

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

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

**POST HEARING BRIEF**

**COMES NOW** the Staff of the Missouri Public Service Commission (“Staff”), by and through counsel, and for its *Post Hearing Brief*, states as follows:

**Introduction**

Indian Hills Utility Operating Company, Inc. (“Indian Hills”) is a small water utility serving 715 customers, half are full time residents and half are part time residents, with primary residency elsewhere.<sup>1</sup> Indian Hills acquired the system from I.H. Utilities, Inc., and upon Commission approval in WO-2016-0045.<sup>2</sup> The Commission granted Indian Hills permission to acquire the system and its assets, to issue indebtedness, and to encumber those acquired assets to bring the 50-year-old system into regulatory compliance.<sup>3</sup> When Indian Hills acquired the system, the system was not in compliance with Missouri Department of Natural Resource (“DNR”) standards.<sup>4</sup> In total, the system had 27 DNR compliance issues.<sup>5</sup> To rectify these issues and bring the system into DNR compliance as well as to provide safe and adequate service, Indian Hills

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<sup>1</sup> Ex. 101, *Direct Testimony of Curtis B. Gateley*, p. 3.

<sup>2</sup> Ex. 1, *Direct Testimony of Josiah Cox*, p. 10.

<sup>3</sup> *Id.* at 11.

<sup>4</sup> Ex. 105, *Direct Testimony of David A. Spratt*, p. 1.

<sup>5</sup> Ex. 1, *Direct Testimony of Josiah Cox*, p. 15.

invested \$1.84 million into the system.<sup>6</sup> For \$1.84 million, the customers of Indian Hills received an additional well<sup>7</sup> (required for DNR compliance<sup>8</sup>), two new well houses with improved and standby disinfection and chlorination systems<sup>9</sup> (required for DNR compliance<sup>10</sup>), a backup generator for system reliability<sup>11</sup> (required for DNR compliance<sup>12</sup>), two new storage tanks<sup>13</sup> (required for DNR compliance<sup>14</sup>), and booster pumps to maintain minimum system pressure as required by DNR,<sup>15</sup> among other improvements. Indian Hills also began the long process of repairing and replacing the substandard distribution system, to stop the 75% water loss it was experiencing.<sup>16</sup>

On April 4, 2017, Indian Hills filed a request for a rate increase, utilizing the Commission's small company rate request rule,<sup>17</sup> with the Commission, beginning this case. Staff and Indian Hills were able to reach a *Partial Disposition Agreement*, filed September 1, 2017. Staff and Indian Hills were later able to reach a *Non-unanimous Stipulation and Agreement* ("Stipulation"), filed November 22, 2017. This Stipulation

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<sup>6</sup> *Id.* at 21.

<sup>7</sup> *Id.* at 20.

<sup>8</sup> *Id.* at 12.

<sup>9</sup> *Id.* at 19.

<sup>10</sup> *Id.* at 17.

<sup>11</sup> *Id.* at 19.

<sup>12</sup> *Id.* at 16.

<sup>13</sup> *Id.* at 19.

<sup>14</sup> *Id.* at 14.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 12.

<sup>17</sup> 4 CSR 240-3.050

resolves the case in total for revenue requirement of \$723,466. This is an increase of \$630,911 from the current total annualized revenues of \$97,291.<sup>18</sup>

As the Office of Public Counsel has objected to this Stipulation, the Stipulation has become the joint position of Indian Hills and Staff, as supported by the evidence in the case.<sup>19</sup> The Commission's ultimate responsibility in this case is to set just and reasonable rates.<sup>20</sup> The Stipulation is a path forward to resolve all issues in the case and would result in just and reasonable rates, rates that allow the utility to recover its prudently incurred costs and earn a reasonable return, but do not require ratepayers to pay more than necessary for safe and adequate service.<sup>21</sup>

## **ARGUMENT**

### **Payroll**

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

As part of the Stipulation that now encompasses Staff's position, Indian Hills and Staff agreed to a payroll cost of \$51,722 annually. This is the amount in Staff's accounting schedules, which was adopted by Indian Hills and Staff as part of the

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<sup>18</sup> See Attachment B to the *Non-Unanimous Stipulation and Agreement*, filed November 22, 2017.

<sup>19</sup> 4 CSR 240-2.115(D).

<sup>20</sup> Mo. Rev. Stat. § 393.130 and 393.140.

<sup>21</sup> See *St. ex rel. Washington University et al. v. Public Service Commission*, 308 Mo. 328, 344-45, 272 S.W. 971, 973 (banc 1925).

Stipulation.<sup>22</sup> This amount is supported by Staff's filed testimony on the record. The Stipulation does not reflect an Employment Cost Index inflation factor rate and uses an assumed allocation factor. The Stipulation is silent as to the Missouri Economic Research and Information Center Employment ("MERIC") experience levels and job titles, and not binding any party to a particular job title or MERIC experience level. As outlined in their testimony and stated in their position statement, OPC agreed with Staff on not applying an Employment Cost Index inflation factor rate, using an assumed allocation factor, and using a mean level of experience and the job title of Construction Manager for Mr. Todd Thomas.<sup>23</sup> As the stipulated payroll number was based off of Staff's accounting schedules with those assumptions, the remaining differences between OPC's positions and the Stipulation regard the appropriate job title for Mr. Josiah Cox (issue A) and the appropriate MERIC wages for Mr. Cox and Mr. Thomas (issue B).

*What are the appropriate job titles to be used in MERIC to compare and determine labor expense associated with Mr. Josiah Cox and Mr. Todd Thomas?*

Staff believes the appropriate job title for Mr. Cox to be Chief Executive. As Mr. Cox is the President of Central States Water Resources, Inc. ("CSWR"), he is responsible for the administration and operation of not only Indian Hills, but also four other regulated utilities, as well as the acquisition activities of CSWR and the operation and administration of five wastewater treatment plants.<sup>24</sup> OPC's witness Ms. Keri Roth notes that Mr. Cox's job duties are to "[l]ead and direct overall company strategy and

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<sup>22</sup> The EMS run and Staff's filed testimony remain largely unchanged by the Stipulation, the EMS only differs as to the Return on Equity ("ROE") and the repair expense, discussed later in this brief.

<sup>23</sup> See OPC Position Statement, filed November 21, 2017.

<sup>24</sup> Ex. 1, *Direct Testimony of Josiah Cox*, p. 3-4.

direction, contact for financial regulatory compliance (PSC, OPC) and environmental regulatory compliance (MDNR, Attorney General), and director of all financing activities including debt and equity raises.”<sup>25</sup> The Commission has decided this issue in a previous case involving Mr. Cox, and found Chief Executive to be the appropriate job title.<sup>26</sup> The Commission found:

The appropriate job titles to use in MERIC to determine labor expense for Mr. Cox and Mr. Chalfant are President and Chief Financial Officer, respectively. These are the titles presently used by Hillcrest to describe those two employees, and Staffs comparison of their job duties to MERIC found that these titles should continue to be used for ratemaking purposes. Since Hillcrest is part of a group of commonly-owned regulated utilities and has plans to acquire additional utilities, it is appropriate to assign employee titles similar to larger utilities rather than single utility companies.<sup>27</sup>

OPC has not presented compelling evidence to overturn this decision. OPC only points to Indian Hills classification as a small utility and that CSWR’s combined customer count would still fall short of being a large utility, consisting of more than 8,000 customers.<sup>28</sup> First, the Commission has previously reached the conclusion that Chief Executive was the appropriate job title for Mr. Cox in the Hillcrest case. At the time that case was decided, Hillcrest was also a small utility, and the combined customer count was less than 8,000. The Commission, with knowledge of those facts, still decided to classify Mr. Cox as a Chief Executive. Second, if one were to only view Indian Hills as the guidepost for Mr. Cox’s job title, then it would be inappropriate to

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<sup>25</sup> Ex. 200, *Direct Testimony of Keri Roth*, p. 4.

<sup>26</sup> *In the Matter of the Water Rate Request of Hillcrest Utility Operating Company, Inc.*, Case No. WR-2016-0064, **Report and Order**, filed July 12, 2016. (“Hillcrest”).

<sup>27</sup> *Id.* at 12.

<sup>28</sup> See Ex. 200, *Direct Testimony of Keri Roth*, Ex. 202, *Rebuttal Testimony of Keri Roth*, and Ex. 203, *Surrebuttal Testimony of Keri Roth*.



