

Exhibit No.
Issue: Company Background, Payroll, Property
Tax, Auditing and Tax Preparation Expense,
Capital Structure, Cost of Capital, Rate Case
Expense
Witness: Josiah Cox
Type of Exhibit: Direct Testimony
Sponsoring Party: Hillcrest
Case No.: WR-2016-0064
Date: April 15, 2016

Missouri Public Service Commission

Direct Testimony

of

Josiah Cox

On Behalf of

Hillcrest Utility Operating Company, Inc.

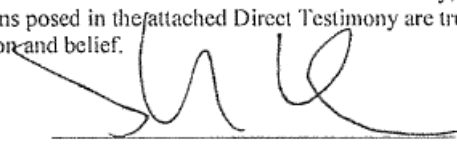
April 15, 2016

JOSIAH COX
DIRECT TESTIMONY

AFFIDAVIT

STATE OF MISSOURI)
)
COUNTY OF St. Louis) ss

I, Josiah Cox, state that I am the President of Central Rivers Wastewater Utility, Inc. and, that the answers to the questions posed in the attached Direct Testimony are true to the best of my knowledge, information and belief.



Subscribed and sworn to before me this 15th day of April, 2016.


Notary Public

My Commission Expires: 2-18-18



RACHEL WALLIS
My Commission Expires
February 18, 2018
Franklin County
Commission #14582537

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**DIRECT TESTIMONY OF
JOSIAH COX
HILLCREST UTILITY OPERATING COMPANY, INC.**

WITNESS INTRODUCTION

1

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. My name is Josiah Cox. My business address is 500 Northwest Plaza Drive
4 Suite 500. St. Ann MO, 63074

5

6 **Q. WHAT IS YOUR POSITION WITH HILLCREST UTILITY OPERATING
7 COMPANY, INC. (HILLCREST OR COMPANY)?**

8 A. I hold the office of President of Hillcrest and I am a member of its Board of
9 Directors.

10

11 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND PROFESSIONAL
12 EXPERIENCE.**

13 A. I received a Bachelor of Science with a major in Environmental Science from the
14 University of Kansas. After graduation and a brief tenure at the Kansas
15 Biological Survey, I was employed by Fribis Engineering, a Civil Engineering
16 Firm in Arnold, MO. I spent approximately two and a half years working with
17 Fribis Engineering. I was involved during that time in various facets of the land
18 development process to include permitting, entitlement, civil design, project
19 management, and construction management. I focused mainly on the water and

1 wastewater side of the civil engineering business and participated in every part of
2 the civil business from wasteload allocation studies (now known as the anti-
3 degradation processes), design, permitting, project management, and
4 construction management. I also ran the environmental consulting division and
5 was the second private consultant to submit a water quality impact study in the
6 state of Missouri in 2003. At Fribis Engineering, I joined the executive leadership
7 team and helped run all of the operations of the firm. Thereafter, in 2005, I raised
8 money from a group of investors and formed Trumpet LLC. Trumpet LLC was a
9 full service civil engineering, environmental consulting, general contracting, and
10 construction management firm. In early 2006, I started the Executive Masters of
11 Business Administration (MBA) program at Washington University in St. Louis. I
12 graduated with my MBA from Washington University in the 2007. At Trumpet
13 LLC, as the Chief Operating Officer and finally Chief Executive Officer, I obtained
14 extensive experience with rural communities in every facet of the water and
15 wastewater compliance process including environmental assessment, permitting,
16 design, construction, operation and community administration of the actual water
17 and wastewater (sewerage) systems. At Trumpet, we performed stream
18 sampling and built waste-load allocation models to determine receiving water-
19 body protective permit-able effluent pollutant loads. We have done full
20 engineering design of multiple whole community wastewater and water
21 infrastructure systems including wells, water distribution, water treatment, water
22 storage, wastewater conveyance, and wastewater treatment plants and taken
23 these designs through federal and state administered permitting processes in

1 Missouri. Trumpet also administered the construction of these water and
2 wastewater systems from green field site selection all the way through system
3 startup and final engineering sign off. In 2008, I took over the operations on an
4 existing rural sewer district and I still currently operate a system actually
5 managing the functioning, testing, and maintenance of the system. Finally, I also
6 act as the administrator for this municipal system performing all the billing,
7 emergency response, accounts payable / accounts receivable, collections,
8 budgeting, customer service, and public town meetings required to service the
9 community.

