allowing recovery of these fees, costs associated with a substitute method would need to

[2] While, as indicated, Indian Hills believes these fees are a net benefit for its customers, it has agreed to perform a cost benefit analysis of the bank services fees (both for the current provider and others) for Staff review. (Exh. 6, Macias Sur., p. 12; Tr. 249, Macias)

included in the revenue requirement – such as additional payroll for in-house personnel or alternate charges for a different bank. No such proposal has been made by the OPC. In fact, OPC witness Roth states that her concern is that the fees might be "excessive," she does not know what other banks would charge for the lockbox services. (Tr. 255, Roth)

The Commission should recognize the Company's lockbox fees (otherwise known as Bank Analysis Fees) in Indian Hills' revenue requirement as the level proposed by Staff.

7. **Rate Case Expense**
    a. What is the appropriate rate case expense to include in the cost of service for Indian Hills?

The Company is incurring rate case expense in order to bring matters before the Commission related to its investment in the water system. (Exh. 1NP, Cox Dir., p. 29) Those rate case expenses include payments made for attorneys fees, consultant fees, and expenses related to rate case process (such as those associated with customer notices). (*Id.*)

If the Commission does not issue an order consistent with the Non-Unanimous Stipulation, Indian Hills' rate case expenses, brought forward to a cut-off date at least one week after the filing of the post-hearing brief (and normalized over three years) should be included in the Company's revenue requirement. (Exh. 1NP, Cox Dir., p. 28-29)

A 50/50 sharing of Indian Hills expert witness fees is proposed by Staff. (Indian Hills would note that 50% of Mr. D'Ascendis' $295 per hour rate (or $147.50) would be substantially less than the $250 per hour OPC has paid its cost of money witness, Mr.

Gorman. (Tr. 550, Gorman) It would also be less than the $180 per hour OPC has paid Mr. Meyer. (Tr. 488, Meyer)

Lastly, to the extent a "Before and After" video produced by the Company may be raised as an issue (Exh. 111, Grisham Sur., p. 2), Indian Hills reiterates that it is not seeking rate recovery of that expense. (Tr. 259-260, Cox)

8. **<u>Treatment of Leak Repair Costs</u>**
    a. What are the appropriate accounts to book leak repair?
    b. What is the appropriate level of leak repair to include in the cost of service?

As described in the testimony of Indian Hills witness Thomas and Staff Witness Spratt, the existing Indian Hills water system has been in a significant state of disrepair due to a lack of re-investment and substandard construction over the last 50 years. (Exh. 105, Spratt, p. 1-4; Exh. 7, Thomas Dir., p. 4-6).

The past use of water service connection pipe that is low pressure plastic pipe typically utilized in lawn irrigation systems is a prime example. (Exh. 8, Thomas Reb., p. 8-9) Now that Indian Hills has completed the system upgrades to bring the pressure of the system up to regulatory drinking water safety standards, the connection pipe is further stressed. (*Id.*) The extra water pressure is also moving mains without proper bedding, sometimes on bedrock, causing leaks. (*Id.*) When Indian Hills began work on water system upgrades to address MDNR regulatory requirements for minimum pressure, water availability, and service stability more repair issues immediately began to arise. (*Id.*) These larger ongoing maintenance and repair issues are the direct result of aging infrastructure, made from substandard materials, originally installed without basic best practices, lacking rudimentary water hydraulic design uniformity, being forced to convey higher volumes of water at higher pressures. (*Id.*)

Repairs on the systems, even will additional investment in replacement of mains and services, will be a continuing expense. (Exh. 6, Macias Sur., p. 2-3) As such, they are part of Indian Hills' on-going operational requirement to provide safe, reliable service, and should be reflected in the Company's revenue requirement. (*Id.*) For example, while the test year amount of leak expense is $99,303, if maintenance and repair expenses included in the revenue requirement were updated to reflect actual expenses from the current year (12 months ended September 2017), which more fully covers the period when the new plant additions were in operation (higher pressure was not in place until November of 2016), they would total $189,300. (Exh. 5NP, Macias Reb., p. 3; Exh. 4, Macias Dir., Sch. PM-1; Exh. 7, Thomas Dir., p. 6)