Indian Hills based on the assumed allocation factor.<sup>33</sup> This would be an increase of \$47,833 over OPC's salary position for Mr. Cox.<sup>34</sup> The Staff and OPC assumed allocation factor of 16.61% would allocate \$7,945.06<sup>35</sup> to Indian Hills, and increase OPC's payroll expense to \$53,696.06, an amount higher than the annual payroll number contained in the Stipulation.<sup>36</sup>

What are the appropriate MERIC salary wages?

As outlined above, the appropriate job title for Mr. Cox is Chief Executive, and the appropriate salary for that job under a mean level of experience in MERIC is \*\* \*\* . OPC recommends a salary of \$124,049, based on the erroneous classification, rebutted above, that Mr. Cox's correct job title is General and Operations Manager. OPC also recommends a slightly higher overall salary for Mr. Thomas, of \$102,049, compared to the stipulated number supported by Staff's testimony and accounting schedules of \*\* \*\* . The slight variation results from Staff using the 2015 MERIC wages as a proxy for a three-year average ("Staff determined that the MERIC wage levels for 2015 were closer to the three-year average")<sup>37</sup> as opposed to OPC's use of 2016 MERIC wages.<sup>38</sup> Staff noticed significant fluctuation in the wages examined, for example between 2014-2016 the wages for a Financial Manager increased by \$14,209, but the wages for Accounting and Auditors decreased

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<sup>33</sup> See Attachment B to the *Non-Unanimous Stipulation and Agreement*, filed November 22, 2017.

<sup>34</sup> See OPC Position Statement, filed November 21, 2017.  $171,882 - 124,049 = 47,833$ .

<sup>35</sup>  $47,833 \times 16.61\% = 7,945.0613$ .

<sup>36</sup> Ex. 200, *Direct Testimony of Keri Roth*, Schedule KNR-2.  $45,751 + 7,945.06 = 53,696.06$

<sup>37</sup> Ex. 104, *Direct Testimony of Ashley Sarver*, p.5, ll. 7-8.

<sup>38</sup> Ex. 200, *Direct Testimony of Keri Roth*, p. 5, l. 16.

by \$212 for the same period.<sup>39</sup> Another example is the mean salary for the Chief Executive.<sup>40</sup>

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To even out the fluctuations, Staff used the 2015 number as a proxy for a three-year average. Averaging costs that exhibit variability is a common method to normalize expenses to determine cost of service which is used to establish just and reasonable rates without relying on a peak or a valley for a fluctuating cost.<sup>41</sup> Using an average is an appropriate and common method to normalize expenses, and under that method the appropriate salary for Mr. Todd Thomas is \*\* .

### **Auditing and Tax Preparation Fees**

As part of the Stipulation that now encompasses Staff's position, Indian Hills and Staff agreed to an auditing and tax preparation fee figure of \$13,993. This is the amount in Staff's accounting schedules, which was adopted by Indian Hills and Staff as part of the Stipulation. This amount is supported by Staff's filed testimony on the record. This amount also includes known and measurable accounting costs that were paid outside of the test year, but that Indian Hills will incur in the future on an ongoing basis.

<sup>39</sup> Ex. 104, *Direct Testimony of Ashley Sarver*, p.5, ll. 2-4.

<sup>40</sup> Ex. 110, *Rebuttal Testimony of Ashley Sarver*, p.8, ll. 3-4.

<sup>41</sup> The Commission has supported this method in the past for fluctuating costs stating; "[t]he Commission agrees with OPC that using an average smooths out the peaks and valleys." *In the Matter of the Tariff Filing of The Empire District Electric Company to Implement a General Rate Increase for Retail Electric Service Provided to Customers in its Missouri Service Area*, Case No. ER-2006-0315, **Report and Order**, issued December 21, 2006.

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

*Should accounting costs paid outside the test year be included in Indian Hill's cost of service?*

The appropriate amount of auditing and tax preparation fees is \$13,993. Indian Hills provided invoices, and they are attached to the testimonies of Mr. Cox and Mr. Macias.<sup>42</sup> These amounts are known and measurable. Some of that expense was incurred outside of the test year, but as Staff witness Ms. Ashley Sarver testified, the Commission has had a practice of including certain known and measurable expenses that occur outside the test year in a utility's cost of service; the most common examples are increases in postage and union wages.<sup>43</sup> Those are not the only examples. For instance, in ER-2014-0370, Kansas City Power and Light Company ("KCPL") requested the Commission exclude test-year revenues from a contract with KMEA, as the contract would be expiring.<sup>44</sup> However, the expiration of the contract would be outside of the test year, and traditionally, items and events outside of the test year are not included in the Company's cost of service analysis. The Commission found that revenues that KCPL would lose were known and measurable, since it was known the contracts would expire on September 30, and the amount of revenues lost was measurable.<sup>45</sup> This is directly analogous to the invoices for tax and auditing fees in this case. The invoices were

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<sup>42</sup> Ex. 1, *Direct Testimony of Josiah Cox*, Schedule JC-03C Confidential, Ex. 5, *Rebuttal Testimony of Phil Macias*, Schedule PM-1R-C.

<sup>43</sup> Tr. III, 224:16-24.

<sup>44</sup> *In the Matter of Kansas City Power & Light Company's Request for Authority to Implement a General Rate Increase for Electric Service*, File No. ER-2014-0370, **Report and Order** issued September 2, 2015.

<sup>45</sup> *Id.* at 106.

issued in the test year.<sup>46</sup> The exact dollar amount for these fees is both known and measurable. Much like it was appropriate to recognize the loss of KMEA revenues KCPL would experience after the conclusion of the test year in ER-2014-0370, it is appropriate to include these known and measurable expenses.

In hearing, OPC put forth the argument that the audited financial statements and tax reports were not required by Commission rules, so those fees should not be included.<sup>47</sup> However, OPC witness Ms. Roth admitted that all small companies prepare tax returns.<sup>48</sup> As for the audited financial statements, items such as plant or other expenses do not have to be required by PSC rule to be included in the cost of service.<sup>49</sup> The inquiry for inclusion of a cost is not “does a Commission rule require this expense to be incurred”; the Greenwood Solar Facility and AMI meters would be examples of innovations not required by Commission rule but allowed in rates.<sup>50</sup> The inquiry instead revolves around the prudence of the expenditure, if the expenditure is used and useful, and does the expenditure further the utility’s duty in providing safe and adequate service. Mr. Macias testified that CSWR had been denied an equipment loan based, in part, on a lack of audited financials.<sup>51</sup> Mr. Cox provided testimony that every

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<sup>46</sup> Tr. III, 215:11-13.

<sup>47</sup> “Q. Are you aware if any PSC or SEC reporting requirement that would require a company of this size to obtain an audited financial statement?” Tr. 3, 222:21-24.

<sup>48</sup> Tr. III, 227:20-22.

<sup>49</sup> Tr. III, 219:6-9.

<sup>50</sup> *In the Matter of the Application of KCP&L Greater Missouri Operations Company for Permission and Approval of a Certificate of Public Convenience and Necessity Authorizing it to Construct, Install, Own, Operate, Maintain and Otherwise Control and Manage Solar Generation Facilities in Western Missouri*, File No. EA-2015-0256, **Report and Order** issued March 2, 2016 and *In the Matter of Kansas City Power & Light Company’s Request for Authority to Implement a General Rate Increase for Electric Service*, File No. ER-2016-0285, **Report and Order** issued May 3, 2017, respectively.

<sup>51</sup> Tr. III, 212:22-25.

government funding source for water and wastewater improvements requires audited financials.<sup>52</sup> The cost of auditing these financial statements should be included in the determination of cost of service.

OPC points to the Hillcrest decision to stand for the proposition that auditing and tax preparation fees should not be included.<sup>53</sup> However, Hillcrest is distinguishable, as the tax and auditing preparation fees in that case were estimates, and not paid at any point, and those estimated costs violated the matching principle.<sup>54</sup> In this case, the tax and auditing preparation fees are known and measurable, as they were paid (outside the test year) and have been attached to the testimonies of Mr. Cox and Mr. Macias. There is no estimation, which makes it distinguishable from Hillcrest, and therefore, appropriate to include in rates.

### **Management Consulting Fees**

As part of the Stipulation that now encompasses Staff's position, Indian Hills and Staff agreed to a management consulting fee figure of \$6,000. This is the amount included in Staff's accounting schedules, which was adopted by Indian Hills and Staff as part of the Stipulation. This amount is supported by Staff's filed testimony on the record.