10
11 **PARTIAL DISPOSITION**

12 **Q. HAS HILLCREST BEEN ABLE TO REACH AGREEMENT IN REGARD TO**
13 **ANY RATE CASE ISSUES?**

14 A. Yes. On March 25, 2016, the Staff of the Public Service Commission filed a
15 Partial Disposition Agreement, which encompasses a great many rate case
16 issues.

17
18 **Q. IS IT YOUR UNDERSTANDING THAT THE STAFF WILL FILE DIRECT**
19 **TESTIMONY IN SUPPORT OF THAT PARTIAL DISPOSITION AGREEMENT?**

20 A. Yes.

21
22 **PURPOSE**

23 **Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY?**

1 A. I will first provide the Missouri Public Service Commission (Commission) with a
2 description of Hillcrest and its operations. I will further describe the
3 improvements that have been made to the water and sewer systems owned by
4 Hillcrest. I will then provide testimony concerning the specific issues upon which
5 Hillcrest was not able to reach agreement with the Staff. Those issues are as
6 follows: (1) Payroll; (2) Property Taxes; (3) Auditing and Income Tax Preparation
7 Fees; (4) Capital Structure; (5) Cost of Capital (equity and debt); and, (6)
8 Allowance for Funds Used During Construction (AFUDC).
9 It is my understanding that the Office of the Public Counsel (Public Counsel) has
10 identified additional issues it wishes to raise in this case. Hillcrest will address
11 those issues in its rebuttal testimony.

12
13 **HILLCREST BACKGROUND**

14 **Q. PLEASE DESCRIBE HILLCREST.**

15 A. Hillcrest provides water and sewer service to approximately 218 residential
16 customers, 20 apartment customers, and four commercial customers located in
17 Cape Girardeau County. Hillcrest is a "water corporation," "sewer corporation,"
18 and a "public utility" as those terms are defined in Section 386.020, RSMo.

19
20 **Q. IS HILLCREST A PART OF A LARGER ORGANIZATION?**

21 A. Yes. Hillcrest is an operational subsidiary of Central States Water Resources,
22 Inc. (Central States).

23

1 **Q. ARE YOU CONNECTED WITH CENTRAL STATES?**

2 A. Yes. Hillcrest Utility Operating Company, Inc. is wholly owned by Hillcrest
3 Holding Company, Inc. which is managed by Central States Water Resources,
4 Inc. Central States' day to day operations are managed by myself as the
5 President.

6

7 **Q. WHAT WAS THE ORIGIN OF CENTRAL STATES?**

8 A. In late 2010, after working on a number of small failing water and wastewater
9 systems, I created a business plan to acquire and recapitalize existing failing
10 utilities as an investor owned regulated water and wastewater utility company.
11 In early 2011, I went out to the capital markets to raise money for the purchase
12 and recapitalization of water and wastewater utilities. I spent approximately three
13 years raising money toward this utility business meeting with over fifty-two capital
14 groups before closing on equity and raising debt financing in February of 2014,
15 and starting Central States.

16

17 **Q. WHAT IS CENTRAL STATES' BUSINESS PLAN?**

18 A. Central States' plan is to pursue the purchase and recapitalization of failing water
19 and wastewater utilities across the state of Missouri under the regulated utility
20 small rate case technical format. As an example of market size and future plans,
21 Central States estimates there to be 52 PSC regulated small sewer companies in
22 Missouri (Central States defines small sewer companies as sewer companies
23 servicing under 8,000 customers by firms that are not publically traded). Out of

1 those 52 small companies, 7 are currently in state appointed receivership and in
2 the immediate danger of being closed down for Missouri Department of Natural
3 Resources (MDNR) regulatory reasons. The average tariff rate (individual
4 customer utility rate approved by the Commission) in the remaining 44 systems
5 has not been changed for approximately 10 years. This means most of the
6 Commission-regulated small sewer companies in the state have not been in a
7 rate case for over a decade. Based on recent regulatory permit changes, Central
8 States estimates 40 of the entire 52 regulated small sewer companies are
9 currently out of, or about to be out of, federal and state regulatory pollution or
10 dispense permit compliance. Central States does not believe any of these
11 existing small utility companies have corporate debt, and that their debt is based
12 on unrelated personal assets. As the vast majority of permitted water and sewer
13 operations in the state are unregulated, these 40 targets are just a small portion
14 of the potential Central States utility targets.

