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Rate of Return
Hyneman/Rebuttal
Public Counsel
SR-2016-0202

REBUTTAL TESTIMONY

OF

CHARLES R. HYNEMAN

Submitted on Behalf of the Office of the Public Counsel

**RACCOON CREEK UTILITY
OPERATING COMPANY INC.**

CASE NO. SR-2016-0202

October 13, 2016

In the Matter of the Application)
of a Rate Increase for Raccoon Creek) Case No. SR-2016-0202
Utility Operating Company Inc.)

STATE OF MISSOURI)
) SS
COUNTY OF COLE)

3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

A circular notary seal for the State of Missouri. The outer ring contains the text "NOTARY PUBLIC" at the top and "STATE OF MISSOURI" at the bottom, separated by small stars. The center of the seal contains the words "NOTARY" and "SEAL" stacked vertically.

My Commission expires August 23, 2017.

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REBUTTAL TESTIMONY
OF
CHARLES R. HYNEMAN
RACCOON CREEK UTILITY OPERATING COMPANY, INC.
CASE NO. SR-2016-0202

1 **Q. Please state your name and business address.**

2 A. My name is Charles R. Hyneman. My business address is PO Box 2230, Jefferson City,
3 Missouri 65102.

4 **Q. By whom are you employed and in what capacity?**

5 A. I am employed by the Missouri Office of the Public Counsel ("OPC") as Chief Public
6 Utility Accountant.

7 **Q. What is the purpose of your rebuttal testimony?**

8 A. My testimony addresses OPC's position on Raccoon Creek Utility Operating' Company's
9 ("RCUOC", "Raccoon Creek" or "Company") appropriate cost of debt to incorporate as a
10 component of its capital costs in determining the Company's revenue requirement in this
11 rate case. I also address the return on equity testimony of Company witness Dylan
12 D'Ascendis and discuss OPC's support of the Public Service Commission Staff's ("Staff")
13 recommended cost of equity. Finally I express OPC's concern about the Staff's unsupported
14 change in position on its recommended cost of debt for Raccoon Creek in this rate case.

15 Staff, without analysis or support, increased its cost of debt rate in this rate case from 8.15%
16 to 14%. Moreover, this Staff position abandons the very solid work performed by Staff's
17 Financial Analysis Department just a few months ago in the Hillcrest Utility Operating
18 Company ("Hillcrest") rate case No. WR-2016-0064 as well as analysis they presented in
19 publicly-filed documents in this current case.

20 Staff, in this case, has failed to support material ratemaking positions in its direct testimony.
21 Staff has also refused to meet with OPC to discuss Staff's direct testimony or to clarify

1 questions OPC had in regards to Staff's evidence. Finally, Staff has failed to provide data to
2 support its changed cost of debt position in this rate case by making the claim that all
3 documents surrounding this changed position on a standard rate case ratemaking issue are
4 privileged under the attorney-client relationship even though this Staff position was included
5 documents filed publicly.

6 **EDUCATION AND EXPERIENCE**

7 **Q. Please describe your educational background.**

8 A. I earned an MBA from the University of Missouri - Columbia and a Bachelor of Science
9 degree, *cum laude*, in Accounting and Business Administration from Indiana State
10 University at Terre Haute. I have also earned an AAS in Contracts Management from the
11 Community College of the Air Force, Wright-Patterson Air Force Base Ohio.

12 **Q. Please summarize your professional experience in the field of utility regulation.**

13 My professional experience as an auditor began in 1993 when I was employed by the
14 Missouri Public Service Commission ("Commission") as part of the audit division of Staff's
15 Accounting department. As a member of the Staff from 1993 to 2015, I participated in rate
16 cases and other regulatory proceedings involving all major electric, gas, and water utilities
17 operating in the state of Missouri. I also held various positions including Audit Manager of
18 the Commission's Kansas City Auditing Office. I left the Commission Staff in December
19 2015, holding the position of Regulatory Auditor V, the Staff's senior level auditing
20 position.

21 **Q. Are you a Certified Public Accountant ("CPA") licensed in the state of Missouri?**

22 A. Yes. I hold a CPA license in the state of Missouri. I am also a member of the American
23 Institute of Certified Public Accountants ("AICPA"). The AICPA is an organization that
24 represents the CPA profession nationally regarding rule-making and standard-setting. The

AICPA established accountancy as a profession and developed its educational requirements, professional standards, code of professional ethics, licensing status, and its commitment to serve the public interest.

Q. Please summarize your rebuttal testimony.

A. In this testimony, I explain OPC's support for the Staff's original filed position of an 8.15% debt cost rate for Raccoon Creek. I also explain that, contrary to its initial position, sometime during the period between August 30, 2016 and September 30, 2016, Staff's proposed cost of debt rate in this rate case increased from 8.15% to 14%. In effect, the Staff abandoned its long-held position that the Company's 14% cost of debt rate is unreasonable and inappropriate. Without support or analysis, Staff now determines that a 14% debt rate for Raccoon Creek is reasonable. Staff's position changed from one based on expert witness analysis and evidence, to one based on a basis not found in the record or in discovery. Staff, however, made no effort at all to explain, justify, or support its new position on the cost of debt rate for Raccoon Creek.

COST OF DEBT

Q. What cost of debt rate is the Company proposing for Raccoon Creek in this rate case?

A. The Company is recommending a 14% cost of debt rate based on agreement between the owners of Raccoon Creek and Mr. Josiah Cox, also an owner of Raccoon Creek, through a series of other legal entities. This matter is further addressed by OPC witness Keri Roth in her testimony.

Q. What cost of debt rate is Staff recommending for Raccoon Creek?

A. As will be discussed below, Staff initially recommended a cost of debt rate of 8.15% based on an audit performed by Staff's Financial Analysis Department. This position is reflected in the Staff's and Company's August 30, 2016 filing in this case. OPC agrees with and

supports this Staff recommendation on cost of debt. However, Staff very recently changed its position, and, despite its longstanding opposition to this 14% debt rate, adopted the Company's proposed 14% cost of debt rate. Staff made this change without any explanation or testimony to support its changed position.

Q. What is the position taken by Staff's Financial Analysis experts in this rate case as it relates to the capital structure and capital costs for Raccoon Creek?

A. On August 30, 2016 Staff, along with the Company, filed with the Commission a *Partial Disposition Agreement* ("Disposition Agreement"). At page 5 of Staff's Auditing Department Recommendation (Attachment A to this August 30, 2016 Disposition Agreement) the Staff's Financial Analysis Department experts provided its position on Raccoon Creek's capital structure and capital costs. In this Auditing Department's Recommendation, the positions of Staff's Financial Analysis experts are described below:

Weighted Cost of Capital

The rate of return and capital structure used to develop Staff's recommended revenue requirement in this case were provided by Ms. Shana Griffin of the Staff's Financial Analysis Unit. **Staff's recommended capital structure, equity, and interest rate for Raccoon Creek is 75% long term debt and 25% common equity, equity is 12.15% and interest is 8.15%. Staff's overall rate of return for Raccoon Creek is 9.15%. (emphasis added)**

The position supported by the Staff's Financial Analysis witness resulted in an overall rate of return of 9.15%, when, after grossed up for income taxes, results in an actual rate of return of 9.91%.

Commission Staff Before "Policy Change"	Capital Structure	Wgt	Cost Rate	Weighted Cost	Tax Gross up	Total Cost
Common Stock	\$410,929	25%	12.2%	3.04%	1.249	3.79%
Long-term debt	\$1,232,788	75%	8.15%	6.11%	<u>1</u>	6.11%
Weighted Cost				9.150%		9.91%

STAFF'S CHANGED IN POSITION ON COST OF DEBT FROM 8.15% TO 14%

Q. Did OPC agree with the Staff's recommendation on Raccoon Creek's debt cost rate as expressed in the publicly-filed Disposition Agreement?

A. Yes, it did. OPC believes this cost of debt rate is reasonable. OPC reviewed the results of Ms. Griffin's analysis and determined not to pursue this revenue requirement area in its audit of Raccoon Creek's cost of service as we agreed with the conclusion and the work done to reach that conclusion. It was not until Staff filed its direct testimony in this case on September 30, 2016, that OPC became aware of the changed Staff position by reviewing the cost of debt rate embedded in Staff's Accounting Schedules. Staff did not even acknowledge this significant change in its position in its direct testimony.

Q Did OPC address the cost of debt issue in its direct testimony?

A. OPC witness Keri Roth expressed support for the Staff's capital costs in her direct testimony. OPC assumed the position taken by Staff's Financial Analysis experts as reflected in the August 30th, 2016 filing would continue to be the Staff position in this case. As a result of Staff sudden change in position on the cost of debt issue, OPC had seven business days in which to address this issue in its rebuttal testimony in this rate case with no chance to conduct substantial discovery. When OPC did conduct discovery on this issue, Staff objected with an illusory attorney-client privilege argument on a document filed publicly.

Q. Is this a sufficient time period for OPC to review testimony, issue discovery, review the issue, review discovery and write comprehensive rebuttal testimony in this case?

A. No, it is not, especially given the number of ongoing major utility rate cases. Staff also not agreeing to meet informally with OPC on the cost of debt issue only made matters worse. This kept OPC from getting a basic understanding of Staff's newly-revised position on this

1 issue. As noted in this testimony, to my knowledge, Staff has never in the past refused to
2 meet with OPC on an issue in a rate case.

3 **Q. Explain how Staff changed its cost of capital ratemaking positions during the period**
4 **between August 30, 2016 when Staff filed its Disposition Agreement and September 30,**
5 **2016, when Staff filed its direct testimony.**

6 A. On August 30, 2016, as an attachment to the Staff and Company's Partial Disposition
7 Agreement, Staff Financial Analyst Shana Griffin supported a 8.15% cost of debt for
8 Raccoon Creek. However, in Staff's September 30, 2016 direct filing, neither Ms. Griffin
9 nor any other Staff witness filed testimony supporting the Staff's August 30, 2016 position
10 concerning Raccoon Creek's capital structure, cost of debt or cost of equity.

11 Staff did, however, file with its direct testimony on September 30, 2016 Accounting
12 Schedules supporting a 75% debt 25% equity capital structure, a recommended cost of
13 equity of 12.15% and a recommended cost of debt of 14%. These recommendations are
14 included in Staff's Accounting Schedule 4 sponsored by Staff witness Shana Griffin in
15 Staff's September 30, 2016 Accounting Schedules filed to support its direct testimony.

16 **Q. Do you believe Staff Financial Analyst Shana Griffin supported a 14% cost of debt**
17 **rate as reflected in Staff Accounting Schedule 4 page 1 of 1 filed with Staff's direct**
18 **testimony in this case?**

19 A. No. Ms. Griffin opposed this cost of debt rate in the Hillcrest rate case just a few months
20 ago. In this current rate case, she also opposed this 14% debt rate and supported an 8.15%
21 cost of debt rate, which is also reflected in Staff's Auditing Department Memo attached to
22 the August 30, 2016 Disposition Agreement filed publicly with the Commission. Unless
23 Staff can produce evidence that Ms Griffin supported a 14% debt rate for Raccoon Creek,
24 Staff should correct its mislabeled Accounting Schedules filed with the Commission in this

1 rate case as they reflect support for a position that the evidence strongly indicates Ms.
2 Griffin does not support.

3 **Q. Mr. Hyneman, you indicated you worked with Commission Staff before coming to the**
4 **OPC. How many years were you employed by the Commission Staff?**

5 A. Approximately 23 years.

6 **Q. During those 23 years, have you ever seen the Staff file rate case direct testimony**
7 **making recommendations for capital structure, debt, and equity costs without a**
8 **witness to support those positions?**

9 A. No. I do not believe the actions taken by Staff in this rate case (failing to support its
10 material direct testimony positions) have ever previously been taken by Staff at least in my
11 experience. Staff's actions in this rate case are unique.