### **Should a management consulting fee be included in the cost of service for Indian Hills?**

Yes, a management consulting fee of \$6,000 should be included in the cost of service. Ms. Lois Stanley, the prior owner of Indian Hills, has been hired on a contract

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<sup>52</sup> Ex. 1, *Direct Testimony of Josiah Cox*, p. 23, ll. 19-21.

<sup>53</sup> Ex. 202, *Rebuttal Testimony of Keri Roth*, p. 5, ll. 1-7.

<sup>54</sup> *In the Matter of the Water Rate Request of Hillcrest Utility Operating Company, Inc.*, Case No. WR-2016-0064, **Report and Order**, issued July 12, 2016, p. 21.

basis for a period of three years<sup>55</sup> to provide locational information in regards to the distribution facilities of Indian Hills. Indian Hills is a 50 year old system and maps of the distribution system do not exist.<sup>56</sup> Ms. Stanley's knowledge of the system has helped save the ratepayers money; for example, Ms. Stanley was able to locate existing isolation valves, which avoided the expense of installing new ones.<sup>57</sup> Even OPC's witness admitted that efficiently performed repairs and replacements save ratepayers time and hassle via less disruption of service and roads, and that a primary source, such as a former owner, could possibly be a useful source of information regarding of the distribution system.<sup>58</sup> Ms. Stanley has shown to be useful in this regard by locating where pipes are actually installed. This location service saved Indian Hills from, as an example, excavating the wrong side of the road. , Since only one dig is performed, this saves ratepayers money and hassle. The road and service is not disrupted by excavating and refilling excavation sites multiple times.<sup>59</sup> Ms. Stanley's institutional knowledge of the system is a valuable tool in a system without maps or historic records.

OPC's arguments against including Ms. Stanley's management consulting fees boil down into two points: a) there are no timesheets, and, b) OPC believes there is another locator due to OPC's apparent confusion over how Missouri One Call operates.<sup>60</sup> Indian Hills has a contractual relationship with Ms. Stanley, in which she is

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<sup>55</sup> Tr. III, 231:10-12.

<sup>56</sup> *Id.* at 247:1-3.

<sup>57</sup> *Id.* at 233:9-23.

<sup>58</sup> *Id.* at 246:18-25 – 247:1-14.

<sup>59</sup> *Id.* at 238:1-15.

<sup>60</sup> Ex. 203, *Surrebuttal Testimony of Keri Roth*, p. 2, ll.1-4.

paid a fixed \$500 a month for her services.<sup>61</sup> As she is not an employee of Indian Hills, nor someone who directly interacts with Indian Hills, Indian Hills does not keep a time log for her.<sup>62</sup> OPC's second argument against including Ms. Stanley's consulting fees is a misunderstanding that Indian Hills must also pay another locator to find lines from Indian Hills in addition to Ms. Stanley. OPC has confused Missouri One Call with a private, locator service.<sup>63</sup> Missouri One Call is a service that the public and excavators utilize to "call before they dig" to avoid striking underground utilities during an excavation, and prevent damage to human health and life, as well as to utility equipment and services. Missouri One Call is a notification service that notifies public utilities whenever the public or an excavator wants to dig within a given utility territory, and that utility is then required by law to locate and mark its own facilities.<sup>64</sup> Utilities perform locates, in response to a request submitted to Missouri One Call, not the other way around.<sup>65</sup> For instance, an Indian Hills excavator might be required to use One Call to locate the underground electric, natural gas, telecommunications or cable facilities in the area it plans to excavate. Even after Mr. Cox provided on the record clarification, OPC's witness still expressed confusion, claiming that having another outside contractor and Ms. Stanley is just doubling the costs.<sup>66</sup> When questioned, OPC's witness stated the outside contractor she was referring to was

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<sup>61</sup> Ex. 3, *Surrebuttal Testimony of Josiah Cox*, p. 3, ll. 9-11.

<sup>62</sup> Tr. III, 231-20-25 –232:1-3.

<sup>63</sup> "Q. Don't you also pay Missouri One to help with line locates? A. No." Tr. III, 236:2-4.

<sup>64</sup> Sections 319.010 *et seq.* RSMo.

<sup>65</sup> *Id.* at 4-7.

<sup>66</sup> *Id.* at 245:16-19.

Missouri One Call.<sup>67</sup> Indian Hills is required by law to participate in Missouri One Call,<sup>68</sup> but Missouri One Call is not a private contractor hired by Indian Hills to locate Indian Hills' facilities; therefore, there is no duplication of services, and Indian Hills should be able to recoup their incurred cost of \$6,000.

In relation to management consulting fees, OPC at hearing tried to strike a portion of Staff witness Ms. Grisham's testimony regarding the lack of electronic records for the Indian Hills system prior the transfer in March 2016 on the basis of hearsay. Ms. Grisham stated senior Staff members who had worked previous Indian Hills' cases or on cases involving the system before its current ownership informed her that there was a lack of electronic records for this system.<sup>69</sup> OPC's arguments as to the weight of Ms. Grisham's testimony, or any arguments that testimony should be rejected, are erroneous, as RSMo. 490.065 (2) allows an expert witness to "base an opinion on facts or data in the case that the expert has been made aware of or personally." Ms. Grisham based her expert opinion the need for management consulting fees for Ms. Stanley on a fact made aware to her by a more senior Staff member. Furthermore, hearsay is an allowable source of information for an expert to use to form their opinion. The Western District has found that "[t]his statute does not prohibit an expert from relying on hearsay. Instead, it recognizes the generally accepted principle that an "expert necessarily acquires his knowledge and expertise from many sources, some of which are inadmissible hearsay."<sup>70</sup>

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<sup>67</sup> *Id.* at 245:20-23 – 246:2-6.

<sup>68</sup> § 319.030 RSMo.

<sup>69</sup> *Id.* at 242:2-4.

<sup>70</sup> *Peterson v. Nat'l Carriers, Inc.*, 972 S.W.2d 349, 354 (Mo. Ct. App. 1998)

## **Bank Fees**

As part of the Stipulation that now encompasses Staff's position, Indian Hills and Staff agreed to a bank fee figure of \$4,714. This is the amount in Staff's accounting accounting schedules, which was adopted by Indian Hills and Staff as part of the Stipulation. This amount is supported by Staff's filed testimony on the record.

### **What is the appropriate level of bank fees to include in the cost of service for Indian Hills?**

The appropriate level of bank fees to include in the cost of service for Indian Hills is \$4,714. The majority of Indian Hills' bank fees go towards a Lockbox service that receives payments from Indian Hills' customers and records the cash receipts on behalf the company, processing payments much faster.<sup>71</sup> The Lockbox service processes a large quantity of low dollar payments that allows Indian Hills to avoid a labor intensive and time consuming project, and to only pay for the exact amount of expense required to complete this task, instead of hiring an additional employee.<sup>72</sup> The Lockbox also enhances the cash flow of the company, and for a small utility, enhanced cash flow is vital to meet the ongoing maintenance and repair of the system.<sup>73</sup>

OPC's arguments against including the bank fees revolve around an affiliate transaction between the bank and the Company, and that it could be cheaper to perform this work in-house.<sup>74</sup> There has been no substantive proof offered at hearing or in the pre-filed testimony that Indian Hills could perform bank services in house at a lower

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<sup>71</sup> Ex. 5, *Rebuttal Testimony of Phil Macias*, p. 12, ll. 2-14.

<sup>72</sup> *Id.*

<sup>73</sup> Tr. III, 251:15-18.

<sup>74</sup> Ex. 200, *Direct Testimony of Keri Roth*, p. 11, ll. 20-22 – p. 12, 3-5.

rate. If the Stipulation is approved, Indian Hills has agreed to perform an analysis of its bank fees within 180 days of a Commission order setting new rates.<sup>75</sup> Approving the Stipulation allows the Commission to receive substantive data regarding the cost effectiveness of using an outside source to perform certain banking activities. In this case, there is no evidence to the contrary regarding the appropriate level of bank fees, so \$4,714 should be included in rates. OPC's argument regarding affiliate transactions also fails, as there are no affiliate transaction rules applicable to water.<sup>76</sup> Even for utilities that operate under affiliate transaction rules, there must be a showing that ratepayers were harmed by the utility operating imprudently. In a case regarding Union Electric Company d/b/a Ameren Missouri and its purchase of generation assets from an affiliate, the Western District stated, "[a]lthough UE purchased the CTGs from its affiliates, the commission properly presumed that UE was prudent in its purchase of the CTGs, until the State or Public Counsel presented evidence that raised a "serious doubt" concerning the prudence of its expenditure."<sup>77</sup> No such evidence was presented here, and Indian Hills should be allowed to recoup prudently incurred bank fees in the amount of \$4,714.