15
16 **Q. DOES HILLCREST HAVE ANY OF ITS OWN EMPLOYEES?**

17 A. No.

18
19 **Q. HOW DOES IT PROVIDE SERVICE?**

20 A. Hillcrest hired a local third party Operations and Maintenance (O&M) firm that
21 carries the mandatory MDNR licenses and appropriate insurance to manage the
22 daily drinking water and wastewater operations. The O&M firm has a 24-hour
23 emergency service line for service disruption services that forwards all service

1 issues to me, as president of Hillcrest. Hillcrest also hired a billing and customer
2 service firm to send out bills and handle customer service related to billing
3 questions. Moreover, Hillcrest has setup an online billing system to receive
4 credit card and e-checks and customer service email accounts specific to
5 Hillcrest to field on-going customer interactions.

6 All of the management, financial reporting, underground utility safety and location
7 services, Commission regulatory reporting, MDNR regulatory reporting,
8 environmental management, operations oversight, utility asset planning,
9 engineering planning, on-going utility maintenance, total utility record keeping,
10 and final customer dispute management is done out of the corporate office with
11 proportional costs passed down to Hillcrest.

12
13 **OWNERSHIP AND IMPROVEMENT OF SYSTEMS**

14
15 **Q. HOW DID HILLCREST ACQUIRE ITS WATER AND SEWER SYSTEMS?**

16 A. Hillcrest acquired these systems from Brandco Investments, LLC, which was a
17 company regulated by the Commission. The Commission provided approval of
18 this transaction in its File No. WO-2014-0340.

19
20 **Q. WHAT APPROVAL DID HILLCREST SEEK FROM THE COMMISSION IN FILE
21 NO. WO-2014-0340?**

22 A. Hillcrest sought the Commission's permission to acquire the water and
23 wastewater assets of Brandco, and to issue indebtedness and to encumber

1 those acquired assets in order to fund the construction necessary to bring the
2 systems into regulatory compliance. Hillcrest's proposed financing was
3 examined in great detail by the participants in that case. Ultimately, a Stipulation
4 was reached and the Commission approved the transactions, with conditions, by
5 its Order Approving Stipulation and Agreement and Granting a Certificate of
6 Convenience and Necessity issued October 22, 2014, effective November 1,
7 2014.

8
9 **Q. ON WHAT DATE DID HILLCREST CLOSE ON THIS TRANSACTION?**

10 A. March 13, 2015.

11
12 **Q. WHAT WAS THE CONDITION OF THE WATER AND SEWER SYSTEMS
13 WHEN THEY WERE ACQUIRED BY HILLCREST?**

14 A. The water and sewer systems were in a complete state of disrepair when
15 Hillcrest acquired the utility assets of Brandco Investments, LLC.

16
17 **Q. WHAT WAS THE CONDITION OF THE WASTEWATER SYSTEM?**

18 A. On the wastewater side, beginning May of 2014, the Hillcrest Subdivision
19 wastewater treatment plant (WWTP) had been under multiple Missouri
20 Department of Natural Resources (MDNR) and Missouri Attorney General
21 compliance and enforcement actions. These actions were the result of 15+ years
22 of general plant neglect and lack of investment. The compliance issues involved
23 wastewater directly discharging into a creek without treatment during rain events,

1 the WWTP not disinfecting sanitary sewer waste before discharging it into the
2 adjoining stream, and the WWTP being unable to treat waste for nutrient removal
3 as required by the MDNR. In addition, the existing lagoon berm system was in
4 significant danger of structural failure due to slope erosion and a lack of
5 maintenance with the slope vegetation.

6
7 **Q. WHAT VIOLATIONS HAD BEEN CITED BY MDNR IN REGARD TO THE**
8 **WASTEWATER SYSTEM?**

9 A. MDNR formally cited numerous regulatory violations inside the old Brandco
10 wastewater system including the following significant deficiencies:

- 11 1. The WWTP could not properly disinfect sanitary sewer waste for
12 pathogens prior to creek release;
- 13 2. The plant had sanitary storm overflows during rain events; and,
- 14 3. The wastewater treatment plant was not removing nitrogen as ammonia
15 before discharging into the creek.

16 Attached as **Schedule JS-1** are some pictures of the original WWTP system.
17

18 **Q. WHAT WAS THE CONDITION OF THE WATER SYSTEM?**

19 A. On the drinking water side, beginning in May of 2014, the Hillcrest Subdivision
20 was put on an eight week boil order due to positive E. coli tests in the drinking
21 water system. After tank inspections done by the Missouri Department of Natural
22 Resources (MDNR) it was determined that the most likely source of bacterial

1 contamination was a rusted out vent screen on top of the existing drinking water
2 storage tank possibly allowing bird feces to contact the drinking water system.