OPC on the other hand wants to use a number that is less than that found in the test year. (Tr. 355, Robinett) This is based upon OPC witness Robinett's assumption as to what will happen in the future. (*Id.*)

Mr. Robinett along with Ms. Grisham state that the leaks should not be expensed because they believe it is more prudent to replace service connections versus repairing leaking service connections. (Exh. 9, Thomas Sur., p. 5) This is not a practical solution. At Indian Hills there have been approximately 300 leaks in the past 12 months. (Exh. 9, Thomas Sur., p. 6) With this frequency of leaks, it is impractical to believe that the vast majority of leaks could be addressed by replacing the service without causing a delay of repairs and impacting customer service as it takes approximately 3 to 4 times as long to replace a service than it does to repair a leak. (*Id.*) This is because with a repair the Company is cutting out a replacing only that section of line that has the leak. (Tr. 316, Thomas) When the Company refers to a "replacement" of a service line, it is referring to replacing the line all the way from the main to the meter. (*Id.*) If a replacement-only approach was to be implemented, this would extend the delays significantly. (Exh. 9, Thomas Sur., p. 6)

The leaks that are occurring also include main leaks. (*Id.*) A replacement approach on mains is also highly impractical because a full replacement approach would require the crew to spend 9 to 10 times the amount of time it would take to complete a repair. (*Id.*) This is possible at times as we have demonstrated in the past, but at the current frequency of leaks, completing a full replacement would delay the speed at which most leaks would be repaired and create additional dissatisfaction on the part of the residents with leaks that are impacted by the delay. (*Id.*)

Given that there are over 700 customers receiving service from the Indian Hills water system, and that over 200 of the approximately 300 repairs have taken place since the new booster station came on line and they are continuing at an average of 6 per week, it is expected that the leaks will continue for many years until all the water service connections are replaced and the water mains begin being replaced. (Exh. 8, Thomas Reb., p. 9)

The repair costs at Indian Hills were incurred inside the test year, they are known, measurable and, as the NARUC USOA states, the expenses clearly qualify as "Work performed specifically for the purpose of preventing failure, restoring serviceability, or maintaining the life of the water systems." (Exh. 6, Macias Sur., p. 3-4) In addition, the repair costs are going to be reoccurring. (*Id.*) Amortization is inappropriate. (*Id.*)

The Commission should include $99,303 in Indian Hills' revenue requirement for leak repair costs and reject the proposal to amortize past costs. (*Id.*)

9. <u>Extension of Electric Service</u>

a. Should the Company be able to capitalize the electric line extension?
b. If so, what are the appropriate accounts to book the extension of electric line service?

This issue concerns the installation of equipment to provide a three-phase power connection that was required for the industrial electrical and pumping equipment used in the Indian Hills system. (Exh. 8, Thomas Reb., p. 15) Pursuant to its agreement with the Crawford Electrical Cooperative, Indian Hills was required to make "a non-fundable payment in the sum of $23,000 on account of the cost of facilities required to make service available to the Consumer on or before commencement of construction of such facilities." (*Id.* at p. 16) Payment of this amount was made to Crawford Electric Cooperative on May 17, 2016. (*Id.*)

Without this electrical improvement/construction, a phase-a-matic converter would have been required at Indian Hills. (*Id.*) A phase-a-matic converter would be an additional cost, is unreliable, susceptible to power surges, lowers equipment life spans, and would increases operations and maintenance costs at Indian Hill resulting in higher customer rates. (*Id.*)

OPC argues that this expenditure may not be included in Indian Hills plant accounts because Indian Hills does not own the lines themselves and must be expenses (albeit, utilizing a five year amortization). However, Indian Hills need not own those lines from an accounting perspective. (Tr. 362-363, Macias) The electric service extension was a reasonable and necessary expenditure related to a larger project – the building of the new well, booster pumps, ground storage and well house. (*Id.*; Exh. 6, Macias Sur., p. 4)