### **Rate Case Expense**

As part of the Stipulation that now encompasses Staff's position, Indian Hills and Staff agreed to a rate case expense figure of \$5,722. This is the amount in Staff's accounting schedules, which was adopted by Indian Hills and Staff as part of the Stipulation. This amount is supported by Staff's filed testimony on the record. If the

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<sup>75</sup> *Non-Unanimous Stipulation and Agreement*, filed November 22, 2017, p. 2.

<sup>76</sup> See 4 CSR 240

<sup>77</sup> *State ex rel. Pub. Counsel v. Pub. Serv. Comm'n*, 274 S.W.3d 569, 578 (Mo. Ct. App. 2009)

Stipulation is approved, this number is frozen, and there will be no true-up to increase the rate case expense incurred in this case due to the hearing.<sup>78</sup> If the Stipulation is not approved, Indian Hills will be able to submit a higher, final rate case expense number to be included in the cost of service.

What is the appropriate rate case expense to include in the cost of service for Indian Hills?

The appropriate amount of rate case expense is \$5,722, to be amortized over a period of 5 years. This amount recognizes a 50/50 sharing of the cost of two outside consultants on rate of return.<sup>79</sup> The Commission has recognized that “rate case expense can benefit both utility shareholders and customers, though often in different ways.”<sup>80</sup> Sharing costs between both utility shareholders and customers recognizes the benefits that both parties receive from the rate case process. The Western District has found the Commission has the legal authority to “apportion rate case expenses between ratepayers and shareholders” and it is appropriate to do so when “the inclusion of all the rate case expenses for payment by ratepayers would not be just and reasonable.”<sup>81</sup> Due to high rate of consulting fees charged by the two rate of return experts and the impact it would have on a small utility such as Indian Hills, sharing is appropriate, as passing the full amount of those charges to ratepayers would not be just and reasonable. OPC also shared Staff’s concerns about the high expense related to the

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<sup>79</sup> Ex.111, *Surrebuttal Testimony of Jennifer K. Grisham*, p. 2, ll. 13-20.

<sup>80</sup> *In the Matter of Kansas City Power & Light Company’s Request for Authority to Implement a General Rate Increase for Electric Service*, File No. ER-2014-0370, **Report and Order** issued September 2, 2015, p. 64.

<sup>81</sup> *In Matter of Kansas City Power & Light Co.’s Request for Auth. to Implement a Gen. Rate Increase for Elec. Serv. v. Missouri Pub. Serv. Comm’n*, 509 S.W.3d 757, 776 (Mo. Ct. App. 2016), reh’g and/or transfer denied (Nov. 1, 2016), transfer denied (Feb. 28, 2017)

rate of return experts, but instead proposed a \$250 per hour rate for those experts.<sup>82</sup> Staff's proposal, which is reflected in the Stipulation, is the better resolution for the case, as it recognizes the Commission's accepted practice of rate case expense sharing to limit the amount of consulting fees passed on to ratepayers. Staff's proposal addresses OPC's concerns in the approved Commission framework of rate case expense sharing. Both OPC's position and Staff's position, incorporated in the Stipulation, include a five-year amortization period for the rate of return witness expense.<sup>83</sup> Staff's position, as reflected in the Stipulation, also proposes a longer normalization period for attorney fees (five years), while OPC proposes a three-year normalization period, which would mean ratepayers pay more per year, since the expense is being built into cost of service over a shorter period. The Commission should approve rate case expense in the amount of \$5,722, as well as approved the overall Stipulation. Approving the Stipulation will freeze rate case expense, and result in a lower rate case expense cost for ratepayers.

### **Treatment of Leak Repair Costs**

As part of the Stipulation that now encompasses Staff's position, Indian Hills and Staff agreed to a leak repair expense of \$90,000. The Stipulation also includes a two-way tracker for water main and service line repair expenses. The Stipulation also includes a replacement plan. Due to confusion at the hearing over the details of the replacement plan, Indian Hills and Staff have worked together to clarify the language included in the Stipulation, and present the final replacement plan language below.

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<sup>82</sup> Ex. 203, *Surrebuttal Testimony of Keri Roth*, p. 11, l. 1.

<sup>83</sup> *Id.* at l. 8

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

*What are the appropriate accounts to book leak repair?*

Repair expense should be recorded in operation and maintenance expense accounts, in accordance with the Uniform System of Accounts (“USOA”). Page 38 of the 1973 National Association of Regulatory Utility Commissioners (“NARUC”) USOA for Class A and B Utilities provides a list of maintenance items to describe work that qualifies as operating expenses.<sup>84</sup> Item 3 states that work performed specifically for the purpose of preventing failure, restoring serviceability or maintain life of plant is to be booked as an operating expense.<sup>85</sup> Leak repair expense squarely falls within this definition because the purpose of a repair is to restore proper function to the system.<sup>86</sup> OPC’s witness Mr. Robinett agreed that the definition of repair is work performed to restore service, maintain life, or prevent failures.<sup>87</sup> Since leak repair is work performed

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<sup>84</sup> Ex. 114, USOA Operating Expense Instructions.

<sup>85</sup> *Id.*

<sup>86</sup> Ex. 109, *Rebuttal Testimony of Stephen Moilanen, P.E.*, p. 3, ll. 15-16.

<sup>87</sup> Tr. III, 344:9-13.

to restore service, maintain life, or prevent failures, it must be booked in operation and maintenance expense accounts.

OPC argues that repair expense should be recorded in plant accounts, specifically Account 343 Transmission and Distribution Mains,<sup>88</sup> contrary to NARUC USOA. The USOA instructs that a minor item of property be charged to a maintenance account, unless a substantial addition results.<sup>89</sup> OPC's witness agreed that substantial means something of considerable size, importance, or worth, and that a clamp or seal would not be substantial.<sup>90</sup> Since the clamp or seal that would be the addition added as part of repair is not substantial, it is inappropriate under the USOA to book the leak repair expense in a plant account.

The Commission can prescribe uniform methods of keeping accounts, records and books, to be observed by...water corporations[.]<sup>91</sup> Water corporations must use the USOA.<sup>92</sup> The USOA dictates that the leak repair expense be booked in operation and maintenance expense accounts. With Indian Hills' new programming, Indian Hills should book repair and replacement expenses in the correct accounts (operation and maintenance, and plant, respectively) with no mistakes going forward.<sup>93</sup>

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<sup>88</sup> See OPC Position Statement, filed November 21, 2017, p. 5.

<sup>89</sup> Ex. 115, Utility Plant Instructions.

<sup>90</sup> Tr. III, 349:21-25 – 350:10-18.

<sup>91</sup> RSMo. 393. 140(4).

<sup>92</sup> 4 CSR 240-50.030(1).

<sup>93</sup> Tr. III, 299:5-17.

What is the appropriate level of leak repair to include in the cost of service?

The appropriate level of repair expense to include in the cost of service is \$90,000. This is \$426 lower than the amount OPC proposes to include in the cost of service.<sup>94</sup> Indian Hills' distribution system is 50 years old and until Mr. Cox took over the system, did not receive many of the necessary capital improvements.<sup>95</sup> Much of the system is still original, and any repairs made previously were made with substandard material.<sup>96</sup> To upgrade the system and prevent leaks and minimize costs, the Stipulation includes a replacement plan so Indian Hills can move forward on a plan to replace aging infrastructure in an efficient, cost effective manner that mitigates disruptions to service. However, repair expenses will continue to be incurred in the future. It is not practical to replace the entire system wholesale.<sup>97</sup> The condition of the piping and materials will make ongoing repairs necessary to prevent loss of service to customers and damage to property.<sup>98</sup> It will not always be feasible to make a replacement instead of a repair, for instance the location of the leak and the cost to replace versus repair may make a repair the better alternative for ratepayers.<sup>99</sup> Including an amount of \$90,000 in the cost of service allows Indian Hills to still make repairs on aged infrastructure, and ratepayers have the added protection of the tracking mechanism, discussed below, so if repair expense does not occur as set in rates, the ratepayers have the opportunity to have any underutilized amounts returned to them.

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<sup>94</sup> See OPC Position Statement, filed November 21, 2017, p. 5.

<sup>95</sup> Ex. 105, *Direct Testimony of David A. Spratt*, p. 3, ll. 2-4.

<sup>96</sup> *Id.* at ll. 3-7.

<sup>97</sup> Ex. 6, *Surrebuttal Testimony of Phil Macias*, p. 2, ll. 18-19.