12 **Q. Did OPC attempt to meet with the Manager of the Staff's Financial Analysis**
13 **Department, Mr. David Murray?**

14 A. Yes. OPC attempted to meet with Staff's Manager of the Financial Analysis Department
15 Mr. David Murray to discuss this issue and the audit and findings of his department as it
16 related to this rate case. Mr. Murray supervised Ms. Shana Griffin who Staff now asserts
17 sponsored Staff's capital structure and debt and equity costs in Staff Accounting Schedule 4
18 in this case. Mr. Murray also worked with Ms. Griffin on this Raccoon Creek rate case,
19 particularly on the cost of debt issue and also supervised her work. Since Ms. Griffin
20 recently left the Commission Staff, OPC assumed that Mr. Murray would adopt her work in
21 this case and moreover felt he would understand his subordinate's position. But Mr. Murray
22 offered no testimony and OPC was not allowed any opportunity to meet with Mr. Murry
23 other than to depose him. This option, I was informed, offered many concerns for our office.

1 **Q. Did Staff find a witness who would support this revised position on Raccoon Creek's**
2 **cost of debt?**

3 A. Yes. Through discovery I am aware that Staff's new witness on this issue is Matthew
4 Barnes of the Staff's Water and Sewer Department.

5 **Q. Do you believe this is the first time that no member of the Staff's Financial Analysis**
6 **Department sponsored, supervised, or was directly involved in the issues of capital**
7 **structure, debt costs and equity costs in a rate case?**

8 A. In my experience of 23 years, yes. I also believe that this would occur only in highly
9 unusual situations and no member of the Commission's Water and Sewer Department has
10 ever sponsored capital structure and rate of return testimony in a utility rate case.

11 **Q. Did Staff agree to allow OPC to meet with Mr. Murray?**

12 A. No. Staff refused to allow Mr. Murray to meet with OPC to discuss Staff's cost of debt
13 position in its filing.

14 **Q. Do you believe that the Staff has an obligation to meet with OPC, the entity that**
15 **represents the Company's ratepayers before the Commission?**

16 A. I am not aware of any legal obligation but I do believe there is a professional obligation on
17 the part of Staff to not only allow, but to encourage meetings between the parties in rate case
18 proceedings. The policy of encouraging meetings between rate case parties was the position
19 of Staff when I left the Staff in the fall of 2015.

20 **Q. In your 23 years as a member of the Commission Staff, do you ever recall a time when**
21 **the Staff refused to meet with any party, let alone OPC, to discuss the position in its**
22 **direct testimony recommendations to the Commission?**

A. No. I believe this is the first time when Staff refused to meet with a party to a rate case who wanted to discuss Staff positions taken in a rate case.

Q. Is the value of the issue in which Staff refused to meet with OPC significant to this rate case?

A. Yes, it is. As shown below, the total revenue requirement impact of Staff's changed position is approximately \$76,000. For a sewer utility the size of Raccoon Creek, the revenue requirement impact of Staff's changed position is material and likely the most significant issue in this rate case.

Commission Staff After "Policy Change"	Capital Structure	Wgt	Cost Rate	Weighted Cost	Tax Gross up	Total Cost
Common Stock	\$410,929	25%	12.2%	3.04%	1.249	3.79%
Long-term debt	\$1,232,788	75%	14.0%	<u>10.50%</u>	1	<u>10.50%</u>
Weighted Cost				13.538%		14.29%
Commission Staff Before "Policy Change"	Capital Structure	Wgt	Cost Rate	Weighted Cost	Tax Gross up	Total Cost
Common Stock	\$410,929	25%	12.2%	3.04%	1.249	3.79%
Long-term debt	\$1,232,788	75%	8.2%	<u>6.11%</u>	<u>1</u>	<u>6.11%</u>
Weighted Cost				9.150%		9.91%
	Rate Base					
Villages	\$656,992					
WSS	\$482,125					
WPC	<u>\$494,901</u>					
Total Raccoon Creek	\$1,634,018			Rate Base	\$1,634,018	\$1,634,018
				Grossed Up ROR	14.29%	9.91%
				Revenue Requirement Impact	\$233,564	\$161,871
				ROR issue		(\$71,693)
				Est. AFUDC impact		(\$4,500)
				Total Value of Issue		(\$76,193)

Q. Do you believe that the actions taken by Staff in this rate case are consistent with its purpose?

1 A. No. Staff's actions in this rate case are in direct contradiction to its role. The role of the
2 Staff is to support the Public Service Commission ("Commission"). The Commission has
3 declared its "guiding purpose" in a rate proceeding is to protect the consumer against the
4 natural monopoly of the public utility. That should be the guiding purpose of the Staff as
5 well.

6 The Commission stated that its dominant "thought and purpose in setting rates" is to
7 protect the public. The Commission addressed this point in its December 3, 2014 Report
8 and Order in Case No. GR-2014-0152, ("2014 Liberty Report and Order"). At paragraph
9 Commission stated:

10 The Commission's guiding purpose in setting rates is to protect the
11 consumer against the natural monopoly of the public utility,
12 generally the sole provider of a public necessity.²⁹ "[T]he dominant
13 thought and purpose of the policy is the protection of the public . . .
14 [and] the protection given the utility is merely incidental."
15

16 The actions taken by Staff in this rate case, specifically abandoning its position on the
17 14% cost of debt rate taken in very recent prior cases and in this rate case and failing to
18 support its new position in its direct case, are not actions taken to protect the public but
19 are simply actions that appear to benefit only the utility.

20 **Q. In this rate case, has the Staff acted in a manner that is contradictory to the**
21 **Commission's stated purpose of the Commission?**

22 A. Yes. The evidence in this case indicates that Staff made a deal with the Company to accept
23 its 14% debt rate despite the positions taken by Staff's expert witnesses and financial analyst
24 experts. Staff failed in its obligation to support its sudden change in position and Staff failed
25 in its obligation to support its position on capital structure and debt and equity costs in its
26 direct testimony.

It is my understanding that the Staff exists to support the Commission. Its rate setting role, the Staff exists to support the "guiding purpose of the Commission" as stated by the Commission itself, and that that is to protect the consumer. Protection of the interests of the utility should merely be an incidental purpose. Protection of Raccoon Creek's ratepayers should be Staff's "dominant thought and purpose" in this rate case.

STAFF'S RESPONSE TO OPC DATA REQUESTS

Q. You stated earlier that Staff refused to meet with OPC prior to rebuttal testimony to discuss Staff's new position, a position Staff failed to support in its direct testimony. Did Staff provide any data to OPC on which OPC could gain an understanding of Staff's new and unsupported position?

A. The response to OPC Data Request Nos. 25 and 26 below. OPC is unable to fully understand Staff's position from these responses:

OPC Data Request No. 25 to the Commission Staff

October 4, 2016 - It is OPC's understanding that Staff's was proposing a cost of debt rate of 8.15% prior to the accounting schedules being filed with direct testimony in this case. Please identify each and every reason why Staff changed its recommendation to include a cost of debt rate of 14% as opposed to the lower 8.15% rate. Due Date: 10/12/2016 Requested By: Chuck Hyneman

Commission Staff's October 6, 2016 OBJECTION: The DR seeks internal discussions that are privileged pursuant to the Attorney Work Product Privilege and the Attorney Client Privilege.

Staff's October 11, 2016 Response: Without waiving its previously stated objection, Staff has decided as a matter of policy to not oppose the cost of debt proposed by the Company in its Application. Response provided by Whitney Payne.

OPC Data Request No. 26 to the Commission Staff

It is also OPC's understanding that Staff was supporting the cost of debt rate of 8.15% based on new information and/or documentation.

1 Please describe this new documentation and/or information and
2 explain why Staff is no longer using this documentation or
3 information to support a cost of debt rate different from the 14% rate
4 included in its Accounting Schedules. Due Date: 10/12/2016
5 Requested By: Chuck Hyneman
6

7 OBJECTION: Commission Staff's October 6, 2016 – "The DR
8 seeks internal discussions that are privileged pursuant to the Attorney
9 Work Product Privilege and the Attorney Client Privilege."
10

11 Staff's October 11, 2016 Response: "Without waiving its previously
12 stated objection, Staff has decided as a matter of policy to not oppose
13 the cost of debt proposed by the Company in its Application. Data
14 Request response provided by Whitney Payne"
15

16 **COMMISSION'S ZONE OF REASONABLENESS TEST**

17 **Q. Has OPC compiled a list and performed an analysis of the debt and equity cost rates of**
18 **various small water and sewer companies operating in Missouri?**

19 A. Yes.

20 **Q. Please describe the results of this analysis?**

21 A. Attached as Schedule CRH-R-1 is a workpaper that lists small water and sewer rate cases
22 over the past five years with the resulting capital structure and debt and equity costs that
23 resulted from the rate case. It is clear that the 14% debt cost rate proposed by Staff and
24 Raccoon Creek in this rate case is unreasonable.

25 **Q. Does the Commission often consider a "zone of reasonableness" when it evaluates**
26 **differing proposed capital costs in a rate case?**

27 A. Yes, it does. This Commission consideration is done primarily, if not solely, with equity
28 cost proposals in a rate case but the concept and methodology applies equally to all capital
29 costs, including debt costs.

1 The Commission has found it appropriate to consider both quantitative and qualitative
2 information when developing its zone of reasonableness, which has been viewed by the
3 Commission as a range within 100 basis points of the national average. The average debt
4 cost rate in this list of Missouri water and sewer companies is around 5% to 6%, or 800 to
5 900 basis points below the rate proposed by the Company and Staff.

6 The Commission described how it applies the zone of reasonableness in its May 22, 2007
7 Report and Order in Case No. ER-2007-0002, Ameren Missouri:

8 Findings of Fact: In recent rate cases, the Commission has used what
9 has been described as a zone of reasonableness to assist it in
10 evaluating the recommendations offered by return on equity experts.
11 The zone of reasonableness has been described as a range 100 basis
12 points above and 100 basis points below the national average
13 allowed return on equity. If the national average is taken to be 10.36
14 percent, then the zone of reasonableness runs from 9.36 percent to
15 11.36 percent. The zone of reasonableness is simply a tool to help the
16 Commission evaluate the recommendations offered by various rate
17 of return experts. It should not be taken as an absolute rule
18 precluding consideration of recommendations falling outside that
19 zone. However, a recommendation greatly varying from the national
20 norm will be viewed with skepticism.
21
22

23 **Q. If the Commission's first consideration of the Company's proposed debt cost of 14% is**
24 **whether or not it was in a "zone of reasonableness" what should it conclude?**

25 A. A simple review of the debt costs listed on Schedule CRH-R-1 shows that the Company's
26 proposed 14% debt cost is unreasonable, an outlier and way outside the zone of
27 reasonableness. The only other case where a 14% debt rate was included was with Hillcrest
28 Utility Operating Company, which is a part of the same holding company as Raccoon
29 Creek. Excluding the unreasonable debt costs included in the Hillcrest rate case, the
30 proposal by Raccoon Creek in this rate case is clearly unreasonable and, based on this new
31 evidence, should be rejected by the Commission as outside the zone of reasonableness.

As the Commission should conclude, based on its very own standard application of the zone or reasonableness test, “a recommendation greatly varying from the national norm will be viewed with skepticism.” Raccoon Creek and the Staff’s proposed 14% cost of debt rate varies greatly from the average debt rate used by the Commission for all Missouri’s small water and sewer companies over the past five years and it should be viewed with skepticism.

Q. In its Reply Brief in Case No. WR-2016-0064, Hillcrest, did Staff assert that it was opposing the Company’s proposed 14% debt cost for Hillcrest as it was seeking to protect Hillcrest customers from a high interest rate that was no consistent with the then current junk bond yields?

A. Yes and I believe in that rate case the Staff was attempting to protect Hillcrest’s ratepayers on this particular issue by strongly opposing the proposed 14% debt rate. Staff stated at page 2 of its June 15, 2016 Reply Brief in Case No. WR-2016-0064:

As stated in Staff’s Initial Brief,³ “...the Commission is not bound to accept whatever cost of debt is “negotiated” and presented to it.”⁴ Staff has no intention of cutting Hillcrest off at the knees, but rather seeks to protect the Hillcrest customers from a high interest rate that is not consistent with current, applicable junk bond yields. In addition, even though the investors and investment structure changed, this high interest rate was not reduced to reflect the new circumstances. However, as outlined in Staff’s Initial Brief,⁵ in this case the debt investors have no incentive to renegotiate the interest rate on the financing agreement as they have provided all of the equity and debt capital invested in Hillcrest, which reduces any such transaction to less than arms-length. (emphasis added).