The total cost of any investment in capital equipment properly includes any of a number of other associated expenditures such as the cost of delivery, of labor expenses related to set-up, installation, testing & evaluation prior to placing the equipment in service, taxes, certain employee benefits, certain insurance costs and any additional special services and/or construction specifically related to the asset(s) and which are a functional necessity – i.e., required to ensure the equipment can operate and operate properly. (Exh. 6, Macias Sur., p. 5) The expense was absolutely necessary to place the remainder of the equipment and make it used and useful. Without that cost, there would be no point in installing the rest of the plant. (Tr. 363-364, Macias)

Both GAAP and the NARUC USOA allow Account 325 of the USOA to capture the cost of electrical pumping equipment, including installation. (*Id.*) This includes the electrical facilities needed to bring power to the equipment, whether owned by Indian Hills or not. (*Id.*) The initial service fee paid to Crawford County Electrical Cooperative was nonrefundable, was required for a permanent improvement to the water system, and was an ordinary and necessary cost directly associated with the building of the new well, booster pumps, ground storage, and well house. (*Id.*) The electrical equipment associated with Indian Hills falls within the scope of USOA Account 325. (*Id.*) Accordingly, this electrical line improvement should also be appropriately recorded in Account 325, as Staff Witness Grisham also recommends. (*Id.*)

10. Rate Design

a. How should rates be developed based on the cost of service approved in this case?
b. Should a seasonal rate design be adopted in this case, and if so, what should be the structure of the seasonal and non-seasonal rates?

Indian Hills agrees with the Staff that OPC's rate design, which has a different customer base charge based on seasonality, does not effectively provide an opportunity for Indian Hills to recover whatever revenue requirement may be ordered in this case. (Exh. 3, Cox Sur., p. 3)

Indian Hills instead recommends that the water commodity charge be higher during the lake recreation season (*Id.* at p. 4) - the period April 1st through September 30th. (*Id.* at p. 5) This is similar to the "recreational season" used by the Missouri Department of Natural Resources (MDNR) uses in the context of Water Quality. (10 CSR 20-7.031- Table A) (*Id.*)

The lake recreation season is when second home owners are most often present and thus the drinking water system is running at the MDNR mandated design peak to accommodate the additional demand generated by most to all existing homeowners being present simultaneously. (*Id.* at p. 4) There is a variation in occupancy and seasonal water use by Indian Hills ratepayers that causes the entire drinking water system to run at its design peak in the summer associated with second homes during seasonal recreational lake use. (*Id.*)

Because the system must be constructed to provide service during peak usage times, a rate design with higher commodity charge during the peak usage season would more efficiently pass costs to customers based on system utilization. (*Id.*) This type of rate design, in conjunction with a standard monthly base charge, if properly implemented, would provide that users of the system, whether they are full time residents or second home owners, are proportionally bearing the ongoing costs associated with the provision of water service to the entire community year-round. (*Id.*) In addition, a seasonally adjusted commodity charge would allocate more costs to users who participate in the peak demand consumption that drives the total system MDNR design requirements. (*Id.*)

11. <u>Rate of Return</u>

a. What capital structure should be used for determining rate of return?
b. What cost of debt should be used for determining rate of return?
c. What return on common equity should be used for determining rate of return?

Capital Structure

The Commission should use the actual capital structure consisting of 21.2% equity and 78.8% debt. (Exh. 1NP, Cox Dir., p. 24-28)

Use of the actual capital structure is important. A potential investor should have confidence that the actual capital structure required to fix failing water and sewer utilities will be recognized for rate making purposes. (Exh. 1NP, Cox Reb., p. 28) This is especially true for systems that are out of regulatory compliance and carrying higher commercial liability risks with lower equity bases. (*Id.*) The capital structure Indian Hills is utilizing is the only structure that could be found. (*Id.*) Moreover, this is the same structure Indian Hills presented to Commission in its acquisition and financing application. (*Id.*)

OPC witness Gorman proposes a hypothetical capital structure consisting of 50% debt and 50% equity. (Exh. 213, Gorman Dir., p. 3) This is a capital structure that is not available to Indian Hills. (Exh. 2NP, Cox Reb., p. 16) Mr. Gorman utilizes Dayton Power and Light, which is over 4,400 times larger than Indian Hills pre-investment, for his debt rate proposal. (*Id.*) However, he then ignores Dayton Power and Light's existing capital structure (which is 67.73% debt to 32.27% equity), instead applying a 50%/50% structure to Indian Hills as a target. (*Id.*)