<sup>98</sup> Ex. 113, *Surrebuttal Testimony of David A. Spratt*, p. 1, ll. 19-21, Tr. III, 323:4-13.

<sup>99</sup> Tr. III, 301:5-15.

## Trackers

A tracker compares the actual cost a company incurs to the baseline set in rates.<sup>100</sup> A company has an opportunity, but not a guarantee, to collect and amortize amounts spent over the baseline in their next rate case.<sup>101</sup> Conversely, if a company spends less than the baseline amount, customers may receive credit for amounts contributed that the company did not utilize.<sup>102</sup> The Commission has approved trackers in limited circumstances for costs that are volatile and costs for which there is no historical data, such as pensions and other post-employment benefits and the vegetation management trackers, respectively.<sup>103</sup> For instance, in approving the tracker for vegetation management expense, the Commission cited the unknown expense as a compelling reason to grant a tracker.<sup>104</sup> A tracker would encourage the company to quickly take the steps needed to improve the reliability of its service.<sup>105</sup> The same logic is present in this case. Indian Hills faces an unknown expense. Encouraging Indian Hills to make repairs to improve the reliability of its service benefits ratepayers. Prior to Mr. Cox taking over the system, customers often complained about water pressure issues.<sup>106</sup> However, increasing the water pressure to meet DNR standards has

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<sup>100</sup> Tr. IV, 388:3-15.

<sup>101</sup> *Id.* at 391:8-12.

<sup>102</sup> *Id.* at 392:1-3.

<sup>103</sup> *Id.* at 4-15.

<sup>104</sup> *In the Matter of The Empire District Electric Company's Tariffs to Increase Rates for Electric Service Provided to Customers in the Missouri Service Area of the Company*, Case No. ER-2008-0094, **Report and Order** issued July 30, 2008, p. 70.

<sup>105</sup> *Id.*

<sup>106</sup> Tr. III, 327:18-21.

increased the amount of leak repair expense.<sup>107</sup> So in order to improve the reliability of the system and meet DNR requirements, certain upgrades to address pressure, water availability and service stability were performed that caused the system to experience more leaks.<sup>108</sup> Much like the Commission incentivized the electric utilities to improve service reliability by granting vegetation management trackers, a tracker for leak repair incentivizes Indian Hills to continue to make improvements to its system.

The Commission also granted the vegetation management trackers due to the uncertainty in the level of expense the utilities may incur in complying.<sup>109</sup> Due to the utilities lack of experience with vegetation management requirements, and therefore, lack of long term historical cost data, there was uncertainty in how much expense would be incurred and how volatile that expense would be.<sup>110</sup> Again, this situation is analogous to the leak repair situation in this case. Indian Hills has only a year of historical data on leak repair expense. Indian Hills does not know where, how, or when repair issues will arise due to the severe disrepair state of the system.<sup>111</sup> The current data is not sufficient to predict how leak repair expense will trend, as it only contains a few months of leak repair expense due to the increase in pressure from the new booster stations required by DNR.<sup>112</sup> With the uncertainty in how much leak repair expense will occur, a tracker is an appropriate tool to ensure Indian Hills is able to continue to make

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<sup>107</sup> *Id.* at 286:3-13.

<sup>108</sup> Ex. 8, *Rebuttal Testimony of Todd Thomas*, p. 8, ll. 19-20.

<sup>109</sup> *In the Matter of Union Electric Company, d/b/a Ameren Missouri's Tariff to Increase Its Revenue for Electric Service*, **Report and Order** issued April 29, 2015.

<sup>110</sup> *Id.*

<sup>111</sup> Ex. 6, *Surrebuttal Testimony of Phil Macias*, p. 2, ll. 20-21.

<sup>112</sup> Ex. 7, *Direct Testimony of Todd Thomas*, p. 6, ll. 15-18.

needed repairs on the system, while allowing ratepayers to recoup any expenses not incurred once the leak repair costs level off.

OPC expressed confusion at hearing regarding customer notices and interim rate increases due to the tracker that Staff would like to address.<sup>113</sup> For clarity of the record, no customer notice is required and trackers are not interim rate adjustments.<sup>114</sup> Any amounts over or under collected from the base amount in rates is examined in the next rate case.<sup>115</sup>

### **Extension of Electric Service**

As part of the Stipulation that now encompasses Staff's position, Indian Hills and Staff agreed to a capitalized electric line extension figure of \$23,000, booked to account 325 "Electric Pumping Equipment". This is the amount in Staff's accounting schedules, which was adopted by Indian Hills and Staff as part of the Stipulation. This amount is supported by Staff's filed testimony on the record.

### **Should the Company be able to capitalize the electric line extension?**

Yes, Indian Hills should be able to capitalize the electric line extension expense. These costs were ordinary, necessary cost directly associated with the new well, booster pumps, ground storage, and well house. An item does not need to be owned by a utility for it to be capitalized. For instance, items such as delivery expenses, sales taxes, or other costs associated with construction activities can be capitalized.<sup>116</sup> As long as the goods or services were incurred to prepare the plant to be used and useful,

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<sup>113</sup> "Q. To your knowledge, is there any customer notice associated with rate increases or decreases relating to this two way tracker?" Tr. III, 275:20-23.

<sup>114</sup> Tr. III, 360:6-20.

<sup>115</sup> Tr. IV, 393:16-20.

<sup>116</sup> Tr. III, 363:1-25.

USOA and generally accepted accounting practices (“GAAP”) allow for capitalization.<sup>117</sup> The Commission has recognized this principle as well, allowing a former electric utility, Missouri Public Service, to capitalize Sibley inspection costs, as they were related to construction at the plant.<sup>118</sup> Missouri Public Service did not own inspection costs, but they were costs reasonably incurred relating to construction at the Sibley facility. Similarly, Indian Hills does not own the electric service line extension, but that expense was incurred due to the construction of a new well house and new pumping equipment, and safe and adequate service. Indian Hills is allowed to capitalize this expense. Amortization of the expense is also inappropriate, because OPC mistakes a five-year Purchase Power Agreement for a five-year payment plan.<sup>119</sup> Indian Hills did not pay the electric service line extension fee over five years; instead, they paid the full amount on May, 17, 2016.<sup>120</sup>

*If so, what are the appropriate accounts to book the extension of electric line service?*

The appropriate account to record the extension of electric line service in is Account 325. The USOA states, “this account shall include the cost installed of pumping equipment driven by electric power.”<sup>121</sup> Items to be booked under this account include:

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<sup>117</sup> Ex. 6, *Surrebuttal Testimony of Phil Macias*, p. 4, ll. 18-22.

<sup>118</sup> *Re Missouri Public Service, a division of UtiliCorp United, Inc*, Case No. ER-90-101, **Report and Order** issued October 5, 1990.

<sup>119</sup> Ex. 8, *Rebuttal Testimony of Todd Thomas*, p. 16, ll. 3-11.

<sup>120</sup> *Id.*

<sup>121</sup> Ex. 5, *Rebuttal Testimony of Phil Macias*, p. 4, ll. 8-9.

“5. Electric power lines and switching.”<sup>122</sup> Installation costs are allowable under the USOA and GAAP, therefore the \$23,000 installation payment for the extension is appropriate to book under account 325.<sup>123</sup>

### **Rate Design**

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

As part of the Stipulation that now encompasses Staff’s position, Indian Hills and Staff agreed to the following seasonal rate design.

<u>Season</u>	<u>Customer Charge</u>	<u>Commodity Charge</u>
Summer (April 1 – Sept. 30)	\$59.02	\$9.37
Winter (Oct. 1 – March 31)	\$59.02	\$7.67

As OPC also advocated for seasonal rates, the remaining issue is what structure the seasonal and non-seasonal rates should take.

### **Should a seasonal rate design be adopted in this case, and if so, what should be the structure of the seasonal and non-seasonal rates?**

A moderate seasonal rate design should be adopted in this case. As OPC recognizes,<sup>124</sup> there is limited usage data, so a slight shift is the most conservative way to address cost causation issues while limiting impacts to ratepayers. The rate design presented in the Stipulation shifts cost recovery towards the summer months, when more customers, including part-time users, are more likely to be present and using the system.<sup>125</sup> This is opposed to OPC’s rate design, which has a low usage commodity

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<sup>122</sup> *Id.* at, l. 15.

<sup>123</sup> *Id.* at 3-4.

<sup>124</sup> See OPC Position Statement, filed November 21, 2017, p. 6.