Q. By now supporting the same 14% cost of debt, do you believe Staff’s decision is detrimental to the ratepayers in this case?

A. Yes.

COST OF EQUITY

Q. At page 10 line 6 of his direct testimony, Company witness Dylan W. D'Ascendis describes his two methods of estimating Raccoon Creek's cost of equity. What is the first method?

A. The first method he used was to compare Raccoon Creek to Missouri American Water Company ("MAWC") and make various utility size adjustments and risk adjustments to arrive at a cost of equity for Raccoon Creek of 15.01%. This 15.01% Raccoon Creek cost of equity was compared to and based on MAWC's cost of equity that was a result of settlement negotiations in MAWC's 2015 rate case.

Q. In your experience has the Commission ever accepted a cost of equity recommendation based on a comparison of two individual and unlike utility comparisons that operate in different industries?

A. No. I think the Commission can see the total lack of reasonableness in such a comparison. MAWC is a very large primarily water utility part of a utility with operations throughout the United States. Raccoon Creek is a very small sewer company operating in and around Sedalia Missouri.

Q. Could Mr. D'Ascendis base his company comparison on smaller sewer or even water and sewer companies operating in Missouri?

A. Yes, he could have. While I may not agree and the Commission may not agree with his method of estimating the cost of equity by comparing two separate companies and making what appear to be arbitrary adjustments, at least such a comparison would make his analysis somewhat more reasonable.

Q. What is Mr. D'Ascendis' second method of estimating Raccoon Creek's cost of equity?

1 A. Mr. D'Ascendis again uses what he refers to as the "M&M" method and simply adds 4.34%
2 to Staff's proposed 12.15% equity cost rate to arrive at a cost of equity of 16.49%. He then
3 averages his two M&M method calculations of 15.01% and 16.49% to arrive at a
4 recommended equity cost rate of 15.75%.

5 **Q. Is this 15.75% cost of equity within the Commission's standard zone of reasonableness**
6 **test of 100 basis points?**

7 A. No. Referring to Schedule CRH-R-1, the average equity costs of these small Missouri water
8 and sewer companies over the past five years averages between 10 and 11%. The
9 Company's proposed equity rate of 15.75% is significantly outside of the zone of
10 reasonableness indicated by this average and it should be rejected by the Commission.

11 **Q. If the Commission's first consideration of the Company's proposed equity cost of**
12 **15.75% is whether or not it was in a "zone of reasonableness" what should it conclude?**

13 A. An equity cost rate of 15.75% is 475 basis points higher than the average equity rates for
14 Missouri small water and sewer companies over the past five years. This is far in excess of
15 the Commission's 100 basis point test used for other large utilities. As such, the
16 Commission should conclude, based on its very own standard application of the zone of
17 reasonableness test, a recommendation of 15.75% greatly varies from the norm (11%) and
18 should be viewed with skepticism and rejected.

19 **Q. Does OPC support the Staff's proposed 12.15% equity cost for Raccoon Creek?**

20 A. Yes, while just barely outside the 100 basis point test for reasonableness, the Staff's
21 recommended cost of equity is far more reasonable than the rate proposed by Company
22 witness D'Ascendis.

1 Q. At page 10 lines 11 through 14 Mr. D'Ascendis states that Staff's recommended cost of
2 equity of 12.15% is unreasonable because it is less than Raccoon Creek's contracted
3 debt rate of 14%. Please comment.

4 A. I think Mr. D'Ascendis testimony just got the facts backwards. It is Raccoon Creek's 14%
5 cost of debt that is unreasonable on its face because it is higher than its own 12.15% cost of
6 equity. Staff's Financial Analysts did a very good job of analyzing the debt and equity cost
7 factors in the Hillcrest rate case and then applied that same analysis in this rate case.

8 The Commission should rely on its own Financial Analysts expert witnesses to determine
9 the appropriate cost of capital in this rate case. The Commission should reject the opinion of
10 the Staff who are not in any way experts in this area. The public is not well serviced when
11 the Staff ignores the work of its experts and makes unsupported policy decisions that are
12 clearly detrimental to the public interest.

13 Q. In addition to Schedule CRH-R-1, are you attaching additional schedules to your
14 rebuttal testimony?

15 A. Yes. In this testimony I address the Staff's position on the 14% cost of debt rate proposed
16 by Raccoon Creek. This is the same debt rate and loan arrangement Staff opposed in the
17 very recent Hillcrest rate case. I am attaching Staff's briefs filed in that case to add more
18 information about the Staff's opposition to this excessive cost of debt rate. Also, to add
19 more information surrounding the Hillcrest rate case, I am attaching a news article related to
20 that rate case.

21 Q. Does this conclude your rebuttal testimony?

22 A. Yes, it does.

Water/Sewer Company	Case No.	Equity/Debt	ROE	Debt Cost
RDE Water Company	WR-2016-0267	89.66%/10.34%	8.03%	4.31%
Cannon Home Association, Inc.	SR-2016-0112	100%/0%	8.36%	0%
Roy-L Utilities	SR-2016-0110	26.62%/73.38%	11.07%	5%
Roy-L Utilities	WR-2016-0109	26.62%/73.38%	11.07%	5%
Hillcrest Utility Operating Company, Inc.	SR-2016-0065	19%/81%	13%	14%
Hillcrest Utility Operating Company, Inc.	WR-2016-0064	19%/81%	13%	14%
Raytown Water Company	WR-2015-0246	82.16%/17.84%	7.70%	3.17%
Valley Woods Utility, LLC	WR-2015-0197	25%/75%	11.18%	5%
Valley Woods Utility, LLC	SR-2015-0198	25%/75%	11.18%	5%
Taney County Water, LLC	WR-2015-0196	25%/75%	11.18%	5%
Riverfork Water Company	WR-2015-0195	25%/75%	11.18%	5%
Moore Bend Water Utility, LLC	WR-2015-0194	25%/75%	11.18%	5%
Midland Water Company	WR-2015-0193	25%/75%	11.18%	5%
Bilyeu Ridge Water Company	WR-2015-0192	25%/75%	11.18%	5%
Village Greens Water Company	WR-2015-0138	100%/0%	7.87%	0%
Spokane Highlands Water Company	WR-2015-0104	100%/0%	8.01%	0%
Central Rivers Wastewater Utility, Inc.	SR-2014-0247	66.65%/33.35%	8.60%	9.75%
Peaceful Valley Service Company	WR-2014-0154	100%/0%	8.79%	0%
Peaceful Valley Service Company	SR-2014-0153	100%/0%	8.79%	0%
Terre Du Lac Utilities Corp	SR-2014-0105	80.58%/19.42%	7.44%	5.40%
Terre Du Lac Utilities Corp	WR-2014-0104	80.58%/19.42%	7.44%	5.40%
P.C.B., Inc.	SR-2014-0068	0%/0%	0%	0%
M.P.B., Inc.	SR-2014-0067	0%/0%	0%	0%
Roy-L Utilities	SR-2013-0544	20%/80%	14.82%	5.00%
Roy-L Utilities	WR-2013-0543	20%/80%	14.82%	5.00%
Lake Region Water & Sewer	WR-2013-0461	40%/60%	11.93%	5.00%
Lake Region Water & Sewer	SR-2013-0459	40%/60%	11.93%	5.00%
Rogue Creek Utilities, Inc.	WR-2013-0436	50.10%/49.90%	11.22%	7.22%
Rogue Creek Utilities, Inc.	SR-2013-0435	50.10%/49.90%	11.22%	7.22%
Woodland Manor Water Company, LLC	WR-2013-0326	100%/0%	8.02%	0%
Lincoln County Sewer & Water, LLC	WR-2013-0322	25%/75%	13.38%	4.50%
Lincoln County Sewer & Water, LLC	SR-2013-0321	25%/75%	13.38%	4.50%
Gladlo Water & Sewer Company, Inc.	WR-2013-0259	49.75%/50.25%	10.21%	6.21%

Gladlo Water & Sewer Company, Inc.	SR-2013-0258	49.75%/50.25%	10.21%	6.21%
W.P.C. Sewer Company	SR-2013-0053	25%/75%	12.09%	6.00%
Emerald Pointe Utility Company	WR-2013-0017	29.79%/70.21%	13.26%	5.35%
Emerald Pointe Utility Company	SR-2013-0016	29.79%/70.21%	13.26%	5.35%
Raytown Water Company	WR-2012-0405	87.44%/12.56%	8.25%	4.28%
House Springs Sewer Company	SR-2012-0399	25%/75%	12.15%	6.95%
Meramec Sewer Company	SR-2012-0309	100%/0%	8.93%	0%
Oakbrier Water Company, Inc.	WR-2012-0267	25%/75%	12.22%	3.30%
Lakeland Heights Water Company, Inc.	WR-2012-0266	25%/75%	12.22%	3.30%
R.D. Sewer Company LLC	SR-2012-0263	25%/75%	12.22%	3.30%
Taney County Water Company	WR-2012-0163	25%/75%	12.05%	5.88%
Midland Water Company	WR-2012-0031	100%/0%	8.84%	0%

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the Matter of the Water and Sewer)
Rate Increase Request of Hillcrest)
Utility Operating Company, Inc.) Case No. WR-2016-0064

INITIAL BRIEF OF STAFF

Respectfully submitted,

WHITNEY PAYNE, Mo Bar 64078
Legal Counsel

Attorney for the Staff of the
Missouri Public Service Commission

June 3, 2016

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**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the Matter of the Water Rate)
Increase Request of)
Hillcrest Utility Operating)
Company, Inc.)

Consolidated with,)

Case No. WR-2016-0064

In the Matter of the Sewer Rate)
Increase Request of)
Hillcrest Utility Operating)
Company, Inc.)

STAFF'S INITIAL BRIEF

COMES NOW the Staff of the Missouri Public Service Commission (Staff), by and through counsel, and for its *Initial Brief* in the above-referenced matters, hereby states the following synopsis of its positions.

INTRODUCTION

This case is a small utility water and sewer rate proceeding, initiated by Hillcrest Utility Operating Company (Hillcrest) on September 15, 2015 by the filing of a letter with the Missouri Public Service Commission (Commission) requesting increases in annual sewer and water system operating revenues. Hillcrest is a Missouri company in good standing, with its principal place of business at 500 Northwest Plaza Drive, Suite 500, St. Ann, MO 63074. Hillcrest operates under a certificate of convenience and necessity issued by this Commission as part of its order dated October 22, 2014, in conjunction with the Commission's approval of the current owner's acquisition of the systems in Case No. WO-2014-0340. The water system provides service to approximately 241 customers and the sewer system services approximately 240. While this utility operates

as a small water and sewer company pursuant to 4 CSR 240-3.050(1), its corporate structure is more akin to that of a larger entity. Hillcrest Utility Operating Company is wholly owned by Hillcrest Utility Holding Company, which is wholly owned by First Round CSWR, LLC, which is managed by Central States Water Resources.¹ In the interest of simplicity, actions taken by the company will be referred to as either “Company” or “Hillcrest” even on occasions where the actions were taken by Central States Water Resources or First Round CSWR, as all actions are attributed to Hillcrest for the purpose of inclusion in rates.

Hillcrest is a water utility pursuant to Section 386.020(52), RSMo, a sewer utility pursuant to Section 386.020(49), RSMo, and, therefore, subject to the Commission’s jurisdiction pursuant to Section 386.250(3) and (4), RSMo. Also party to this proceeding are Staff pursuant to Section 386.071 and Rule 4 CSR 240-2.010(10), and the Office of the Public Counsel (OPC) pursuant to Section 386.710(2) and Rule 4 CSR 240-2.010(10).

Hillcrest was granted authority to acquire the water and sewer assets of Brandco Investments, LLC, as part of an acquisition case before this Commission, Case No. WO-2014-0340, by the Commission’s order dated October 22, 2014. However, Hillcrest did not actually begin operating the system until March 26, 2015.

As with any case, a test year is integral to the ratemaking process. Rates are usually established based upon a historical test year² which focuses on four factors: (1) the rate of return the utility has an opportunity to earn; (2) the rate base upon which a

¹ *Griffin Rebuttal* P. 8, lines 17-20.