The hypothetical capital structure recommended by Staff witness Gorman is based on the faulty premise that Indian Hills is or could be traditionally financed. (Exh. 11, D'Ascendis Reb., p. 4) As discussed in detail in the direct testimonies of Indian Hills witnesses Cox and Thaman, the operations of Indian Hills cannot be traditionally financed.[3] (*Id.* at p. 5)

When presented with this issue previously, in a *Report and Order* in Case No. WR-2016-0064, issued on July 12, 2016, this Commission authorized the actual capital structure of Hillcrest Utility Operating Company, Inc., which consisted of 81.00% long-term debt and 19.00% common equity. The Commission stated:

> The Commission concludes that in calculating Hillcrest's cost of capital and cost of debt, the appropriate capital structure to use is the actual capital structure of Hillcrest as of September 2015, which was 19% equity and 81% debt.

(Exh. 10, D'Ascendis Dir., p. 5; Exh. 11, D'Ascendis Reb., p. 5)

Indian Hills witness D'Ascendis showed that two scenarios presented by Staff witness Barnes provide very little return for Indian Hills' equity investors and two scenarios do not even cover the Company's debt service. (Exh. 11, D'Ascendis Reb., p. 2-3) Mr. D'Ascendis' recommendation, however, satisfies the Company's debt service and also provides an adequate return on equity commensurate with the risk of the Company's operations. (*Id.*)

[3] Cox Direct Testimony, at 24-28. Thaman Direct Testimony, at 4-5.

The capital structure identified by Indian Hills is derived by dividing the net book value of Indian Hills from the Staff's EMS run ($1,837,997, outside of AFUDC), into the principal on long term debt ($1,450,000). (Id. at p. 27; Exh. 3, Cox Sur., p. 2) This produces the 78.8% debt percentage. The balance is assumed to be equity.

OPC witness Gorman suggests that the actual capital structure consists of 2.8% equity and 97.2% debt. (Exh. 214, Gorman Reb., p. 3) Mr. Gorman suggests that these numbers are based on Indian Hills audited financials. However, he ignores the $2,114,937 in Property, Plant, and Equipment carried in the audited financials. (Exh. 3, Cox Sur., p. 2) Mr. Gorman instead uses the total capitalization inside the financial audit of $45,748 and the long term note inside the current liabilities section of the audit of $1,609,551, for a total plant in service of $1,655,748. (*Id.*) OPC's own witness Keri Roth identifies a greater plant in service of $1,793,334. (*Id.*) Mr. Gorman ignores the Property, Plant, and Equipment carried in the Indian Hills audited financials and OPC witness Roth's plant in service number to produce his "actual" capital structure. (*Id.*)

Indian Hills witness D'Ascendis also points out that Indian Hills' 2016 annual report to the Commission a common equity balance of $234,560 was reported, which is significantly different from the common equity balance reported by Mr. Gorman. (Exh. 12, D'Ascendis Sur., p. 4)

The Commission should use the actual capital structure consisting of 21.2% equity and 78.8% debt

Debt

A long-term debt cost rate of 14.00% is reasonable and appropriate as it is the actual cost of the Company's long-term debt outstanding. (Exh. 11, D'Ascendis Reb., p.

7) The operations of small water utilities like Indian Hills cannot attract traditional financing from commercial lenders. (*Id.*)

Indian Hills entered into the financing agreement approved by the Commission in Case No. WO-2016-0045, on February 3, 2016. At that point in time, Indian Hills was projected to need $1.84 million, in a very short time frame, to bring it into compliance. (Exh. 2NP, Cox Reb., p. 5) Indian Hills ultimately borrowed the principal amount of $1.45 million and invested those funds in Indian Hills by making over 1.8 million of improvements to the system. (Exh. 2NP, Cox Reb., p. 20)