<sup>125</sup> Tr. IV, 508:17-19.

charge for the summer months, when the part-time residents, who own a second home and are presumably more affluent, are present and benefitting from the system.<sup>126</sup> OPC's winter commodity charge of \$16.11 per thousand gallons is too extreme for Staff to support, especially with the lack of data.<sup>127</sup> A \$16.11 per thousand gallons commodity charge is unusually high and could cause customers to modify their behavior to such an extreme degree to avoid using water, to their detriment.<sup>128</sup> Furthermore, OPC's rate design could lead to Indian Hills not recovering enough of its costs to maintain safe and adequate service.<sup>129</sup> As Staff witness Mr. Curtis Gateley testified "It is not a situation where a company might not earn the profit that they're entitled of (sic) a chance to earn but it's a situation potentially of a catastrophically short amount of revenue coming in."<sup>130</sup> In a small system in disrepair, revenue streams are vital to maintain service. Staff's rate design is a moderate step towards seasonal rates and addressing cost causation issues, but does not make drastic changes without proper usage data. If the Stipulation is approved, Indian Hills will submit usage data to Staff and OPC, allowing the parties to adjust and refine the rate design in a future rate case, to better align rates with principles of cost causation and other policies the Commission upholds.<sup>131</sup>

-Nicole Mers

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<sup>126</sup> *Id.* at 523:1-10.

<sup>127</sup> *Id.* at 510:1-2.

<sup>128</sup> *Id.* at 509:16-21.

<sup>129</sup> *Id.* at 516:1-4.

<sup>130</sup> *Id.* at 513:20-23.

<sup>131</sup> *Id.* at 5-21.

## IX. Rate of Return:

The rate of return is a percentage which, multiplied by the current net value of the Company's rate base, constitutes a reasonable annual return to the shareholders on their investment in the Company. In ratemaking, the calculated amount of the annual return is added to the operating and other costs in calculating the cost of service, which is the total annual revenue that the Company's rates are designed to produce. The rate of return is itself the result of a calculation; in fact, it is identical to the weighted average cost of capital ("WACC") which is calculated by multiplying the percentage of each type of capital by its cost and summing the results. Thus, to determine the rate of return, one must know the capital structure and the cost of both debt capital and equity capital. The contested issues in this case concern all three of these inputs. The positions of the parties on each of these issues are set out below:<sup>132</sup>

	<b>Company</b>	<b>Staff</b>	<b>OPC</b>	<b>Stipulation</b>
<b>Percentage of Debt:</b>	78.8%	65%	50%	65%
<b>Percentage of Equity:</b>	21.2%	35%	50%	35%
<b>Cost of Debt:</b>	14.00%	14.00%	6.75%	14.00%
<b>Cost of Equity:</b>	15.20%	12.00%	9.34%	12.00%
<b>Rate of Return:</b>	14.254%	13.30%	8.045%	13.30%

In determining this case, the Commission must be mindful of the Constitutional parameters that guide regulatory decision-making. In two frequently-cited decisions,<sup>133</sup>

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<sup>132</sup> Derived from the parties' filed position statements, except for Staff's ROE position, which was incorrectly stated in Staff's position statement and corrected by Nicole Mers in her opening statement for Staff. The debt-to-equity ratio and resulting rate of return discussed by Company witness D'Ascendis differ slightly from the figures presented in the Company's position statement. Staff witness Matt Barnes presented scenarios depicting the results of various capital structure debt-equity ratios and cost inputs. Ex. 106, Barnes Rebuttal.

<sup>133</sup> *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1943); *Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923).

the United States Supreme Court described certain principles with which the Commission's decision must comply:

(1) An adequate return is commensurate with the returns realized from other businesses with similar risks. This is the principle of the commensurate return.

(2) An adequate return is sufficient to assure confidence in the financial integrity of the utility and to maintain the utility's credit rating. This is the principle of financial integrity.

(3) An adequate return is sufficient to enable the utility to obtain necessary capital. This is the principle of capital attraction.

***a. What capital structure should be used for determining rate of return?***

The capital structure is simply the relative proportions for a given company of each type of financing, equity and debt. In this case, Staff recommends a hypothetical capital structure of 35% equity to 65% debt.<sup>134</sup> This ratio was agreed to by both Staff and the Company in a non-unanimous stipulation and agreement dated November 21, 2017.<sup>135</sup> Staff often proposes the use of a hypothetical capital structure when the actual capital structure is inappropriate for ratemaking purposes, particularly for small or distressed companies. Staff witness Matt Barnes explained:

Staff typically proposes a hypothetical capital structure when the company is not rated by a credit rating agency, such as Indian Hills, they don't issue their own stock, they're not publicly traded. So it's very difficult to -- it's kind of difficult to come up with an actual capital structure.

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<sup>134</sup> Ex. 100, Dietrich Direct, p. 4, lines 5-9.

<sup>135</sup> By its terms, the non-unanimous stipulation and agreement is void if not approved by the Commission. See Paragraph 15.

Indian Hills asserts that its actual capital structure is 77.12% long-term debt and 22.88% equity;<sup>136</sup> however, Mr. Gorman testified that the utility's financial statements "simply didn't support it."<sup>137</sup> Company witnesses Josiah Cox and Dylan D'Ascendis testified that the Commission should use the Company's actual capital structure in recognition of the practical difficulties in obtaining capital for small water and sewer operations.<sup>138</sup> However, due to its negligible equity component, this capital structure is not appropriate for ratemaking purposes.<sup>139</sup> Mr. Michael Gorman testified, "IHUOC's actual capital structure has a *de minimis* amount of common equity. Effectively, this utility is almost exclusively debt financed."<sup>140</sup> Mr. Gorman testified that Indian Hills' actual capital structure is not appropriate for ratemaking purposes and that the Commission should use a hypothetical capital structure and require the Company to make efforts to conform its actual capital structure to it.<sup>141</sup> Mr. Gorman testified that Staff's proposed hypothetical capital structure is supported by the public interest.<sup>142</sup>

OPC's position is that the Commission should use a hypothetical, 50-50 capital structure and require Indian Hills to work toward achieving it in actuality. However, OPC's proposed hypothetical capital structure is not based on reality. OPC's own expert witness noted that the Company is almost entirely financed by debt and testified that the public interest supports the use of Staff's hypothetical capital structure, which

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<sup>136</sup> Ex. 10, D'Ascendis Direct, p. 4, lines 9-11.

<sup>137</sup> Tr. 6:557, lines 6-8.

<sup>138</sup> Ex. 1, Cox Direct, pp. 24-28; Ex. 10, D'Ascendis Direct, pp. 4-6.

<sup>139</sup> Ex. 214, Gorman Rebuttal, p. 3, lines 12-16. Mr. Gorman expressed doubt that this even is Indian Hills' actual capital structure. *Id.*, p. 3, lines 1-11. Based on DR responses, he suggested that the actual capital structure contains almost no equity. *Id.*

<sup>140</sup> Ex. 216, Gorman Surrebuttal, p. 4, lines 20-21.

<sup>141</sup> Ex. 216, Gorman Surrebuttal, p. 4, lines 18-23, through p. 5, lines 1-9.

<sup>142</sup> Ex. 215, Gorman Rebuttal, p. 3, lines 16-19.

contains significantly more debt than does OPC's.<sup>143</sup> The public interest would not be well served by denying this company the revenue necessary to defray its actual cost of capital.

For all of these reasons, the Commission should adopt Staff's proposed hypothetical capital structure, consisting of 35% equity and 65% debt, for use in making rates in this case.

***b. What cost of debt should be used for determining rate of return?***

The cost of debt is one of the inputs necessary for calculating the rate of return. It may be readily determined by reference to the notes, documents and securities that memorialize a company's long-term debts. Sometimes, as in the present case, one or more parties contend that the actual cost of debt is inappropriate for ratemaking purposes.

The actual cost of Indian Hills' long-term debt is 14%.<sup>144</sup> Mr. Gorman admitted as much.<sup>145</sup> Staff agreed to use the 14% cost of debt in the *Partial Disposition Agreement* executed between the Company and Staff on September 1, 2017, and again in the non-unanimous stipulation and agreement dated November 21, 2017. Staff witness Natelle Dietrich supported the 14% cost of debt in her testimony<sup>146</sup> and it is Staff's position in this case that the appropriate cost of debt input for ratemaking is 14%. Why? Simply because it is Indian Hills' actual cost of debt and no one has convincingly demonstrated that capital is actually available to Indian Hills at a lower cost of debt.

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<sup>143</sup> Ex. 216, Gorman Surrebuttal, p. 4, lines 18-23, through p. 5, lines 1-9; Ex. 215, Gorman Rebuttal, p. 3, lines 16-19; Tr. 6:556, line 24, through p. 557, line 1.