² *State ex rel. Utility Consumers’ Council of Missouri, Inc. v. Public Service Comm’n*, 585 S.W.2d 41, 59 (Mo. banc 1979) (“Past expenses are used as a basis for determining what rate is reasonable to be charged in the future”).

return may be earned; (3) the depreciation costs of plant and equipment; and (4) allowable operating expenses.³ Staff determined a test year for this matter based on less than one year of data, using a period beginning immediately following acquisition, of April 1, 2015 through July 31, 2015, with an update period of August 1, 2015 through October 31, 2015. All elements of Staff's revenue requirement calculations were measured based on use of this test year and this update period.

Following negotiations related to the requested increases in annual sewer and water system operating revenues between the parties, Staff and Hillcrest came to a partial disposition agreement of certain issues, which was filed March 25, 2016. The three parties requested an evidentiary hearing to determine the remaining issues, (1) rate design; (2) rate of return; (3) corporate allocations; (4) payroll; (5) auditing and income tax preparation fees; and (6) property taxes. In all proceedings before the Commission, the burden of proof shall be upon the party adverse to the Commission.⁴ Outlined below are those issues along with Staff's support for its position on each issue, gleaned from its investigation and the evidentiary hearing. To the extent that that a party raises an issue in briefs that was not a part of the filed issue lists or position statements, Staff reserves the right to address the issue(s) in its Reply Brief.

³ *State ex rel. Union Electric Company v. Public Service Comm'n*, 765 S.W.2d 618, 622 (Mo. App. 1988).

⁴ Section 386.430, RSMo.

ARGUMENT

Issue 1: Rate Design

Facts:

1. Hillcrest provides service to residential, apartment and commercial customers for water and sewer.⁵

2. Currently Hillcrest's sewer customers are divided into two rate classes, one for residential and commercial and another for apartment. Its water customers currently have only one rate class.⁶

3. The actual rates have been unchanged since 1989.⁷

4. This increase in rates, as requested, will be a significant rate increase to customers.⁸

How many classes should Hillcrest's customers be divided into for the purpose of designing rates for both water and sewer?

Staff for the purposes of its position, kept the sewer customer classes as they are and divided Hillcrest's water customers into two classes aligning with the utility's sewer class structure. Hillcrest is unopposed to this design as stated in company witness, Josiah Cox's Rebuttal Testimony, "Hillcrest has no objection to the proposals to move to more than one class of customers."⁹ It is Staff's opinion that two classes are sufficient to meet the diverse structure of Hillcrest's customers. However, should the Commission

⁵ *Robertson Direct*, P. 3, lines 13-14.

⁶ *Id.* at P. 6, line 20 to P. 7, line 4.

⁷ *Cox Direct*, P.13, line 19.

⁸ *Id.* At P.14, lines 2-4; Tr. 2:8, 30.

⁹ *Cox Rebuttal* P. 2, lines 6-7.

determine that additional classes are necessary in the course of formulating rate design; Staff does not oppose.

What are the proper allocation percentages to be used to allocate expenses between the customer charge and volumetric rate?

Staff did not provide testimony on this issue; however, OPC has applied it as an issue in this case. Staff takes the position that this argument is better applied to the issue: what is an appropriate monthly customer charge for each customer class. To that end, an appropriate customer charge based on Staff's calculations for the water customers would be \$34.72 for the residential/commercial customer class and \$27.78 for the proposed apartment class. Staff also would recommend a universal usage or commodity fee of \$6.53 per 1,000 gallons used, applicable to each class. For the sewer customers an appropriate monthly customer charge would be \$73.75 for the residential/commercial customer class and \$58.98 for the apartment class. Should the Commission choose Staff's phase-in approach as described in this brief below, an appropriate monthly customer charge for water customers would be \$28.65 for the residential/commercial customer class and \$22.92 for the apartment class. Staff also would recommend a universal usage or commodity fee of \$4.26 per 1,000 gallons used, applicable to each class. For sewer customers under a phase-in approach an appropriate customer charge would be \$55.53 for residential/commercial and \$44.41 for apartment.

Should a rate increase be implemented all at once or phased-in over time?

The Commission's task of fixing just and reasonable rates requires it to balance the interests of the investor and the consumer.¹⁰ Recognizing that duty, Staff provided the Commission with two alternatives for rate design. The alternatives seek to reconcile the issues of permitting the company to collect the appropriate amount of revenue to cover its cost of service, while also addressing the substantive increase and its impact on the ratepayers.¹¹ Staff has not taken a stance on which alternative is better; there are benefits and detriments to the company and the customers with both approaches. Hillcrest and Staff, as part of their joint partial disposition agreement, have already agreed that Hillcrest will either file a new rate case or Staff will file a rate review of the utility 12 months after the effective date of rates in this matter.¹²

Staff's alternative proposals include a "traditional implementation" of rates and a "phase-in" approach. Traditional implementation results in customers experiencing increases of anywhere from 303% to 420% depending on the class to which they belong.¹³ It would also mean that Hillcrest is made immediately whole for all costs of the improvements previously installed along with the regular costs of operation and maintenance. A phase-in approach results in a reduction in the rate shock experienced by customers.¹⁴ Staff proposes that non-cash flow items in the revenue requirement not be given immediate recovery and instead be carried over to a new rate case to be filed 12 months from the effective date of rates in this proceeding. The amounts from those

¹⁰ *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603, (1944).

¹¹ *Robertson Direct* P. 6, lines 15-18.

¹² *Partial Disposition Agreement and Request for Evidentiary Hearing*, filed March 25, 2016, P. 3, subsection 11.

¹³ *Robertson Direct* P. 8, lines 1-10.

¹⁴ *Robertson Direct* P. 8, lines 11-13.

items, after inclusion of carrying costs, would be included in rate base for the new case and amortized over five years.¹⁵ This approach produces increases to customers of approximately 203% to 279%.¹⁶ The company claims choosing this approach would mean that Hillcrest would be unable to meet its financial obligations for the duration these rates are collected, all else being equal.¹⁷ However, Staff specifically removed only non-cash items to ensure that a phase-in approach will not cause harm.¹⁸ As the Missouri Court of Appeals said in citing the United States Supreme Court, “Under the statutory standard of ‘just and reasonable’ it is the result reached, not the method employed which is controlling. It is not theory but the impact of the rate order which counts”.¹⁹

OPC has proposed a different style of phase-in than Staff’s, which would create a longer phase-in period (two years)²⁰ than Staff’s design.²¹ The rates initially would increase by 50% of the overall recommended increase, then 50% of the remaining balance, plus carrying costs, would be implemented after the first year. Finally, the remaining balance and remaining carrying costs would be phased in after year two.²² Unlike the OPC proposal, Staff’s design anticipates another rate case at which time more data will be available and Staff can better calculate and update rates to reflect an entire year of Hillcrest’s expenses. This should also prevent the need for a phase-in period longer than one year.

¹⁵ *Robertson Direct*, P. 8, lines 15-20.

¹⁶ *Robertson Direct* P. 8, lines 1-16.

¹⁷ *Cox Rebuttal* P. 9, lines 17-19.

¹⁸ *Robertson direct* P. 8, lines 17-20.

¹⁹ *State ex rel. Associated Natural Gas Co. v. Pub. Serv. Comm’n*, 706 S.W. 2d 870, 873 (Mo. App. W.D. 1985).

²⁰ *Russo Direct* P. 15, line 11.

²¹ *Cox Rebuttal* P. 10, lines 10-13.

²² *Russo Direct* P. 15, lines 11-15.

Phase-in rates are not unheard of, but are uncommon in utility regulation. However, Section 393.155, RSMo, permits the phase-in of rates for electrical utilities under two conditions. One condition specifically permits phased-in rates in circumstances where implementation of Federal Energy Regulatory Commission's (FERC) regulations results in an unusually large increase in total revenue. The other condition permits phase-in when the total increase in revenue results primarily from an unusually large increase in a corporation's rate base following a rate increase request. In a 2013 Western District case, *In re KCP&L Greater Missouri Operations Co*, the court found that phase-in rates were appropriate and the Commission had jurisdiction to order them, so long as the utility was permitted to recover its carrying costs.²³ In another 2013 case from the Western District, *State ex rel. KCP&L Greater Missouri Operations Co. v. Missouri Public Service Com'n*, the court specifically stated that the phase-in rate increase was reasonable to mitigate rate shock to customers in the rate district.²⁴ Section 393.146.11, RSMo, permits the Commission, after ordering the acquisition of a small water or sewer corporation, to authorize the acquiring utility to use the small company rate case procedure to establish rates. The statute continues by stating that those rates **may** be designed to recover the costs of operating the system and one hundred percent of the revenues necessary to provide a return. This statute specifically references the ratemaking process in conjunction with the acquisition process, and it does not require the Commission to order rates consistent with one hundred percent of the operating costs or revenues. In summary, the statutes and standing legal authority

²³ *In re KCP&L Greater Missouri Operations Co.*, 408 S.W.3d 175, 186 (Mo. App. 2013).

²⁴ *State ex rel. KCP&L Greater Missouri Operations Co. v. Missouri Public Service Com'n*, 408 S.W.3d 153, 170 (Mo. App. 2013).

do not expressly, but do implicitly, permit the Commission to implement phased-in rates for water utilities.

Issue 2: Rate of Return

Facts:

1. The overall ownership structure is as follows: Hillcrest Utility Operating Company, Inc., which holds the utility assets, is wholly owned by Hillcrest Utility Holding Company, Inc., which is wholly-owned by First Round CSWR, LLC, which is managed by Central States Water Resources, Inc.²⁵

2. Hillcrest invested over \$1.2 million in the system following acquisition.²⁶

3. Hillcrest has a financing agreement with Fresh Start Venture, LLC, with a 14% interest rate.²⁷

4. Fresh Start Venture is owned by Robert Glarner and David Glarner.²⁸

5. The owners of GWSD, LLC are Robert Glarner and David Glarner.²⁹

6. Josiah Cox is the president of Central States Water Resources, Inc.³⁰ with 51% of the shares; and the other shareholders in Central States Water Resources, Inc. with 49% of the shares are GWSD, LLC.³¹

7. GWSD, LLC owns 869,999.99 Units (or 87%) of First Round CSWR, LLC; Josiah M. Cox owns 130,000 Units (or 13%) of First Round CSWR, LLC; and Central States Water Resources owns .01 Units (or 0.000001%) of First Round CSWR, LLC. GWSD, LLC is the only member that has contributed capital to First Round CSWR,

²⁵ *Griffin Rebuttal* P. 8, lines 17-20.

²⁶ *Id.* At P. 23, line 18.

²⁷ *Griffin Direct* P. 4, line 19.

²⁸ *Griffin Rebuttal* P. 5, line 1.

²⁹ Tr. 2, P. 50.

³⁰ Tr. 2, P. 45.

³¹ *Id.* At P. 50.

LLC. According to the Amended and Restated Operating Agreement of First Round CSWR, LLC, dated March 5, 2015, GWSD's capital contribution is \$1,479,763.³²

8. GWSD, LLC, and Fresh Start Venture have contributed all of the financial capital invested in Hillcrest.³³

9. The investors in Central States Water Resources changed following signature of the Construction Loan Agreement and prior to disbursement of funds.³⁴

10. Hillcrest has not attempted to renegotiate its 14% investment rate even though the investment structure and investors have changed since the contract with Fresh Start was originally executed.³⁵

What is the appropriate capital structure for purpose of setting Hillcrest's allowed rate of return?

Staff for the purposes of this case designed a hypothetical capital structure of 25% equity and 75% debt.³⁶ This structure would limit the amount of leverage resulting in a more practical application than the present structure.³⁷ As Staff stated in rebuttal testimony, Hillcrest's capital structure is essentially one hundred percent equity due to all financial capital being provided by the same parties, either directly or indirectly.³⁸ Based on statements made to Staff in the Hillcrest acquisition case, the company

³² Staff Ex 13, 25: Schedule A.

³³ Staff Ex. 13, P. 25: Schedule A (reflecting the only capital contribution to First Round CSWR, LLC, came from GWSD); Staff Ex. 14, 1 (outlining the construction loan provided to Hillcrest Utility Operating Company by Fresh Start Venture, LLC); *Griffin Direct* Schedule SG-d5 (outlines the investment structure of Hillcrest Utility Operating Company as well as the other regulated utilities operated by Central States Water Resources).