Staff determined that Indian Hills had a net book value of $43,966 at the time of Indian Hills's acquisition case. (Exh. 2NP, Cox Reb., p. 4-5) Indian Hills' net book value versus dollars required to bring the system into Missouri Department of Natural Resources ("MDNR") compliance represented a 2.5% equity basis. (*Id.*) The actual basis would have been even less as that net book value did not take into account the tax liens against I.H. Utilities (the prior owner) that existed prior to closing. (*Id.*) If the existing $43,357.37 in tax liens were counted against the utility assets, the net book value would be $609, or 0.03%, on an equity basis versus the improvements required. (*Id.*) Moreover, the annual reports filed by the previous owner suggest that it had an Earnings Before Interest, Tax, and Amortization of less than $32,000 annually on $93,940 of revenue. (*Id.*) The utility represented a significant commercial liability with existing tax liens, MDNR compliance issues, on-going and past drinking water violations, and an actual public health risk (a lack of minimum system pressure and corresponding boil water notice allowing residents to be potentially exposed to drinking water contaminants). (*Id.*)

These difficulties for a small water system do not stop with acquisition. Indian Hills began construction on the improvements that are the subject of this case in April of 2016. (Exh. 2NP, Cox Reb., p. 6) The direct costs of operating the Indian Hills system has resulted in a cash loss, outside of any overhead allocations, of $371,611.66, since 2016. (*Id.*) Indian Hills witness Cox estimates, based on experience and statutory guidelines, that small, distressed utilities take 3-4 four months of engineering and permitting with MDNR, and 5-6 months of construction. (*Id.*) The small rate case format has a target of 11 months from filing to new rates. (*Id.*) This means that from initial expenditures on engineering for MDNR permitting, through construction, then through a rate case, a small distressed water and sewer company can expect to lose money on professional operations and pay for major capital improvements (in Indian Hills's case capital costs are over 40x of existing net book value) for 17-21 months before any cash flow stabilization. (*Id.*)

The regulatory lag associated with Indian Hills' third party outside professional certified drinking water operations, critical equipment maintenance, and drinking water infrastructure repairs through the end of September 2017, is 8.5x the rate base of Indian Hills at the time of acquisition. (*Id.*) If corporate allocations were applied, this cash loss would be even higher. (*Id.*) Asking a bank to loan money to a water company with significant MDNR drinking water safety/reliability issues, existing tax liens, that will lose the cash equivalent of 8.5 times the existing balance sheet (cash losses that are unrecoverable on a dollar for dollar basis due to regulatory lag), needs investment capital worth 40 times the existing balance sheet, and isn't going to have new cash flow for over 1.5 years from the first potential bank loan distribution, without any guarantee that financing will be recognized in rates until that future rate case is extremely difficult. (*Id.*) Indian Hills supplied an example of communication from an experienced water and wastewater lender that outlined these problems. (Exh. 2C, Cox Reb., Schedule JC-1R-C)

Indian Hills witness Thaman, who has represented more than 100 client companies in raising debt and/or equity financing in both local and national markets, testified that "financing for distressed public utilities such as Indian Hills is very difficult to source." (Exh. 13, Thaman Dir., p. 4; Exh. 14, Thaman Reb., p. 7) The few sources that may be available would be specialized infrastructure venture investors, high-net-worth private investors, opportunistic specialty-situation financing firms, and similar high-risk investors. (Exh. 13, Thaman Dir., p. 4)

"Lenders to companies with risk profiles similar to that of Indian Hills could expect returns in the range of fifteen (15%) to twenty-one percent (21%) for such loans." (Exh. 13, Thaman Dir., p. 2, 5) Based on the risk profile of Indian Hills and the very few alternatives available for financing, Mr. Thaman testified that the fourteen percent (14%) inertest rate associated with Indian Hill's financing is reasonable. (*Id.* at p. 5)

Staff also utilized a debt cost of 14% for its calculations in the case, a position it believed it could support by fact. (Exh. 100, Dietrich Dir., p. 4)

OPC witness Gorman recommended a cost of debt of 6.75%. Mr. Gorman stated that he investigated the current cost of debt for a "below investment grade utility company." (Exh. 213, Gorman Dir., p. 4) The term "below investment grade" indicates that the utility does have a bond rating from one or both of S&P and Moody's. (Exh. 14, Thaman Reb., p. 2) It is not possible for a very small and distressed utility such as Indian Hills to achieve a rating of any kind from either of these institutions. (*Id.*)

The "below investment grade utility company" Mr. Gorman chose his hypothetical analysis for Indian Hills' cost of debt was Dayton Power and Light ("DPL"), a subsidiary of AES Corp. (Exh. 213, Gorman Dir., p. 4) First, significantly, Mr. Gorman selected DPL because it was the "*one below investment grade utility that recently issued bonds*." (*Id.*) In other words, this was the ONLY example of a "below investment grade" bond issuance he found. He did not have others to choose from.