3
4 **Q. WHAT VIOLATIONS HAD BEEN CITED BY MDNR IN REGARD TO THE**
5 **DRINKING WATER SYSTEM?**

6 A. MDNR cited numerous other regulatory violations inside the old Brandco drinking
7 water system including the following significant deficiencies:

- 8 1. The well casing head was not properly sealed-possibly allowing
9 pathogens direct contact with the drinking water being extracted from the
10 deep water well;
- 11 2. The well house roof was leaking over the top of the well-possibly allowing
12 contaminated outside roof water interaction with drinking water;
- 13 3. The well house vent screen had a hole in it-possibly allowing outside
14 contamination into the drinking water production area;
- 15 4. The ground storage tank at the front of the subdivision had unsealed
16 openings in the roof and vent-possibly allowing direct suspected bird
17 feces' pathogen contact with the community's drinking water; and,
- 18 5. The water system did not have 24 hours of backup drinking water storage
19 or back up power for emergency situations, causing frequent service
20 disruptions.

21 Attached as **Schedule JS-2** are some pictures of the previous drinking water
22 system.

23

1 **Q. WERE THE CUSTOMERS OF THESE SYSTEMS RECEIVING ADEQUATE**
2 **SERVICE BEFORE THEY WERE ACQUIRED BY HILLCREST?**

3 A. I believe they were not. As mentioned previously, on the wastewater side there
4 were 15 years of MDNR compliance and enforcement issues causing pollution in
5 a creek and endangering residents who could come into contact with the
6 receiving stream. Additionally, due to the Missouri Attorney General formal
7 enforcement actions against the previous owner, residents of the subdivision
8 were unable to sell their homes, because lenders were being unwilling to
9 underwrite home loans in the community. Even more significantly, I believe the
10 untreated waste in the receiving stream posed a direct threat to human health.
11 On the drinking water side, MDNR was in the process of forcing the previous
12 owner into receivership due to an eight week boil order over continued positive
13 pathogen tests in the drinking water system. Hillcrest, before it even owned the
14 properties, entered into an emergency agreement with MDNR that provided a
15 means for the subdivision residents to receive water service. As part of this
16 MDNR agreement, Hillcrest paid for emergency drinking water repairs, on-going
17 drinking water system inspections, and a temporary chlorine disinfection system
18 to protect existing customers. Again, all this was done before Hillcrest even
19 owned the system. I believe, and I think MDNR's aggressive action
20 demonstrates, that positive pathogen tests in the Hillcrest drinking water system
21 posed a very real threat to human health.

22

1 **Q. WAS HILLCREST REQUIRED TO MAKE CERTAIN IMPROVEMENTS WHEN**
2 **IT ACQUIRED THE SYSTEMS?**

3 A. Yes. Attached as **Schedule JC-3** is a copy of the Missouri Attorney General,
4 Missouri Department of Natural Resources and Hillcrest Agreement on Consent
5 (AOC), which required Hillcrest to make specified improvements to the Hillcrest
6 wastewater and drinking water systems immediately.

7

8 **Q. WAS THE NECESSITY OF THE IMPROVEMENTS TO THE WATER AND**
9 **WASTEWATER SYSTEMS KNOWN AT THE TIME HILLCREST RECEIVED**
10 **APPROVAL OF THE TRANSACTION IN FILE NO. WO-2014-0340?**

11 A. Yes. Hillcrest's Application, as well as other documents in that matter, described
12 the issues, the planned improvements, and the cost of those improvements.
13 Hillcrest provided the Commission Staff with copies of both the emergency
14 MDNR agreement and the Missouri Attorney General AOC before signing each
15 agreement. Additionally, in the acquisition case, Hillcrest proposed a financing
16 plan/transaction, related to the improvements, that was approved by the
17 Commission.

18

19 **Q. DID HILLCREST MOVE FORWARD WITH THOSE IMPROVEMENTS**
20 **REQUIRED BY THE AOC?**

21 A. Yes. Hillcrest began construction on the drinking water and wastewater
22 improvements approximately 30 days after it acquired the water and wastewater
23 systems.