³⁴ *Griffin Rebuttal* Schedule SG-rl (announcing the new investors in Fresh Start)

³⁵ Tr. 2:63.

³⁶ *Griffin Direct* P. 2, lines 10-11.

³⁷ *Griffin Rebuttal* P. 3, lines 4-19.

³⁸ *Griffin Rebuttal* P. 8, line 15- P. 10, line 20.

intended to use a “highly leveraged”³⁹ structure once it obtained traditional third-party commercial bank financing.⁴⁰ Staff took this into consideration when deciding to recommend a highly-leveraged hypothetical capital structure.

What is the appropriate allowed ROE to apply to the equity in the ratemaking capital structure?

Staff calculated its return on equity (ROE) by taking the projected yield on long-term public utility bonds that would be assigned to a three-month average of debt assigned with a B rating (Staff’s initial cost of debt of 8.88%) and added a 4% risk premium to that amount.⁴¹ From those calculations Staff determined an appropriate ROE of 12.88%. Taking into consideration the change in spread for corporate bond yields in the early part of 2016, Staff updated its recommended ROE to a range of 12.88 to 14.13%.⁴²

What is the appropriate allowed debt rate to apply to the debt in the ratemaking capital structure?

Staff recommends a cost of debt within the range of 8.88% to 10.13% to be fair and reasonable.⁴³ Hillcrest presently has a financing agreement bearing a 14% interest rate.⁴⁴ During the hearing in this matter, Staff learned that First Round CSWR, LLC, was formed early in 2014.⁴⁵ Prior to September 2014, during the acquisition process in Case No. WO-2014-0340, Staff was uninformed of this entity, which wholly owns Hillcrest

³⁹ Tr. 2, P. 164. “As you get higher and higher in leverage, the risk increases, therefore the return increases as you get higher and higher.”

⁴⁰ Tr. 2, P. 164.

⁴¹ *Griffin Direct* P. 7, lines 19-23.

⁴² *Griffin Direct* P. 9, lines 1-3.

⁴³ *Griffin Rebuttal* P. 4, lines 1-8.

⁴⁴ *Griffin Direct* P. 4, lines 19-20.

⁴⁵ Tr. 2: 85-86.

Utility Holding Company. Due to Staff's concerns in course of the acquisition case, the following condition was included in the Stipulation and Agreement approved by the Commission in Case No. WO-2014-0340:

Hillcrest and any successors or assigns shall bear the burden of proof, in subsequent rate cases where such financing is at issue, to show that it sought the least cost option available to it as to the proposed financing and ownership structure. If the Commission determines that Hillcrest has not carried this burden, Hillcrest understands the Commission may order a hypothetical capital structure and cost of capital consistent with similarly situated small water and sewer companies in Missouri, or such other capital structure and/or cost of capital that the Commission may find to be appropriate.⁴⁶

As stated above, despite the fact that the original Fresh Start investors were granted 33% non-controlling, equity interests in the utility entities to lower the rate on the Fresh Start loan agreement from 15% to 14%⁴⁷, after the investors changed to Robert and David Glarner and they acquired an 87% equity interest in First Round CSWR, LLC, the financing agreement was never renegotiated⁴⁸. Mr. Cox admitted he understood the method behind granting investors an equity interest in a company to result in a lower rate on financing⁴⁹, however, Mr. Cox never revisited the rate following the new investors' acquisition.⁵⁰ This fact does not fit with Hillcrest's agreement to the provision in the Stipulation and Agreement cited above to always seek the least cost option.⁵¹

⁴⁶ *Order Approving Stipulation and Agreement and Granting a Certificate of Convenience and Necessity*, Case No. WO-2014-0340, Attachment: Stipulation and Agreement, filed October 22, 2014.

⁴⁷ Tr. 2:105.

⁴⁸ Tr. 2:106-107.

⁴⁹ Tr. 2: 105.

⁵⁰ *Id.*

⁵¹ *Order Approving Stipulation and Agreement and Granting a Certificate of Convenience and Necessity*, Case No. WO-2014-0340, Attachment: Stipulation and Agreement, filed October 22, 2014.

Therefore, Staff supports rejection of the 14% investment rate as the least cost option for Hillcrest and provides a suggested range for cost of debt of 8.88% to 10.13%.⁵²

In a similar proceeding, *State ex rel, U.S. Water/Lexington v. Missouri Public Service Com'n*, Staff also recommended a hypothetical cost of debt which was approved by the Commission and later appealed to the Western District.⁵³ In that matter, Staff had concerns that the interest rate assigned to the financing arrangement was not the product of an arms-length negotiation.⁵⁴ The Western District found that the Commission appropriately took Staff's concerns into consideration when determining the cost of debt applied to the rate of return and upheld the Commission's ordered rate of return.⁵⁵ "...the Commission is not bound to accept whatever cost of debt is "negotiated" and presented to it."⁵⁶

Staff has estimated what it determines to be a more fair and reasonable cost of debt based upon an assigned debt rating and using the business risk and financial risk profiles guided by the Standard and Poor's benchmarks commonly applied in this field.⁵⁷ Staff has applied this method because Hillcrest's present financing agreement is not consistent with that of a traditional passive third-party debt investor.⁵⁸ The majority equity interest unit holders of First Round CSWR also wholly own Fresh Start through their limited liability corporation, Water Fund, LLC.⁵⁹ Furthermore, the

⁵² *Griffin Direct* P. 4, lines 1-5.

⁵³ *State ex rel, U.S. Water/Lexington v. Missouri Public Service Com'n* 795 S.W.2d 593 (Mo. App. 1990).

⁵⁴ *Id.* at 596.

⁵⁵ *Id.* at 596-597.

⁵⁶ *Id.* at 597.

⁵⁷ *Griffin Direct* P. 5, lines 18-23.

⁵⁸ *Griffin Direct* P. 5, lines 1-2.

⁵⁹ Tr. 2, P. 65.

investors/shareholders (Robert and David Glarner), through GWSD, LLC, are entitled to a 14% preferred return on 100% of capital contributions in First Round CSWR.⁶⁰

Utility customers are generally apportioned a fair and reasonable amount and cost of debt based on the costs a utility MUST pay in the course of doing business to secure financing; in this case for projects such as those implemented by Hillcrest upon acquisition of the Brandco water and sewer systems. “The rate of return should not be higher than is necessary to achieve these goals. Otherwise, utility customers will pay excessive prices, something regulation seeks to prohibit.”⁶¹ As Staff witness Shana Griffin stated in rebuttal testimony and on the stand; due to Hillcrest’s capital structure being effectively 100% equity capital, because of the fact that Robert and David Glarner have provided all of the capital contributions through both their equity and debt investments, the resulting investment is “less risky [to the investors/shareholders] and the debt and equity investors are the same, so therefore they have less risk.”⁶² The introduction of leverage into a capital structure is supposed to make the equity investors’ return less certain. However, due to the nature of the investment structure of Hillcrest⁶³, the return on that capital would be looked at in total.⁶⁴ Robert and David Glarner are guaranteed return on payments through the financing agreement, a preferred return and their capital contribution prior to Mr. Cox receiving anything beyond

⁶⁰ Staff Ex. 13, 5 (defining a “preferred return”); 6 (defining an “unpaid preferred return”); 7 (explaining method for cash distributions prior to dissolution).

⁶¹ *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 791–92, 88 S.Ct. 1344, 1372–73, 20 L.Ed.2d 312 (1968).

⁶² Tr. 2, P. 182.

⁶³ *Griffin Direct* Schedule SG-d5.

⁶⁴ Griffin Rebuttal P. 13, lines 20-23.

his salary.⁶⁵ To not consider this affiliation in determining Hillcrest's allowed rate of return would result in an unjust and unreasonable overall rate of return to investors.

The Hillcrest customers should not bear all or most of the risk of the utility, and Staff does not want to burden customers with a cost of debt that it cannot ensure is the least cost option. For these reasons, Staff set its rate of return proposal based on a hypothetical capital structure and capital costs with a recommended cost of debt range of 8.88% to 10.13%.⁶⁶, instead of those amounts provided by the company.

Issue 3: Corporate Allocation

Facts:

1. Hillcrest has applied a 14% corporate cost allocation factor to its request, based on its belief that after Central States Water Resources has successfully acquired the other small utilities it intends, 14% of its resources will be attributable to Hillcrest.⁶⁷

2. Staff has also applied a 14% corporate cost allocation factor based on the number of customers in Hillcrest compared to the number of customers in other utilities already acquired and anticipated to be acquired by Central States Water Resources.⁶⁸

3. OPC has applied a 10.49% corporate cost allocation factor to Hillcrest, based on its calculations of the amount of time that Hillcrest president, Josiah Cox spends working on Hillcrest.⁶⁹

⁶⁵ *Griffin Rebuttal* P. 8, line 15 to P. 10, line 20; Staff Ex. 13, P.5, 6 and 7.

⁶⁶ *Griffin Rebuttal* P. 4, lines 1-8.

⁶⁷ *Cox Direct* P. 15, lines 1-2.

⁶⁸ *Harrison Direct* P. 7, lines 7-11.

⁶⁹ *Roth Rebuttal* P. 5, lines 3-4.

What is the appropriate corporate allocation percentage to apply to corporate costs?

Staff stands behind its 14% allocation factor. While Staff calculated its number separately from the company's calculations, both parties came to the same result. OPC has removed portions of time from its calculations of Mr. Cox's timesheets not directly attributed to Hillcrest, with which Staff disagrees. OPC's proposed allocation factor would result in an approximately \$16,000 reduction to each system (\$32,000 total). While Mr. Cox certainly conducts other work as demonstrated by his timesheets⁷⁰ portions of time charged to such items as "administrative" should be partially attributed to his work on Hillcrest. Therefore, Staff finds that a 14% allocation factor is appropriate for determining the amounts attributed to Hillcrest specifically.

Issue 4: Payroll

Facts:

1. First Round CSWR, LLC (First Round), employs three employees, which provides services to Hillcrest.⁷¹
2. First Round was established in 2014.⁷²
3. The three employees had less than one year experience working for a regulated utility as of the end of the update period for this matter.⁷³
4. The Missouri Economic Research and Information Center (MERIC) employs three levels of experience in determining a range of average base salaries: Entry, Mean and Experienced.⁷⁴

⁷⁰ Hillcrest Ex. 003.

⁷¹ *Cox Direct* P.14, lines 17-20.

⁷² Tr. 2, P. 96.

⁷³ *Id.*

What level of experience should be used to set the labor expense associated with each employee?

Staff's use of the mean level for its proposed salaries for each of the First Round employees is based on the facts that each employee has prior work experience that rises to a level above entry. However, each employee's prior work experience has been for non-regulated entities⁷⁵, in some instances doing work unrelated to their job descriptions for First Round. Additionally, First Round has only existed since 2014⁷⁶ and according to Staff's investigation the Chief Financial Officer and Office Manager have only been with the company since early 2015.

Should the Employment Cost Index inflation rates be applied in setting such amounts?

The Employment Cost Index inflation rate is not necessary in this matter. As is the nature of most reports, the MERIC system uses the prior year's data to report data until the succeeding year is complete and a new report is produced.⁷⁷ For this rate increase request the test year has been set at April 1 to July 31, 2015, updated to October 31, 2015. The 2015 wage estimates would not have been available until early 2016 at the soonest, which is outside of the test year in this matter. Therefore, the 2014 wage estimates are appropriate and no inflation rate need be applied.

⁷⁴ *Harrison Direct* P.5, lines 18-20.

⁷⁵ Tr. 2, P. 96.

⁷⁶ *Id.*

⁷⁷ Missouri Economic Research and Information Center, *Occupational Employment and Wages*, https://www.missourieconomy.org/occupations/occ_wages.stm.

What is the appropriate number of annual work hours to include in calculating salaries for each employee?