<sup>144</sup> Ex. 13, Thaman Direct, p. 4, lines 3-4; Tr. 4:408, lines 10-14; Ex. 208, Meyer Direct, p. 4, lines 1-12.

<sup>145</sup> Tr. 6:559, lines 15-20.

<sup>146</sup> Ex. 100, Dietrich Direct, p. 4, lines 5-9.

Mr. Gorman admitted that he did not know of any alternative lender that was actually willing to lend money to Indian Hills at less than 14%.<sup>147</sup> He agreed that to the extent Indian Hills has the regulatory approval to execute that loan agreement, then after its fully executed Indian Hills is obligated to make significant payments on its debt on a monthly basis.<sup>148</sup> Mr. Gorman also admitted if the Commission authorized the company to execute the loan agreement that rates would need to be sufficient to support those debt payments.<sup>149</sup> The Commission authorized Indian Hills to execute the loan agreement in Case No. WO-2016-0045.<sup>150</sup> It should be noted that OPC did not raise concerns about the financing agreements presented as part of Indian Hill's application.<sup>151</sup> Appendix H attached to Indian Hill's application outlined the 14% cost of debt, which the Commission approved its *Order Approving Transfer of Assets and Issuance of Certificate of Convenience and Necessity*, issued February 2, 2016. Not allowing Indian Hills to recover its actual cost of debt would lead to Indian Hills defaulting on its loan, as Mr. Gorman admits.<sup>152</sup>

OPC strongly opposes the use of 14% as the cost-of-debt input.<sup>153</sup> Indeed, OPC asserts that Indian Hills was imprudent in securing financing at that rate. Consultant Greg Meyer testified on behalf of OPC that the 14% annual interest rate and the

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<sup>147</sup> Tr. 6:560, lines 1-12.

<sup>148</sup> Tr. 6:561, lines 13-19.

<sup>149</sup> *Id.*

<sup>150</sup> *In the Matter of the Application of Indian Hills Utility Operating Company, Inc., to Acquire Certain Water Assets of I.H. Utilities, Inc. and in Connection therewith, Issue Indebtness and Encumber Assets, Order Approving Transfer of Assets and Issuance of Certificate of Convenience and Necessity*, issued February 2, 2016

<sup>151</sup> A review of the docket in Case No. WO-2016-0045 shows that OPC did not file any response to the application or to Staff's *Recommendation to Approve the Transfer of Assets and Issuance of a Certificate of Convenience and Necessity*.

<sup>152</sup> Tr. 6:562, lines 2-5.

<sup>153</sup> Ex. 208, Meyer Direct, pp. 12-13; Ex. 211, Meyer Surrebuttal, p. 6, line 16, through p. 8, line 5; Ex. 213, Gorman Direct, p. 2, lines 6-15; Ex. 214, Gorman Rebuttal, p. 4, lines 1-6; Ex. 216, Gorman Surrebuttal, pp. 5-6;

prepayment amount clause caused him “concern.”<sup>154</sup> The 14% rate, in his opinion, is “excessive”;<sup>155</sup> and he considers the prepayment clause “unreasonable.”<sup>156</sup> However, OPC witness Mr. Gorman testified that the prepayment clause was “not that unusual.”<sup>157</sup> Mr. Meyer further testified that he was not able to conclude, based on his analysis of documents provided by the Company, that Indian Hills was not able to obtain financing on more reasonable terms.<sup>158</sup> Mr. Meyer tried to support this conclusion by compiling a schedule of cost of debt for other small water companies with lower cost of debt rates than Indian Hills.<sup>159</sup> Mr. Cox thoroughly refuted this document by explaining the circumstances surrounding each utility.<sup>160</sup> For instance, Roy-L Utilities only reports a 5% cost of debt on a total debt of \$75,000.00.<sup>161</sup> However, Roy-L Utilities needs \$200,000-\$300,000 in improvements, for which it will need to secure funding.<sup>162</sup>

Mr. Meyer also was concerned by evidence of transfers between various companies controlled by Mr. Cox and by the roles of Robert Glarner, Jr., and David Glarner, and entities controlled by them, as equity investors, debt investors, and bankers for Indian Hills and other of Mr. Cox’s companies.<sup>163</sup> Mr. Meyer commented, “These transactions are not being performed at an arm’s length and the Commission should be cautious of self-dealing as it proceeds.”<sup>164</sup> The implication of Mr. Meyer’s testimony is that the 14% rate and unfavorable prepayment clause are improper

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<sup>154</sup> Ex. 208, Meyer Direct, p. 12, lines 15-19.

<sup>155</sup> Ex. 208, Meyer Direct, p. 13, line 2; p. 14, line 9; Ex. 211, Meyer Surrebuttal, p. 7, line 5; p. 11, line 5.

<sup>156</sup> Ex. 208, Meyer Direct, p. 13, lines 2-6.

<sup>157</sup> Tr. 6:552, lines 11-12.

<sup>158</sup> Ex. 208, Meyer Direct, p. 12, lines 8-14.

<sup>159</sup> Ex. 210, Meyer Surrebuttal, Schedule GRM-SUR-2.

<sup>160</sup> Tr. 4:467, lines 20 to 4:469, line 24.

<sup>161</sup> Ex. 15, Indian Hills Utility Operating Company, Inc., Small Water and Sewer Utility Deb Costs, Table of Financing

<sup>162</sup> Tr. 4:468, line 1.

<sup>163</sup> Ex. 208, Meyer Direct, pp. 1-10.

<sup>164</sup> Ex. 208, Meyer Direct, p. 14, lines 22-23.

“sweetheart” deals intended to enrich the Glarners at the ratepayers’ expense; and that the Glarners, as owners, borrowed money from themselves as lenders on unreasonable and excessive terms.

To rebut OPC’s implications, Indian Hills presented the testimony of Michael Thaman, Sr., an experienced expert in the field of business finance.<sup>165</sup> Mr. Thaman testified, “In my opinion, the risk profile of small utilities in the condition of Indian Hills, particularly with respect to financial position, results of operations, out-of-compliance status, regulatory control of utility rates and related issues, and the potential for unknown contingent liabilities (“Distressed Utilities”), is such that traditional bank financing is not available.”<sup>166</sup> One reason is the negligible available collateral as Mr. Cox explained: “Unfortunately with these small utilities there are almost no tangible assets, you know, at the time of acquisition, and then the existing cash flows are minimal.”<sup>167</sup>

Noting the “significant high-risk characteristics” in an investment in a distressed utility such as Indian Hills,<sup>168</sup> Mr. Thaman pointed out that “very few sources of financing are available.”<sup>169</sup> Financing for Indian Hills and other distressed utilities, in Mr. Thaman’s opinion, might only be available from “high-risk investors . . . in exchange for a commensurate rate of interest.”<sup>170</sup> The interest rate for such financing, in Mr. Thaman’s opinion, might range between 15% and 21%.<sup>171</sup>

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<sup>165</sup> Ex. 13, Thaman Direct, pp. 1-2 (experience); Thaman Rebuttal, p. 5.

<sup>166</sup> Ex. 13, Thaman Direct, p. 4, lines 9-13; see Ex. 10, D’Ascendis Direct, p. 3, lines 5-12; p. 6, lines 6-9.

<sup>167</sup> Tr. 4:428, lines 15-18.

<sup>168</sup> Mr. Meyer denies that Indian Hills is a distressed utility; Ex. 211, Meyer Surrebuttal, p. 5, lines 11-19.

<sup>169</sup> Ex. 13, Thaman Direct, p. 4, lines 14-17.

<sup>170</sup> Ex. 13, Thaman Direct, p. 4, line 22, through p. 5, line 4.

<sup>171</sup> Ex. 13, Thaman Direct, p. 5, lines 11-14. Note that Indian Hills’ actual rate of 14% is lower than the range cited by Mr. Thaman.

Mr. Thaman noted that “the underlying assumptions to Mr. Gorman’s hypothetical analysis bear no resemblance to the reality of securing financing for a very small, distressed and unrated utility such as Indian Hills.”<sup>172</sup> Mr. Thaman dismissed as “invalid” Mr. Gorman’s use of Dayton Power & Light (“DPL”), a below-investment grade electric utility, as a proxy for Indian Hills given that DPL has 519,000 customers compared to Indian Hills’ 715; annual revenues of \$1.3 billion compared to Indian Hills’ \$73,120; assets of \$1.9 billion compared to Indian Hills’ \$2.2 million; and is rated by either S&P or Moody’s or both, whereas Indian Hills is unrated.<sup>173</sup> Noting that “[c]learly, DPL and Indian Hills are in no way comparable,”<sup>174</sup> Mr. Thaman urged the Commission to “dismiss” Mr. Gorman’s invalid comparison and the lessons purportedly drawn from it.<sup>175</sup> Mr. Thaman’s testimony is uncontroverted and Staff urges the Commission to accept it and to disregard the testimony of Mr. Meyer and Mr. Gorman insofar as it is inconsistent with Mr. Thaman’s.