1

2 **Q. WHEN WERE THESE IMPROVEMENTS COMPLETED?**

3 A. The drinking water and wastewater improvements were completed in the fall of
4 2015.

5

6 **Q. WHAT WAS HILLCREST'S INVESTMENT IN THE NEW FACILITIES?**

7 A. Hillcrest has invested approximately \$1,205,000 in the facilities. The original
8 estimate Hillcrest provided in its Application in File No. WO-2014-0340 for these
9 improvements was approximately \$1,230,000.

10

11

EXISTING RATES

12

13 **Q. HAS HILLCREST PREVIOUSLY BEEN THROUGH A RATE CASE?**

14 A. No. With the acquisition, Hillcrest assumed the rates being charged by Brandco.

15

16 **Q. WHEN WERE BRANDCO RATES ESTABLISHED?**

17 A. The original Brandco tariff was established in 1989, and readopted in whole in
18 2007, by the previous owner Brandco Investments, LLC, without a change in the
19 rate. To my knowledge the actual rates have been unchanged since 1989.

20

21 **Q. HOW WAS THIS RATE CASE INITIATED?**

22 A. Hillcrest initiated this small company rate case by its letter to the
23 Commission dated September 15, 2015.

1

2 **Q. WILL THE RATES REQUESTED BY THE COMPANY RESULT IN A**
3 **SIGNIFICANT INCREASE FOR THE HILLCREST CUSTOMERS?**

4 A. Yes, they will. I wish this were not the case. However, both the water and
5 wastewater systems required a substantial rebuild to: (1) to be operational
6 for the provision of service to the customers; and (2) to comply with
7 federal and state regulations related to those services. Unfortunately,
8 there are no shortcuts when systems are in this condition. Choices are
9 very limited and those choices are expensive -- especially when compared
10 to the number of customers served by the systems. Unfortunately, the
11 choice in this case was not between higher or lower rates – the choice
12 was whether to have safe and adequate service, or not.

13

14

PAYROLL

15

16 **Q. WHAT LABOR COSTS ARE RELEVANT TO THIS RATE CASE?**

17 A. As I described previously, Hillcrest has no employees. Several functions related
18 to its operation are provided by three employees of Central States – myself, a
19 financial manager, and an administrative employee. A portion of the costs
20 associated with those employees is then allocated to Hillcrest.

21

22 **Q. WHAT PORTION IS ALLOCATED TO HILLCREST?**

1 A. Fourteen percent (14%). The remainder of those costs will be allocated to future
2 Central States acquisitions.

3

4 **Q. WHAT DISAGREEMENT DOES HILLCREST HAVE WITH THE COMMISSION**
5 **STAFF IN REGARD TO PAYROLL?**

6 A. I do not agree with the method Staff used to derive the base labor costs to be
7 allocated.

8

9 **Q. HOW DID THE COMMISSION STAFF DEVELOP ITS LABOR COSTS?**

10 A. In order to develop the labor costs associated with the Central States'
11 employees, the Commission Staff has used Missouri Economic Research and
12 Information Center (MERIC) wage estimates based on the St. Louis region and a
13 2014 study that has not been adjusted using U.S. Department of Labor,
14 Employment Cost Index (EPI) inflation rates. In addition, the Commission Staff
15 assumed that the employees possessed mean (or average) experience levels.
16 The salaries developed by the Staff are lower than the actual salaries paid for
17 Central States employees.

18

19 **Q. HOW DOES HILLCREST BELIEVE THESE LABOR COSTS SHOULD BE**
20 **DEVELOPED?**

21 A. Hillcrest finds the Staff's general approach to be acceptable. However, in
22 working through that process, the Commission should use EPI inflation adjusted
23 salaries for experienced personnel at each category for rate making purposes.

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Q. WHY IS HILLCREST’S APPROACH MORE APPROPRIATE?

A. All the salaries should be adjusted using the EPI in order to accurately reflect current market conditions, rather than utilizing data that is two years old. Moreover, in the case of the Central States employees, each employee’s actual experience, education levels, and current job roles demand that the individual be recognized as “experienced.”