Staff was unable to calculate a number of annual work hours in determining the appropriate salaries for the Chief Financial Officer and the Office Manager, because they did not keep timesheets prior to November 2015.⁷⁸ For Mr. Cox, the Company president, Staff applied ** _____ ** annual hours into annualized payroll based on his timesheets submitted to Staff.⁷⁹ Staff also calculated all of the hours Mr. Cox reported prior to the acquisition of Hillcrest, and capitalized a portion of them into plant in service and included the calculation in its recommended rate base amount.⁸⁰

OPC has attributed all of Mr. Cox's time prior to the Hillcrest acquisition to non-regulated business activity.⁸¹ Staff finds this inappropriate as Mr. Cox clearly spent time prior to the acquisition of Hillcrest working on elements of the acquisition, which falls under regulated business activities and for which Mr. Cox should be permitted some restitution. Staff supports a requirement that the company's employees maintain and provide timesheets that attribute specific work hours to a certain utility, regulated or non-regulated. The rate case or rate review to take place under the agreement between Company and Staff in the Partial Disposition Agreement would permit Staff to complete reviews of Mr. Cox's newly developed timesheets, as well as timesheets for the Chief Financial Officer and Office Manager.⁸²

⁷⁸ *Cox Rebuttal* P. 13, lines 10-13.

⁷⁹ *Staff's Position Statements* P. 2.

⁸⁰ *Harrison Rebuttal* P. 3, lines 22-24.

⁸¹ *Roth Direct* P. 6, lines 4-8.

⁸² *Company/Staff Partial Agreement Regarding Disposition of Small Water/Sewer Company Revenue Increase Request*, filed as Appendixes A and B to *Partial Disposition Agreement and Request for Evidentiary Hearing* P. 3 (11).

What is the appropriate hourly rate for each employee?

The proper hourly rate for each employee is ** _____

_____.⁸³ Staff calculated these amounts using the timesheets provided, along with the information from MERIC as explained above.

What are the appropriate job titles to use in MERIC to compare and determine labor expense associated with Mr. Josiah Cox and Mr. Jack Chalfant?

The appropriate job titles to use for Mr. Cox and Mr. Chalfant are the titles of President and Chief Financial Officer, respectively. These titles are presently used by Hillcrest to describe its applicable payroll costs and Staff finds no reason to amend those titles.⁸⁴ Staff believes the salaries assigned to employees bearing the titles of President and Chief Financial Officer by MERIC are appropriate for Mr. Cox and Mr. Chalfant, using the mean level of the salary.⁸⁵ Staff evaluated the tasks and job descriptions of each employee as part of its investigation and found that the employees' work is commensurate with those tasks assigned to employees with similar job descriptions.⁸⁶ Furthermore, Staff finds that the structure of Central States Water Resources and First Round CSWR, along with the acquisition plans of those companies, makes it appropriate to assign titles such as president and chief financial officer to the employees akin to those titles assigned to larger utility companies.⁸⁷

⁸³ *Staff's Position Statements* P. 2.

⁸⁴ *Harrison Rebuttal* P. 2, lines 8-11.

⁸⁵ *Harrison Rebuttal* P. 2, lines 19-23.

⁸⁶ *Harrison Direct* P. 5, lines 6-11.

⁸⁷ *Harrison Rebuttal* P. 2, lines 11-23.

Issue 5: Property Taxes

Facts:

1. The test year used to calculate Hillcrest's cost of service ran from April 1, 2015 to July 31, 2015, with an update period through October 31, 2015.
2. Because the parent company had not operated the water and sewer system for a full 12-month period, Staff annualized the available Hillcrest revenue expense, and used the ending balance of rate base based on data for the seven month period (April 1, 2014 to October 31, 2015).⁸⁸
3. Staff obtained Hillcrest's parent company's (CSWR) and Hillcrest's actual personal and property tax expenses as of December 31, 2015. Staff applied the 14% allocator discussed supra to the CSWR portion and included all of Hillcrest's property taxes. The determined appropriate tax expense is \$329.00.⁸⁹
4. Staff included \$164 for water and \$164 for sewer in its cost of service calculation.⁹⁰
5. The company has requested an amount of \$2,972 be included in its cost of service for 2016 property tax.⁹¹
6. The amounts have not been paid yet, and will not be paid until at or near the end of December 2016.⁹²
7. The \$2,972 is an "estimate of the property tax costs."⁹³
8. The final tax rate could rise or fall over the summer of 2016.⁹⁴

⁸⁸ Staff Ex. 8, 3:11 – 19.

⁸⁹ Staff Ex. 11, 3:1 – 4:3.

⁹⁰ *Id.*

⁹¹ Hillcrest Ex. 2, 21:1 – 4.

⁹² *Sarver Direct* P.2, lines 12-13.

⁹³ Hillcrest Ex. 2, 20:20 – 21.

What is the appropriate amount of property taxes to include in the Hillcrest revenue requirements?

Staff's position is that its proposed \$329 amount is appropriate for Hillcrest's property taxes to include within its cost of service because it is the only known and measurable amount available to the parties.

Should estimated property tax amounts be included in rates?

When calculating a utility company's cost of service, the Commission uses a "historical test year."⁹⁵ Staff examines the revenues, expenses, and rate base of a company during that test year, according to the matching principle, which means "simply that rates should be based on a measurement of costs and revenues at a single point in time."⁹⁶ Sticking to the matching principle is important because "updating some costs or revenues at a different time than other costs and revenues risks throwing the measurements out of balance and creating a single-issue ratemaking problem."⁹⁷

The cost of service can include a cost that occurs outside of the test year or true-up period, but only if it is "known and measurable." A cost is known and measurable when it relates to items or events affecting a utility's cost of service that must have been realized (known) and must be calculable with a high degree of accuracy (measurable).⁹⁸

⁹⁴ Hillcrest Ex. 2, 21:3 – 4.

⁹⁵ *State ex rel. Sw. Bell Tel. Co. v. Pub. Serv. Comm'n of Missouri*, 645 S.W.2d 44, 53 (Mo. App. W.D. 1982) ("The accepted way in which to establish future rates is to select a test year upon the basis of which past costs and revenues can be ascertained as a starting point for future projection").

⁹⁶ *In the Matter of the Request for an Increase in Sewer Operating Revenues of Emerald Pointe Util. Co.*, SR-2013-0016, 2013 WL 4507616, at *13 (Mo. P.S.C. July 10, 2013).

⁹⁷ *In re Emerald Pointe*, SR-2013-0016, 2013 WL 4507616, at *13 (Mo. P.S.C. July 10, 2013).

⁹⁸ *In the Matter of Kansas City Power & Light Company's Request for Auth. to Implement A Gen. Rate Increase for Elec. Serv.*, ER-2014-0370, 2015 WL 5244724, at *71 (Mo. P.S.C. Sept. 2, 2015), *reh'g denied*, ER-2014-0370 ET AL, 2015 WL 6577447 (Mo. P.S.C. Oct. 22, 2015). Both the Office of Public Counsel and Staff relied on this definition during the hearing.

In the instant matter, Staff's tax calculation is acceptable, because it is known and measurable; in that the amount was calculated from the amount *actually paid* by Hillcrest, and applied using the corporate allocation factor.⁹⁹

The \$2,970 number proposed by Hillcrest is inappropriate for inclusion in the cost of service. This amount is not known and measurable because the number is, as stated by the Company, an "estimate of the property tax costs"¹⁰⁰ and "the final tax rate could be raised marginally over the summer."¹⁰¹ Finally, at hearing, the Company argued that it is within the Commission's discretion to include the \$2,970 amount through some other ratemaking method.¹⁰² However, none of the parties requested such an approach, nor would Staff recommend any approach that "throw[s] the measurements out of balance and creat[es] a single-issue ratemaking problem."¹⁰³

Issue 6: Auditing and Income Tax Preparation Fees

Facts:

1. Hillcrest paid an actual amount of \$336 in auditing costs and/or tax preparation fees in the test year and update period.¹⁰⁴

2. Based on Staff's determined allocation factor, only 14% of the total auditing and tax preparation costs for Central States Water Resources, Inc. are appropriately allocated to Hillcrest.¹⁰⁵

⁹⁹ Staff Ex. 11, 3:1 – 4:3.

¹⁰⁰ Hillcrest Ex. 2, 20:20 – 21.

¹⁰¹ Hillcrest Ex. 2, 21:3 – 4.

¹⁰² Tr. 16:12 – 17: 25.

¹⁰³ *In re Emerald Pointe*, at *13 (Mo. P.S.C. July 10, 2013).

¹⁰⁴ *Harrison Direct* P. 8, lines 6-8.

¹⁰⁵ *Harrison Direct* P. 8, lines 18-19; *Cox Direct* P. 20, lines 21-22.

3. Hillcrest submitted Requests for Proposal to accountants and accounting firms from which it obtained an estimated cost of auditing and tax preparation for Hillcrest and Central States Water Resources in January 2016.¹⁰⁶

4. Hillcrest will not incur additional expenses related to auditing or tax preparation earlier than July 2016.¹⁰⁷

5. The costs of auditing and tax preparation fees could fluctuate from the estimated amounts provided by the company.¹⁰⁸

What is the appropriate amount of Hillcrest's auditing and tax preparation (accounting) costs to include in Hillcrest's cost of service?

Staff has included an appropriate amount of \$168 each for the water and sewer systems in Hillcrest's cost of service.¹⁰⁹ These amounts reflect the actual amounts spent by the company on auditing and tax preparation for the test year and update period in this matter.

What is the appropriate allocated level of auditing and tax preparation (accounting) costs for Central States Water Resources to include in Hillcrest's cost of service?

The amounts of \$168 each for the Hillcrest water and sewer systems are the only appropriate amounts to include in the cost of service, because they are the only known and measurable amounts incurred within the test year and update period in this matter.

¹⁰⁶ Cox Direct P. 20.

¹⁰⁷ Tr. 2:98.

¹⁰⁸ Harrison Direct P. 9, lines 7-10.

¹⁰⁹ Harrison Direct P. 8, lines 6-8.

Should accounting costs incurred and paid in 2016 by Hillcrest be included in Hillcrest's cost of service?

Any amounts incurred or paid outside of the test year and update period in a rate case are inappropriate to be included in the cost of service for that case unless they are known and measurable. The Commission has consistently applied the known and measurable method to matters of this nature. As stated in this brief regarding property tax fees, "a cost is known and measurable when it relates to items or events affecting a utility's cost of service that must have been realized (known) and must be calculable with a high degree of accuracy (measurable)."¹¹⁰ Mr. Cox himself admitted that the earliest the auditing and tax preparation fees will be paid is July 2016.¹¹¹ Staff has no documentation reflecting a contract with concrete amounts to be paid for auditing and tax preparation. The only documentation that Staff has received from the Company is a fee estimate from Rubin Brown dated Jan 2016.

Additionally, the matching principle applies to these expenses as it does the property tax expenses. As stated above, the matching principle means "simply that rates should be based on a measurement of costs and revenues at a single point in time."¹¹² If Staff updates the auditing and tax preparation fees, along with the property tax expenses, for inclusion in this case, the remaining elements of the revenue requirement will be measured from a different point in time. Hillcrest has not suggested that the remaining elements of the revenue requirement should be updated for reflection

¹¹⁰ *In the Matter of Kansas City Power & Light Company's Request for Auth. to Implement A Gen. Rate Increase for Elec. Serv.*, ER-2014-0370, 2015 WL 5244724, at *71 (Mo. P.S.C. Sept. 2, 2015), *reh'g denied*, ER-2014-0370 ET AL, 2015 WL 6577447 (Mo. P.S.C. Oct. 22, 2015). Both the Office of Public Counsel and Staff relied on this definition during the hearing.

¹¹¹ Tr. 2:98.

¹¹² *In the Matter of the Request for an Increase in Sewer Operating Revenues of Emerald Pointe Util. Co.*, SR-2013-0016, 2013 WL 4507616, at *13 (Mo. P.S.C. July 10, 2013).

in this matter. The rate case or rate review to take place under the agreement between Company and Staff in the Partial Disposition Agreement would permit Staff to update the auditing and tax preparation amounts once those amounts are either paid or known and measurable.¹¹³

CONCLUSION

In summary, today Hillcrest is a well-functioning water and sewer utility. Staff's positions in this brief are a reflection of its attempt to balance the interests of the utility and the ratepayers. The recommendations for each issue in this matter are designed to give the Commission the maximum amount of flexibility in its final determinations. The analyses of each issue are the product of Staff's extensive investigation and counsel's attempt to provide the most concise collection of the information gathered throughout the investigation and litigation of this matter.