Based on his long experience, Mr. Thaman testified that “I know of no source of financing for the Company on terms more favorable than its existing arrangement.”<sup>176</sup> Staff, also based on long experience, is equally unable to identify an alternative, cheaper source of capital for Indian Hills. Mr. Gorman could not identify an alternative lender.<sup>177</sup> The schedule of small water and sewer companies with purportedly lower debt costs assembled by Mr. Meyer was convincingly shown to be unreliable.<sup>178</sup>

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<sup>172</sup> Ex. 14, Thaman Rebuttal, p. 2, lines 12-14.

<sup>173</sup> Ex. 14, Thaman Rebuttal, pp. 2-4, esp. chart on p. 3.

<sup>174</sup> Ex. 14, Thaman Rebuttal, p. 4, line 3.

<sup>175</sup> Ex. 14, Thaman Rebuttal, p. 2, lines 14-16; p. 4, lines 7-11.

<sup>176</sup> Ex. 14, Thaman Rebuttal, p. 7, lines 11-13; Tr. 4:408, lines 15-18.

<sup>177</sup> Tr. 6:560, lines 1-12.

<sup>178</sup> Sch. GRM-SUR-2; Ex. 15; Tr. 4:466, line 25, through p. 470, line 20; p. 472, line 15, through p. 478, line 10.

This lack of access to necessary capital is one very significant problem facing these companies. Despite some distasteful aspects, such as the high interest rate and prepayment penalty, which, if the non-unanimous stipulation and agreement is approved, will be lowered to 10 years, Mr. Cox has found a practical solution to this problem. Capital investments are being made at Indian Hills and at his other companies, with concomitant improvements of infrastructure, service quality, water quality, and compliance status. These desirable and, indeed, essential improvements will likely end if the Commission does not allow the Company to recover in rates the actual cost of this capital.<sup>179</sup>

***c. What return on common equity should be used for determining rate of return?***

The cost of common equity, or return on common equity (“ROE”), is the final input necessary for calculating the rate of return. Unlike the cost of long-term debt, the ROE cannot be ascertained by inspecting notes, bonds or other documents; it must be estimated by the expert application of financial analytical models to market data. Because equity is subordinate to debt, it is more risky by definition and equity investors require a higher return than do debt investors.

Staff recommends a return on common equity (“ROE”) of 12.00% based on the non-unanimous stipulation and agreement dated November 21, 2017.<sup>180</sup> The Company

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<sup>180</sup> Staff’s ROE position in its position statement and in the Direct Testimony of Natelle Dietrich are incorrect in that Staff’s original position of 9.34% has been superseded by the agreed value of 12.00% in the non-unanimous stipulation and agreement.

presents the expert testimony of Dylan W. D'Ascendis, who recommends 15.20%.<sup>181</sup> Mr. Gorman recommends 9.34% based on certain of Mr. D'Ascendis' analyses.

Mr. D'Ascendis applied three commonly used analytical methods, the Discounted Cash Flow ("DCF"), the Predictive Risk Premium Model ("PRPM"), and the Capital Asset Pricing Model ("CAPM") to market-driven data reflecting two proxy groups, one a group of eight regulated water utilities and the other a group of non-regulated companies of comparable risk.<sup>182</sup> He then applied upward adjustments to his initial result of 10.35% -- 2.49% for financial risk and 2.38% for small size, reaching a final figure of 15.22%, which he rounded down in developing his recommendation of 15.20%.<sup>183</sup>

OPC expert witness Mr. Gorman criticized Mr. D'Ascendis' methodology and results, particularly his ECAPM study.<sup>184</sup> Mr. Gorman testified:

A reasonable range in return on equity estimates for IHUOC should be considered to reflect his [i.e., Mr. D'Ascendis'] DCF return estimate of 8.63%, and his traditional CAPM result of 9.94%. Staff's recommended return on equity for IHUOC falls within this range, and thus Mr. D'Ascendis' testimony supports the reasonableness of this finding. However, all of Mr. D'Ascendis' other risk premium studies and external adjustments for IHUOC are without merit and should be disregarded.<sup>185</sup>

OPC adopted Staff's pre-stipulation ROE recommendation of 9.34%.

The Commission's task is to balance the interests of the ratepayers and shareholders in the light of the public interest. Mindful of the *Hope* and *Bluefield* principles, the Commission must keep rates as affordable as possible while allowing the

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<sup>181</sup> Ex. 10, D'Ascendis Direct, p. 2, line 16; p. 6, lines 12-13; Sch. DWD-1.

<sup>182</sup> Ex. 10, D'Ascendis Direct, p. 7.

<sup>183</sup> Ex. 10, D'Ascendis Direct, pp. 7-8.

<sup>184</sup> Ex. 215, Gorman Rebuttal, p. 5.

<sup>185</sup> Ex. 215, Gorman Rebuttal, p. 5, line 24, through p. 6, line 4.

Company to earn sufficient revenue to provide safe and adequate service while servicing its debt and attracting necessary capital. Normally, the return on equity is set higher than the cost of debt, as Mr. D'Ascendis pointed out.<sup>186</sup> However, the financing of Indian Hills is anything but normal, as Mr. Cox, Mr. D'Ascendis and Mr. Thaman acknowledged.<sup>187</sup>

Staff's ROE recommendation of 12.00%, together with Staff's proposed hypothetical capital structure of 65% debt to 35% equity, and Indian Hills' actual cost of long-term debt of 14.00%, best threads the needle by keeping rates as affordable as possible while allowing the Company sufficient revenue to service its debt and continue to operate. Staff's rate of return of 13.30% is somewhat less than Indian Hills' cost of debt at 14.00%, and thereby appropriately burdens the shareholders who incurred debt at such unfavorable terms. Nonetheless, 13.30% is sufficient and will yield adequate funds for the Company going forward.

*Kevin A. Thompson*

### **Conclusion**

The Commission should approve each issue as Staff has set forth, and approve the Stipulation in this case. Unfortunately, even if OPC were to win each of its issues the case, the customers of Indian Hills are facing at least a 444.14% increase, due to the artificially low rates currently in place. Even under OPC's revenue requirement, customers would see a \$30 customer charge increase and \$5 commodity charge

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<sup>186</sup> Ex. 10, D'Ascendis Direct, p. 3, lines 13-14; *and see* Gorman at Tr. 6:563, line 22, through p. 564, line 2.

<sup>187</sup> Ex. 13, Thaman Direct, p. 4, lines 9-13; *see* Ex. 10, D'Ascendis Direct, p. 3, lines 5-12; p. 6, lines 6-9.

increase in the summer, and a \$15 commodity charge increase in the winter. The bulk of the increase stems from Indian Hills needing to expend nearly 2 million dollars into the 50 year old system that has had little to no maintenance or repairs in the last five decades. Indian Hills faced substantial issues with pressures and leaks, no meters, and multiple Missouri DNR compliance issues. Indian Hills, upon taking over, spent \$1.84 million dollars to install new wells, generators, and bring the system back into DNR compliance. This upgrade effort was described to the Commission in the application associated with the Company's asset purchase case, along with an estimate of the investment necessary. DNR compliance is an absolute requirement for safe and adequate service, and no party can argue that dollars spent to meet state and federal regulatory requirements is improper. The bulk of that money was spent to ensure the customers of Indian Hills have safe and adequate service, and OPC has not put forth evidence that the Company did not need to make those improvements to this system. To allow Indian Hills to continue to provide safe and adequate service, a rate increase of \$630,911 as set forth above, should be approved, as well as the Stipulation signed by Staff and Indian Hills.

**WHEREFORE**, on account of all the foregoing, Staff prays that the Commission will issue its findings of fact and conclusions of law as recommended by the Staff herein; and granting such other and further relief as is just in the circumstances.

Respectfully submitted,

**/s/ Nicole Mers**

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**Attorneys for the Staff of the  
Missouri Public Service Commission**

**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 4<sup>th</sup> day of January 2018, to all counsel of record.

**/s/ Nicole Mers**