Q. PLEASE DESCRIBE THE EXPERIENCE OF THOSE CENTRAL STATES EMPLOYEES.

A. Our current chief financial officer (CFO) has over 41 years of financial experience. He is a registered CPA, holds a B.S. in Accounting and an MBA from Kansas State University. Our CFO’s previous experience includes being a Director of Finance at Colgate-Palmolive, a Fortune 100 company, overseeing over \$100MM in budget. Recently, our CFO was the CFO of a privately held surfaces company with over \$90MM in balance sheet and budget. As president of the company, I have a BS in Environmental Science from the University of Kansas and a MBA from Washington University in St. Louis. My previous tenures have included a director role inside an engineer firm, and being the COO and finally CEO of an engineering and construction firm whose peak was over \$14MM annually. As president and founder of CSWR I have been in the capital markets raising debt and equity for CSWR since 2010 visiting with to date over 80 investment banks, private equity firms, institutional investment

1 groups, and financing companies. I am responsible for utility acquisition work
2 including evaluation of the existing utility assets for acquisition, determination of
3 existing net book value of acquisition targets, engineering design/technology
4 selection for new improvements, construction contractor selection, construction
5 management (since 2015 Central States has completed approximately \$4.3MM
6 in new plant investment with \$2MM currently in progress), ongoing O&M
7 management including monitoring all plant remote operations and emergency
8 responses, new utility rate design/pro-forma financial models, and overall
9 companywide management. This myriad current job responsibility is more than
10 almost any executive inside the water and wastewater utility industry.

11 Our office manager holds a BA from Washington University of St. Louis. She has
12 over 30 years of director experience managing large financial institution offices
13 and most recently managed the office of the third largest drinking water well
14 services company in Missouri before coming to Central States.

15
16 **Q. WHAT SHOULD THE COMMISSION DO IN REGARD TO THIS ISSUE?**

17 **A.** The Commission that salaries, for purposes of establishing the revenue
18 requirement in this case, be adjusted to reflect MERIC “Experienced” employees
19 for the St. Louis area, and adjusted to the most recent reporting period of the
20 Employment Cost Index for the US Bureau Labor of Statistics For the following
21 SOC codes and titles:

- 22 a. 11-1011 Experience Chief Executive;
- 23 b. 11-3031 Experience Financial Manager; and,

1 c. 43-6011 Experience Executive Administrative.

2 The Commission should further use actual salaries when they are less than
3 MERIC "Experience" level.

4
5 **PROPERTY TAXES**

6
7 **Q. WHAT DISAGREEMENT DOES HILLCREST HAVE WITH THE COMMISSION**
8 **STAFF IN REGARD TO PROPERTY TAX?**

9 A. Because property taxes were not paid in 2015, the Staff has not provided for
10 Cape Girardeau County property taxes in Hillcrest's revenue requirement.

11
12 **Q. WILL HILLCREST PAY PROPERTY TAXES IN 2016?**

13 A. Yes. The circumstances have changed greatly. First, as I described previously,
14 Hillcrest has made over \$1.2 million in improvements to the water and
15 wastewater systems. These improvements were in service as of January 1,
16 2016. Thus, they will be taken into account in the property tax Hillcrest will pay
17 this year. Second, it appears that the previous owners of the systems did not
18 submit personal property tax information at all. This omission has created record
19 gaps and forced Hillcrest to do a new assessment submission that will include
20 both existing property and the improvements made in 2015.

21
22 **Q. WHAT IS THE APPROPRIATE TREATMENT OF THIS ISSUE?**

1 A. The Commission should order that an amount associated with Cape Girardeau
2 County property taxes be included in the calculation of Hillcrest's revenue
3 requirement. Because Hillcrest completed substantial improvements in 2015, it
4 is known that Hillcrest will be assessed property taxes in 2016, and every year
5 after, for the life of the new assets.

6

7 **Q. WHAT AMOUNT SHOULD THE COMMISSION INCLUDE IN HILLCREST'S**
8 **REVENUE REQUIREMENT FOR PROPERTY TAXES?**

9 A. Based upon an original submission to Cape Girardeau County, Hillcrest
10 estimates that its property taxes will be approximately \$18,723 in 2016.
11 However, Hillcrest is currently working with the Cape Girardeau County
12 Assessor's office in regard to the assessment in an effort to make these taxes as
13 affordable as the County Assessor will allow. Hillcrest hopes to be able to
14 update this information in its rebuttal testimony.

15

16 **AUDITING AND INCOME TAX PREPARATION FEES**

17

18 **Q. WHAT DISAGREEMENT DOES HILLCREST HAVE WITH THE COMMISSION**
19 **STAFF IN REGARD TO AUDITING AND TAX PREPARATION FEES?**

20 A. The Staff has not included the direct audit and tax preparation fees for Hillcrest,
21 or Hillcrest's pro-rata share of tax and audit fees from Central States.