WHEREFORE, Staff prays that the Commission will approve the partial dispositions and based on the foregoing, resolve each issue in this case as recommended by Staff.

Respectfully submitted,

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¹¹³ *Company/Staff Partial Agreement Regarding Disposition of Small Water/Sewer Company Revenue Increase Request*, filed as Appendixes A and B to *Partial Disposition Agreement and Request for Evidentiary Hearing* P. 3 (11).

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served by electronic mail, or First Class United States Postal Mail, postage prepaid, on this 3rd day of June, 2016, to all counsel of record.

/s/ Whitney Payne

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the Matter of the Water Rate)
Increase Request of)
Hillcrest Utility Operating)
Company, Inc.)
)
Consolidated with,)
)
In the Matter of the Sewer Rate)
Increase Request of)
Hillcrest Utility Operating)
Company, Inc.)

Case No. WR-2016-0064

STAFF’S REPLY BRIEF

COMES NOW the Staff of the Missouri Public Service Commission (Staff), by and through counsel, and for its *Reply Brief* in the above-referenced matters, hereby responds to the arguments made by the other parties in their initial briefs.

INTRODUCTION

Staff upholds its positions as stated in its *Initial Brief*.

ARGUMENT

The Commission on its own webpage¹ states that it “must balance the interests of the public – ratepayers as well as company shareholders.” A balancing of interests means just that, a median between conflicting party positions. The Office of the Public Counsel (OPC) in its *Initial Brief*, quotes from case law² that, “the protection given the utility is merely incidental” in cases before the Missouri Public Service Commission.

¹ *A Snapshot of What We Do: A Publication of the Missouri Public Service Commission*, July 2015 <http://psc.mo.gov/CMSInternetData/ConsumerInformation/A%20Snapshot%20of%20What%20Do.pdf>.

² *State ex rel. Crown Coach Co. v. Public Service Commission*, 179 S.W.2d 123, 126 (Mo. App. 1944) “[t]he dominant thought and purpose of the [public utility law] policy is the protection of the public while the protection given the utility is merely incidental.”

Staff does not agree with this viewpoint due to its direct contradiction with the Commission's stated intent.

RATE OF RETURN

Staff recommends the Commission focus on the rate of return as the most critical element when balancing the interests of the parties. As stated in Staff's *Initial Brief*,³ "...the Commission is not bound to accept whatever cost of debt is "negotiated" and presented to it."⁴ Staff has no intention of cutting Hillcrest off at the knees, but rather seeks to protect the Hillcrest customers from a high interest rate that is not consistent with current, applicable junk bond yields. In addition, even though the investors and investment structure changed, this high interest rate was not reduced to reflect the new circumstances. However, as outlined in Staff's *Initial Brief*,⁵ in this case the debt investors have no incentive to renegotiate the interest rate on the financing agreement as they have provided all of the equity and debt capital invested in Hillcrest, which reduces any such transaction to less than arms-length.

Despite any allegations against Staff's numbers, the Company will still continue to have sufficient capital to function and no "theoretical niceties" factored into the calculations of Staff's debt cost. Staff affirms that its calculations relied on actual junk bond rates from widely recognized and easily verifiable sources.⁶ Throughout this case the Company has provided no support or testimony from investors or investing experts

³ Staff's Initial Brief P. 15.

⁴ *State ex rel, U.S. Water/Lexington v. Missouri Public Service Com'n*, 795 S.W.2d 593, 597 (Mo. App. 1990).

⁵ Staff's Initial Brief P. 14.

⁶ *Griffin Direct* Schedule SG-d2.

as to what an investor generally seeks in a company to instill confidence, yet it continually asks the Commission to recognize this interest. In fact, the Company provided no other testimony or witnesses than Josiah Cox. The Commission is left to speculate about investment rationales through a second-hand accounting via the testimony of Mr. Cox, even though the investors in this case, Robert P. and David Glarner, are tangible and real. Staff asks the Commission to consider not only the confidence of the investors, but also the confidence the ratepayers have in the utility. The only way to provide confidence to the ratepayers is for a utility to provide good service, which Staff's investigation revealed that Hillcrest accomplishes, and to charge reasonable rates developed from rate of return calculations that are the product of proper, arms-length transactions.

CORPORATE ALLOCATION FACTOR

Generally, an allocation factor is calculated based on the time devoted specifically to a utility, in this case Hillcrest, by a greater managing or parent company, in this case First Round, CSWR, LLC. Staff calculated its recommended allocation factor of 14% using current customer numbers compared to the anticipated size of First Round CSWR, LLC, once its anticipated acquisitions have been finalized.⁷ First Round CSWR, LLC, already oversees Indian Hills and Raccoon Creek along with Hillcrest, and has three more small utilities in various states of acquisition.⁸ Applying the known and measurable standard to this calculation, Staff determined the utilities First Round has acquired/is acquiring are most certainly known and it is possible to measure with a high

⁷ *Harrison Direct* P. 7, lines 9-11.

⁸ Tr. 2:112-113.

degree of accuracy the customer numbers of those utilities.⁹ OPC challenges Staff by citing to its witnesses Paul Harrison and Ashley Sarver in stating that Staff failed to provide evidence or justification, yet OPC's citations directly point to Staff's work product.¹⁰ Staff finds ample justification and evidence of its 14% allocation factor and prays the Commission will agree.

PAYROLL

Staff upon calculating payroll looked at the current structure of Hillcrest and what the structure will be once the acquisition process for some of the other small utilities is finalized.¹¹ Because Hillcrest is already part of a greater utility system due to the setup of Central States Water Resources, Inc., as the manager of First Round CSWR, LLC, Hillcrest is now comparable to a portion of a larger utility system rather than a small water and sewer system.¹² Due to that setup, it is not proper to compare Hillcrest to standalone water and sewer facilities and for that reason OPC is incorrect when it recommends hourly rates and job titles based on those comparisons.

As to the proper number of work hours to include in payroll calculations, the final dollar amount and the Company's opinion of whether that is a large or small amount should not be the factor in determining the proper accountable hours to include in rate base. Staff determined an appropriate calculation for work hours based on investigation

⁹ *In the Matter of Kansas City Power & Light Company's Request for Auth. to Implement A Gen. Rate Increase for Elec. Serv.*, ER-2014-0370, 2015 WL 5244724, at *71 (Mo. P.S.C. Sept. 2, 2015), *reh'g denied*, ER-2014-0370 ET AL, 2015 WL 6577447 (Mo. P.S.C. Oct. 22, 2015). Both the Office of Public Counsel and Staff relied on this definition during the hearing.

¹⁰ OPC Initial Brief P. 3-4.

¹¹ Tr. 2:191.

¹² *Id.*

of the employee's duties to Hillcrest using Josiah Cox's timesheets, and included these details in its *Initial Brief*.¹³

The fact that the First Round employees have respectable résumés has not been an issue in this matter. The fact that the employees have less than a year's experience applicable to this proceeding working for a regulated utility, specifically Hillcrest, is at issue in this matter.¹⁴ Company witness Josiah Cox candidly agreed at the evidentiary hearing that the NARUC uniform system of accounts and regulated utility tariffs require specialized understanding.¹⁵ The Missouri Economic Research and Information Center (MERIC) established three distinct levels to categorize employees for the purpose of determining salary. Staff used the middle level to recognize that Hillcrest employees have a skillset applicable to some of their assigned tasks, but when it comes to the regulated utility world, are still very new.

The ratemaking process necessarily requires utilities to spend money up front and then collect a reimbursement through rates for those amounts. In this case, the test year begins April 1, 2015, and the update period does not end until October 31, 2015.¹⁶ Contrary to allegations that the data is two years old, Staff actually used salary data updated through December 2014, resulting in data that is not even one year old as of the end of the determination period in this matter. Factoring in that 2016 is only half-done, the data will still not be two years old by the date of the Commission's report and order.

¹³ Staff's Initial Brief P. 20.

¹⁴ Tr. 2:96.

¹⁵ Tr. 2:95, line 18 to 96, line 2.

¹⁶ *Harrison Direct* P. 3, lines 13-14.

RATE DESIGN

In creating its recommended rate design alternatives, Staff focused its concerns on Hillcrest receiving a fair return and the customers paying an amount that was manageable despite the sharp increase.¹⁷ Unlike OPC, Staff did not find it imperative to focus on the allocation of expenses between the customer charge and volumetric rate in testimony. The customer charge and volumetric rate are determined differently by each rate design analyst;¹⁸ it is an art, not a science. Additionally, as one half of the equation varies (i.e. the usage rate), the other half (i.e. the customer charge) naturally trends in the opposite direction; or as one increases, the other decreases.¹⁹ To that end, when OPC allocated its customer charge and volumetric rate differently than Staff's rate design analyst, OPC's customer charge, which is the fixed amount charged to every customer, became higher than that recommended by Staff.²⁰ As stated in the Report and Order for Missouri American Water Company (Case No. WR-2015-0301), utilities usually prefer to recover costs through customer charges because the costs and the charges are fixed rates and the risk that the company will not adequately recover its costs is reduced.²¹ However, as the order also states, consumers' groups and environmentalists generally prefer utilities to recover costs through volumetric rates because it allows customers more control of their total bill.²² OPC witness Russo agreed

¹⁷ *Robertson Direct* P. 6, lines 14-18.

¹⁸ Tr. 2:222, line 19 to 223, line 2 (Where OPC witness Russo was asked, "And do you agree that there's a variety of methods that a rate design analyst could use to develop rates?" and he answered in the affirmative).

¹⁹ Tr. 2:223, line 15 to 224, line 1.

²⁰ Tr. 2:224.

²¹ Report and Order, *In the Matter of Missouri-American Water Company's Request for Authority to Implement a General Rate Increase for Water and Sewer Service Provided in Missouri Areas*, Case No. WO-2015-0301, P. 36.

at the evidentiary hearing that a higher customer charge results in a lower commodity charge in rates.²³ When volumetric rates or commodity charges constitute a higher portion of the overall rate, the customers have less ability to lower their bills through adjusting their usage.

It is difficult to recognize the similarities between Staff and OPC's proposed rate designs due to OPC's witness using a different projected usage amount and applying different property tax amounts than Staff. Staff has created workpapers outlining the similarities when these factors are aligned should the Commission desire demonstrative evidence.

Staff took no position between its phase-in alternatives recommended in this matter. Staff did not want to provide a rate design that favored one party over another and thus gave the Commission the flexibility to determine the best manner to balance party interests. Staff specifically designed its phase-in rate to omit only non-cash items for the one-year period of phase-in so as not to damage the company's ability to continue operations.²⁴

AUDITING AND TAX PREPARATION FEES/PROPERTY TAX

Staff continues to recommend amounts of \$168 for each utility for auditing fees and tax preparation costs.²⁵ In referencing the differing positions of Hillcrest and Staff as to the appropriate property tax amount to include in rate base, the Company stated, "Hillcrest has worked with the Cape Girardeau County Assessor's office in an effort to

²² *Id.*

²³ Tr. 2:223-224.

²⁴ *Robertson Direct* P. 8, Lines 17-20.

²⁵ *Harrison Rebuttal* P. 6, lines 11-13.

make the taxes as affordable as the County Assessor will allow.”²⁶ This statement is confusing as it suggests that a party can negotiate its taxes with the assessor, and to Staff’s knowledge there is no such opportunity available to utilities. Staff has not seen any substantive evidence to sway from its recommended amount for property taxes of \$164 each for water and sewer, with additional amounts to be updated in the rate review or next rate case to be filed one year from the effective date of rates in this matter.

The Company suggests applying a surcharge or tracker to auditing, tax preparation, and property tax amounts. The Commission has found that trackers and surcharges tend to be appropriate when events are known and measurable, certain to occur, and the impact can be calculated with a high degree of accuracy.²⁷ Here the increases are certain to occur but the amounts are neither known and measurable nor able to be calculated with high accuracy as Staff argued in its *Initial Brief*.²⁸ Coupling that with the rate case or review to be filed in one year, which would remedy any differences in projected and actual amounts, Staff would recommend that a tracker or surcharge is inappropriate for this matter.

²⁶ HC Initial Brief P. 11.