More significantly, DPL bears no resemblance to Indian Hills:

Measure	DPL	Indian Hills	Times Smaller
Service Provided	Electric	Water	
Customers	519,000	715	725.87
Service Area	6,000 mi	6.5 mi	923.08
Assets	$1,935,316,257	$2,225,816[4]	869.49
Revenues	$1,346,554,101	$73,120	18,415.67
2016 Actual Capital Structure	67.73% debt, 32.26% equity	87.46% debt, 12.53% equity	
Debt Issue (Size)	$200,000,000	$1,450,000	137.93
Debt Issue (Coupon Rate)	6.75%	14.00%	

(Exh. 11, D'Ascendis Reb., p. 6)

DPL is several magnitudes larger, significantly less leveraged, and operates in a different industry than Indian Hills. (*Id.*) Further, DPL is owned by AES, a company that manages $36 Billion dollars of assets. (Exh. 2NP, Cox Reb., p. 15-16) Therefore, there is no applicability of DPL's marginal cost of debt to Indian Hills' marginal cost of debt. (Exh. 11, D'Ascendis Reb., p. 6)

[4] After construction was completed, but not at the time of financing.

OPC raises in testimony and statement of position the fact that the financing agreement involves affiliate relationships “raising the risk of self-dealing.” While Indian Hills agrees that this is a fact that the Commission should be aware of, it is not per se imprudent or a prohibition to financing (note Missouri-American Water Company’s long time use of American Water Capital Corp.). The question is whether the rate is reasonable, given the circumstances. Here, evidence of those circumstances has been provided and expert testimony from Mr. D’Ascendis and Mr. Thaman states that the rate is reasonable. Further, no witness was aware of any lender actually offering financing in this situation at a rate less than 14%.

OPC witness Meyer, who does not represent himself as having any experience working in the loan industry,[5] raised questions concerning Indian Hills debt application and the correspondence received by Indian Hills in regard to its applications. (Exh. 209, Meyer Dir., p. 10-12) Indian Hills witness Thaman stated that in his experience, he “found the Indian Hills bank application to be of high quality and very thorough such that, should a Lender be interested in considering a loan to Indian Hills and proceed with a review, . . . such Lender would be very impressed and pleased with the form, content, and thoroughness of the Indian Hills bank loan application.” (Exh. 14, Thaman Reb., p. 7) Mr. Thaman further explained (based upon his experience) that the bank rejections “were very typical responses.” (Exh. 14, Thaman Reb., p. 6)

Mr. Meyer also raised issues about intercompany transfers. (Exh. 209, Meyer Dir., p. 5-10) These transfers are necessary because the organization purchases distressed small utilities with very little existing revenue that must run at a cash until

[5] OPC Meyer also does not believe Indian Hills is a “distressed utility.” (Exh. 211, Meyer Sur., p. 5) This will be a surprise to OPC witness Gorman who describes Indian Hills as a “financially distressed utility” in both his Direct and Surrebuttal Testimony. (Exh. 213, Gorman Dir., p. 4-5; Exh. 216, Gorman Sur., p. 5)

rates can be raised to match investments and expenses. (Exh. 2NP. Cox Reb., p. 9) In addition, required critical re-investment costs are lumpy even after rates have been raised. (*Id.*) For example, Hillcrest invested approximately $70,000 in January of this year to replace 65 original system failing meters after only having 3.5 months of rate stabilized revenue (this rate case was also still under appeal by the OPC at that time). (*Id.*) This investment required an cash infusion (intercompany transfer). (*Id.*)