22

1 **Q. DID THE COMPANY TAKE ANY STEPS TO ESTABLISH WHAT A**
2 **REAONABLE LEVEL WILL BE FOR THESE COSTS?**

3 A. Yes. The Company issued requests for proposals (RFP) and circulated those
4 RFP's to a variety of accountants and accounting firms in order to determine the
5 least expensive qualified firm for rate making purposes.

6

7 **Q. WHAT WAS THE LOWEST COST FOR THESE SERVICES HILLCREST**
8 **FOUND THROUGH THE RFP PROCESS?**

9 A. For tax preparation services at Hillcrest, the lowest qualified cost is \$6,000 per
10 year. For audit services at Hillcrest, the lowest qualified cost is \$11,000 per year.
11 For tax preparation services at Central States, the lowest qualified cost is \$4,850
12 per year. For audit services at Central States, the lowest qualified cost is
13 \$10,000.

14

15 **Q. HAS THAT ACCOUNTING FIRM BEEN HIRED BY CENTRAL**
16 **STATES/HILLCREST?**

17 A. Yes.

18

19 **Q. WHAT IS HILLCREST'S ANNUAL SHARE OF THOSE COSTS?**

20 A. \$19,429, which consists of \$6,000 for Hillcrest's tax preparation, \$11,000 for
21 Hillcrest's Audit fees, a 14% allocation of Central States tax preparation fees, and
22 a 14% allocation of Central States Audit Fees.

23

1 **Q. WHY IS IT NECESSARY FOR CENTRAL STATES AND HILLCREST TO HIRE**
2 **AN OUTSIDE ACCOUNTANT OR FIRM TO PERFORM THESE SERVICES?**

3 A. One of the major problems facing failing water and sewer companies is a lack of
4 professional management and attention to regulatory and statutory compliance.
5 The former owner of these systems did not correctly file taxes forms (as
6 discussed above), nor did they develop and maintain accurate financial records.
7 Tax preparation and audit fees are a normal course of business for a
8 professionally managed utility. This is particularly important for a utility, or group
9 of utilities, that is actively engaged in attempting to raise capital.

10

11 **Q. WHAT IS THE APPROPRIATE TREATMENT OF THIS ISSUE?**

12 A. The Commission should order that an amount to Hillcrest's share of the audit and
13 tax preparation fees be included in its revenue requirement.

14

15 **CAPITAL STRUCTURE**

16

17 **Q. WHAT DISAGREEMENT DOES HILLCREST HAVE WITH THE COMMISSION**
18 **STAFF IN REGARD TO CAPITAL STRUCTURE?**

19 A. Instead of using Hillcrest's actual capital structure, Staff has recommended a
20 hypothetical capital structure with a higher equity ratio than is actually being used
21 by Hillcrest.

22

23 **Q. WHAT IS THE APPROPRIATE TREATMENT OF THE ISSUE?**

1 A. The Commission should use Hillcrest's actual capital structure. In this case,
2 Hillcrest's debt is at a higher cost than its return on equity. The result of utilizing
3 an artificially high equity ratio is to hamper Hillcrest's ability to make payments on
4 its loan obligations.

5

6 **Q. WHY SHOULD THIS BE IMPORTANT TO THE COMMISSION?**

7 A. I believe the state of Missouri is facing a crisis in small water and wastewater
8 systems across the state. Central States has intervened in two regulated water
9 systems, Hillcrest and now Smithview/Kuel's H2O, that were in the midst of
10 months long boil orders. I have come across both regulated and un-regulated
11 community utilities across the State that are flagrantly violating minimum MDNR
12 health and safety standards, creating health risks for residents. In addition to
13 individual health risks, these failing systems are degrading the water quality and
14 environmental stability of the state's rivers and streams.

15

16 **Q. HOW DOES THIS SITUATION RELATE TO THE APPROPRIATE CAPITAL**
17 **STRUCTURE?**

18 A. For a utility to invest in basic water and wastewater infrastructure, the regulatory
19 environment must recognize the practical options that are available. Actual
20 market conditions dictate what investment criteria are needed to obtain the
21 capital investment necessary to make MDNR-mandated improvements required
22 to bring failing systems back to health, safety, stability, and environmental

1 compliance. Small, failing water and wastewater utilities represent a unique
2 situation.