²⁷ Report and Order, *In the Matter of the Application of Peaceful Valley Service Company’s Request for Increase in Sewer Operating Revenues; In the Matter of the Application of Peaceful Valley Service Company’s Request for Increase in Water Operating Revenues*, Case Nos. SR-2014-0153 and WR-2014-0154, P. 11.

²⁸ Staff’s Initial Brief P. 24-25.

CONCLUSION

In conclusion, Staff wishes to express that it has not changed its positions from those statements made in its *Initial Brief*. Based on the information in that document and the points Staff addresses here, it asks the Commission to use its recommendations in issuing determinations on the matters of the corporate allocation factor, payroll, rate design, income tax and auditing fees, property taxes and the rate of return.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served by electronic mail, or First Class United States Postal Mail, postage prepaid, on this 15th day of June, 2016, to all counsel of record.

/s/ Whitney Payne

Business

http://www.stltoday.com/business/local/questions-raised-about-water-bill-proposal-and-the-utility-behind/article_0b084a8e-077e-5be6-b22f-d5e31409eae6.html

Questions raised about \$150 water bill proposal and the utility behind it

By Jacob Barker St. Louis Post-Dispatch Jun 13, 2016

EXPLORE THE
JOURNEY OF FOOD

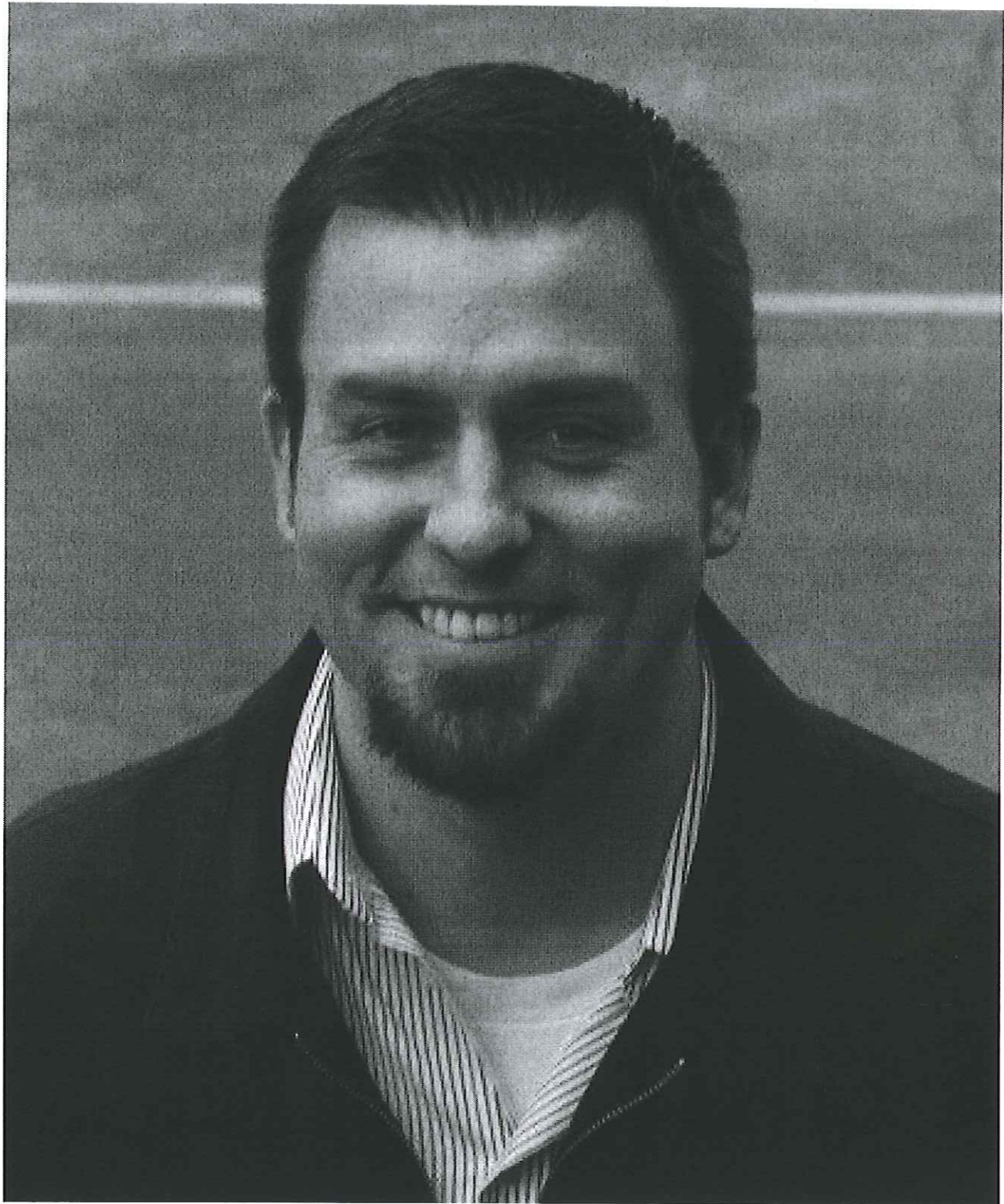
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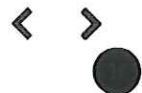


Schedule CRH-R-4

1/8



Josiah Cox, president of Central States Water Resources Inc.



Schedule CRH-R-4



Residents of the Hillcrest Manor subdivision near Cape Girardeau, Mo., were often told not to drink their water.

Contamination led to frequent boil orders in the failing water and wastewater system that serves close to 250 homes in southeastern Missouri. But two years ago, a St. Ann company bought the utility and spent more than \$1 million to fix it up.

Now, the Hillcrest residents are facing a new problem: a huge rate hike that could boost monthly bills from some of the cheapest in Missouri to some of the most expensive.

The hike proposed by the Hillcrest Utility Operating Co., from around \$25 a month to nearly \$150 a month, has put a vexing question in front of state regulators: How do you get investors to pay to fix up failing water and sewer systems without sending customers

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The problem is particularly acute for small, failing systems without enough customers to spread out the costs of big capital increases.

But there's more at stake than a big rate increase, according to the Missouri Office of Public Counsel, which represents ratepayers in front of the Missouri Public Service Commission.

While even that office sees as necessary an increase almost as large as that proposed by Hillcrest Utility, the office is raising questions about the truthfulness of the company's president: Josiah Cox, who heads St. Ann-based Central States Water Resources Inc., the company that runs Hillcrest.

Regulatory staff and the Office of Public Counsel have both questioned whether the 14 percent interest rate on a loan made to Hillcrest to fix up the failing water and sewer system is the best deal for ratepayers. They point out that the company that holds the loan to Hillcrest is owned by the same people who hold a majority stake in Hillcrest: Robert and David Glarner, the St. Louis developers behind the Northwest Plaza redevelopment.

Beyond costs to ratepayers, the Office of Public Counsel even presented evidence that Cox may not have disclosed all of his future income and assets during a personal bankruptcy in 2014, raising questions about whether a bankruptcy trustee could reopen the case and put the utility holding company at risk.

"This has not been a very transparent or cooperative relationship so far," said Cydney Mayfield, deputy counsel for the Office of Public Counsel. "When you're working with regulated entities, that transparency and flow of information is critical."

The PSC will have to decide whether it wants to continue working with Cox and Central States, because Cox has plans to acquire as many as 30 more small, failing wastewater and water systems. Already, Central States runs two other water and wastewater systems in Missouri: one near Cuba and another near Sedalia.

Cox says he

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systems will

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allow it to spread the costs to fix them up over more customers.

"I saw there were a ton of water and wastewater utilities that no one wanted," he said in an interview. "The big utilities aren't interested for various reasons, and there was a need for someone to come in and fix them."

Regulators agree that the systems appear to have improved from a dismal state.

"And obviously, for far too long, these residents have not been paying what they should've been paying," PSC Commissioner Bill Kenney said during a hearing on Hillcrest's rate increase. "I mean, because it's been just in disarray."

Cox says homeowners struggled to sell their houses due to the frequent boil orders, a problem that has since been fixed.

Resident Tonya South, who has lived in Hillcrest since 2012, worries the huge proposed increase could have similar effects. She said one of her neighbors ended up losing a buyer for her house after the real estate agent disclosed water and sewer bills could be increased to \$150.

"We understand you need to raise it, but do a gradual increase," South said in an interview.

Another resident, David Lane, said he wished there had been more warning upfront about what it would cost.

"I know they did a lot of upgrades to it and everything, but we never had a meeting on what it was going to cost," he said. "I know the man's got a right to get his money back, but he doesn't have to get it all back in one year."

But even the Office of Public Counsel is proposing a large rate increase. However, it wants to see a combined average rate of \$133 per month for water and sewer phased in over two years, something Cox opposes.

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Cox says that while he empathizes with the Hillcrest residents, a gradual increase won't work.

"There's just no shortcuts," Cox said. "There's just no easy way to do it. You can't gradually repair systems that have completely failed. It's hard on residents, I understand that, but unfortunately there's no other way to do it."

The PSC will make a final decision on how to structure rates in a ruling expected later this summer.

'Not really a great solution'

Part of the reason Cox is proposing a large increase is the 14 percent loan from the Glarners. Cox said in testimony to the PSC that the company wouldn't be able to make its debt payment with phased-in rates.

But the Office of Public Counsel and the PSC staff say that Cox didn't try to renegotiate the loan term, even after the Glarners bought Fresh Start LLC, the company that held it. They were given a nearly 90 percent stake in the utility company's parent, far larger than the previous debt investors, but the rate on the loan stayed the same.

Cox, a builder who used to own Trumpet Builders and worked in water and wastewater engineering, filed for Chapter 7 bankruptcy in February 2014. In January, Central States Water Resources was formed, as was its parent company, First Round CSWR LLC.

By February, Fresh Start, made up of 12 investors, was formed to invest in Hillcrest Utility. Later, the Glarners bought Fresh Start and the loan. When they did, they also received 87 percent in a company that owned Central States' parent.

In a brief, the PSC staff said that because the Glarners are both the debt and equity investors, it had concerns that the financing agreement wasn't an arms-length transaction.



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Because Robert and David Glarner are both the equity and debt investors, there is less risk, the PSC staff wrote, and thus, it recommended a lower return than pitched by Hillcrest.

Bob Glarner, in an email, said the high rate was already set by a group of California investors Cox worked with.

"But the California investors didn't really have the financial resources nor the tolerance for risk necessary to actually close and fix up a system," Bob Glarner wrote. "So Josiah approached us to buy out the California investors and make financing and capital available to the various companies he set up."

The high rate is appropriate, Glarner said, because the environmental liability would fall to them should the system fail or Cox fail to perform. Banks wouldn't take on environmental risk, and Cox came to them after one bank mentioned the Glarners as possible investors, Bob Glarner wrote.

Beyond costs, the Office of Public Counsel argues Cox's past bankruptcy raises serious questions about his trustworthiness. During testimony, Mayfield presented evidence that suggested Cox did not disclose all of his assets or income when he was filing for bankruptcy.

"There are potential criminal violations related to the fact that he signed a document under oath and was not truthful about it," Mayfield said.

Cox, during testimony, said he was advised by an attorney through his bankruptcy. Asked about public counsel's allegations, he told a reporter: "It's factually not true."

Without Cox, however, or investors like the Glarners, Missouri has to find some other way to deal with the large number of small, failing water and wastewater systems. Combining them under ownership of one company may be a better approach, Bob Glarner suggested.



"Having small independent systems throughout the state without common control or adequate resources is what has contributed to the high number of systems currently in noncompliance with (the Missouri Department of Natural Resources) and in violation of environmental regulations," Glarner wrote in an email.

But in order to fix up small water and sewer systems and, at the same time, protect ratepayers, Mayfield said regulators shouldn't just accept any offer they see.

"There's not really a great solution," she admitted. "But just because Mr. Cox presented this solution does not mean he's the right solution."

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Central States Water Resources

President: Josiah Cox

Headquarters: St. Ann

Investors: Robert and David Glarner

Business: Buying and repairing small, failing water and wastewater systems

Systems owned: Hillcrest, near Cape Girardeau; Raccoon Creek, near Sedalia; and Indian Hills, near Cuba, Mo.

Rate increase sought at Hillcrest: Under the company's proposal, monthly water and sewer bills would rise from about \$25 per month to almost \$150 per month.

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