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

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

INITIAL BRIEF OF STAFF

Respectfully submitted,

WHITNEY PAYNE, Mo Bar 64078
Legal Counsel

Attorney for the Staff of the
Missouri Public Service Commission

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

WHITNEY PAYNE, Mo. Bar 64078
Legal Counsel

Attorney for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 751-8706 (Telephone)
(573) 751-9285 (Fax)
whitney.payne@psc.mo.gov

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