Mr. Meyer's analysis of CSWR's intercompany cash transfers further demonstrates why bank financing is so difficult to obtain for small distressed utilities as existing utilities' revenues are not sufficient to support routine professional operations. (Exh. 2NP. Cox Reb., p. 9-10) Even once rates are raised, capital investments required are lumpy. (*Id.*)

Almost as an afterthought, in his Surrebuttal Testimony, OPC witness Meyer attached a Schedule (GRM-SUR-2) he stated was prepared by a different person (Charles Hyneman) for a different case, which he represented contained debt rates from small water/sewer utility rate cases from the last five years. (Exh. 211, Meyer Sur., p. 6-7) This list is very misleading for many reasons.

First, all the case numbers cited are rate cases. Any true utility debt should have had a financing case. If there is no financing case, that would tell you it is not utility debt.

Second, when you look at each one of those situations in detail, you find they are not comparable. Indian Hills witness Cox was able to prepare a spreadsheet that provided detailed information about each of the matters identified by OPC witness Meyer. (Tr. 472-473, Cox; Exh. 15) Mr. Cox was able to do this because over the past three years he had talked to almost all of the utilities represented on that list, toured many of the facilities, and investigated costs of construction. (Tr. 470, 473, Cox) Further, he examined annual reports for the companies listed. (Tr. 473, Cox)

He found that listed debts are not comparable for a variety of reasons. Either the debt is much smaller than the $1,450,000 issuance for Indian Hills (some of the listed debt is as small as $95,000; $75,000; $43,000; $25,000; $21,000, and $12,000), they are not in compliance and unable to borrow necessary money for the repairs (several are the subject of compliance or enforcement actions), utilize non-utility assets as collateral, or do not truly have utility debt because the money does not represent institutional lenders. (Tr. 467-470, Cox)

At least one listed company did not even have debt. Rogue Creek was in receivership at the time of the listed rate case. (Tr. 468-469, Cox) Rogue Creek's receiver confirmed it had no debt and could not get debt. (Id.)

Gladlo Water & Sewer Company is another utility on the list that is in receivership. (Tr. 469, Cox) The debt listed ($12,272) is "contractor debt." (*Id.*) That is, it is owed to a pump contractor because the company does not have enough money to pay for its pump installation. (*Id.*) Gladlo is one of the companies that is under contract to be purchased by Confluence Rivers. (*Id.*)

Others on the list are not comparable for other reasons. For example, Raytown Water Company, which has annual water revenues of $4,023,423. (Tr. 476, Cox) Lake Region had annual combined water and sewer reviews of approximately $930,000. (*Id.*) The current annual revenues for Indian Hills are about $92,000. (Tr. 477, Cox)

When pressed for the name of any financing institution OPC witness Meyer thought might be prepared to provide financing to Indian Hills at a rate lower than 14%, the only name Mr. Meyer came up with was First State Community Bank. (Tr. 489, Meyer) This was because Mr. Meyer thought there was a favorable response from a meeting he had.

Indian Hills is not a stranger to First State Community Bank. CSWR made nine bank applications for various projects since the financing for Indian Hills was completed. (Exh. 2NP, Cox Reb., p. 4) This includes a loan application inside the lending footprint of First State Community Bank. (*Id.*) That application was rejected. (*Id.* at p. 4, 15)

First State Community Bank is also one of the lenders listed on Ex. 15, along with Peoples Bank. Peoples Bank is another institution with which CSWR companies have placed loan applications and been rejected. (Tr. 475-476, 481-483, Cox; Exh. 2NP, Cox Reb., p. 15)

In fact, Indian Hills provided in Exhibits 16, 17 and 18 copies of its written communication with and, ultimately, rejection by, Peoples Bank. These documents show that the Bank even reached out to Jim Busch of the Commission Staff to learn more about the regulatory rate making process and after this exploration found the environment to not be to its liking and rejected the application. (Tr. 481-483, Cox; Exh. 17)

OPC witness Meyer's testimony suggests that bank financing would be available if Indian Hills only would be willing to offer more favorable terms. (Exh. 2NP, Cox Reb., p. 4) To date, no bank has been interested enough in a CSWR water or sewer utility project to discuss specific terms such as capital structure, interest reserves, etc. (*Id.*)

This is borne out by the previously provided correspondence with potential bank partners. (*Id.*)

Specifically as to capital structure, the organization has shown flexibility. (Tr. 426, Cox) The Peoples Bank transaction is an example of the flexibility as to capital structure that the organization showed in the loan process without success. Peoples Bank presented a spreadsheet with potential interest reserves, debt and equity ratios. (Tr. 426-427, 482-483, Cox) The Company agreed in principal to those terms if they were offered and, unfortunately, after the Bank further considered the deal, the loan application was rejected (Id.)

Another example of this is found in Exh. 238, a document concerning a proposed transaction between Enterprise Bank and Hillcrest Operating Utility, Inc. Mr. Cox states in written communication with the bank that CSWR is willing to be flexible as to the capital structure and invited the Bank to discuss any capital structure that would work for the Bank. (Tr. 439, Cox). However, no Bank proposal was made.

The 14% interest rate reflected in Indian Hills' existing financing agreement is the cost of debt that should be reflected in Indian Hills' revenue requirement.

Return on Equity

Indian Hills witness D'Ascendis assessed the market-based common equity cost rates of companies of relatively similar, but not necessarily identical, risk to Indian Hills. (Exh. 10, D'Ascendis Dir., p. 6) Because no proxy group can be identical in risk to any single company, he also evaluated relative risk between the Company and the proxy group to see if it is appropriate to make adjustments to the proxy group's indicated rate of return. (*Id.*)

Mr. D'Ascendis recommended a return on equity of 15.20% is appropriate given the size and risks associated with Indian Hills.

His recommendation results from the application of several cost of common equity models, specifically the Discounted Cash Flow ("DCF") model, the Risk Premium Model ("RPM"), and the Capital Asset Pricing Model ("CAPM"), to the market data of a proxy group of eight water companies ("Utility Proxy Group"). (Exh. 10, D'Ascendis Dir., p. 7) After analyzing the indicated common equity cost rates derived by these models, he concluded that a common equity cost rate of 10.35% for the Company is indicated before any Company-specific adjustments. (*Id.* at p. 7-8)

Mr. D'Ascendis then adjusted the indicated common equity cost rate upward by 2.49% and 2.38% to reflect Indian Hills' significantly greater financial risk and size risk relative to the Utility Proxy Group, respectively which resulted in a financial and size risk adjusted indicated common equity cost rate of 15.22%. (*Id.* at p. 8) After rounding down to the nearest five basis points, 15.20% he reached his recommendation. (*Id.*)

In their testimony, Staff and OPC both recommended a return on equity of 9.34%. Mr. D'Ascendis observed that the 9.34% cited by Staff and OPC is lower than the mid-point range of 9.625% cited by this Commission in regard to Missouri-American Water Company's last rate case (Case No. WR-2015-0301). (Exh. 11, D'Ascendis Reb., p. 9) Moreover, in Cases Nos. GR-2017-0215 and GR-2017-0216, Staff recommended a range of ROEs between 9.00% and 9.50% for Spire Missouri, an A rated public utility. (Exh. 12, D'Ascendis Sur., p. 4) Recommending an ROE of 9.34% for a highly leveraged, small water utility that is not rated is not consistent with the risk that Indian

Hills' investors face compared to what a larger, more financially viable utility like Spire faces. (*Id.*)

The Commission should adopt Indian Hills recommended return on equity of 15.20%, which is based on the market data of a proxy group of publicly-traded water utilities, adjusted for Indian Hills' unique risks relative to the proxy group. The common equity cost rate reflect Indian Hills' significant investment risk compared to the Utility Proxy Group, due to its necessary, significant investment in the water system after its acquisition on March 31, 2016 to get the system into environmental compliance, and its extremely small size relative to the Utility Proxy Group. (Exh. 11, D'Ascendis Reb., p. 10)

WHEREFORE, Indian Hills respectfully requests that the Commission consider this Brief and, thereafter, issue such orders as it shall find to be reasonable and just.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned certifies that a true and correct copy of the foregoing document was sent by electronic mail on January 4, 2018, to the following:

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