3
4 **Q. HOW DOES THIS APPLY TO THE HILLCREST SYSTEM?**

5 A. For perspective, Staff determined that Brandco had a net book value of \$82,282
6 (water and wastewater combined), at the time of Hillcrest's acquisition case.
7 Hillcrest estimated the MDNR mandated capital expenditure would be
8 \$1,230,000. Hillcrest's net book value versus required MDNR investment dollars
9 represented a 7% equity basis. The utility represented a significant commercial
10 liability with existing Missouri Attorney General enforcement actions, on-going
11 and past pollution, and an actual public health risk with the on-going boil order.
12 In order to keep the system running and provide basic services during the
13 acquisition, Hillcrest had to enter an agreement with MDNR to pay for repairs,
14 disinfection of the drinking water, and on-going inspections for a system it did not
15 yet own. Hillcrest also had to also enter into an agreement with MDNR and the
16 Missouri Attorney General to build all of the necessary improvements during a
17 set time frame, in order to not be held liable for previous violations at the site.
18 This means Hillcrest had to agree to invest over \$1,312,282, in a very short time
19 frame -- something that would be required of any entity that attempted to bring
20 these systems into compliance.

21

1 **Q. DO THESE CIRCUMSTANCES, THE SIGNIFICANCE OF THE INVESTMENT,**
2 **AND THE TIME FRAME GIVE AN ACQUIRING COMPANY MANY OPTIONS**
3 **IN TERMS OF HOW IT ACCESSES CAPITAL?**

4 A. No. Prior to filing its first asset acquisition and financing case, Central
5 States/Hillcrest met with over fifty specialized infrastructure institutional investors,
6 private equity investors, and investment bankers in an attempt to create a
7 program to build water and wastewater improvements to support distressed small
8 water and wastewater utilities in Missouri. In addition, Hillcrest met with
9 numerous traditional banks seeking commercial bank financing. The capital
10 structure Hillcrest is utilizing is the only structure that could be found. Moreover,
11 this is the same structure Hillcrest presented to Commission in its acquisition and
12 financing application.

13
14 **Q. IN YOUR OPINION, WHAT IS NECESSARY FOR INVESTORS TO CONTINUE**
15 **TO PARTICPATE IN THIS PROCESS?**

16 A. Any potential investor has to have confidence that the actual capital structure
17 required to fix failing water and sewer utilities will be recognized for rate making
18 purposes. This is especially true for systems that are out of regulatory
19 compliance and carrying higher commercial liability risks with lower equity
20 bases. Furthermore, I believe that if the investment community has confidence
21 that regulators will use actual structures, it is possible that capital costs
22 associated with distressed small water and wastewater utilities may eventually

1 fall and new capital markets to open, both of which will lower utility customer
2 rates.

3

4 **COST OF CAPITAL (EQUITY AND DEBT)**

5

6 **Q. WHAT DISAGREEMENT DOES HILLCREST HAVE WITH THE COMMISSION**
7 **STAFF IN REGARD TO COST OF CAPITAL?**

8 A. Staff has developed a hypothetical debt cost for the weighted average cost of
9 capital (WACC) calculation, rather than using Hillcrest's actual debt costs.

10

11 **Q. WHAT DEBT COST DID THE STAFF UTILIZE?**

12 A. Nine and eighty-eight hundredths percent (9.88%).

13

14 **Q. WHAT IS HILLCREST'S ACTUAL COST OF DEBT?**

15 A. Fourteen percent (14%).

16

17 **Q. IS DEBT AVAILABLE TO HILLCREST AT THE RATE UTILIZED BY STAFF?**

18 A. No.

19

20 **Q. WHY NOT?**

21 A. Small, distressed water and wastewater systems are shut off from traditional
22 capital markets. Failing water and wastewater systems are shut off from capital
23 markets because of the huge liability associated with existing health and

1 environmental compliance failures, a current lack of professional management or
2 even basic records retention, and a complex regulatory environment which
3 requires huge up-front investments in capital and operations by small entities,
4 regulated by multiple (sometimes opposing) agencies, before a utility is able to
5 recover any costs.

6
7 **Q. PLEASE DESCRIBE HOW THE REGULATORY ENVIRONMENT IMPACTS**
8 **THE CREDIT WORTHINESS OF A SMALL WATER OR WASTEWATER**
9 **UTILITY.**

10 A. Water and wastewater utilities are regulated by The Missouri Department of
11 Natural Resources (MDNR). MDNR is responsible for compliance with federal
12 and state mandated health, safety, service reliability, and environmental statutes
13 and regulations. The majority of these statutes and regulations are becoming
14 increasingly stringent over time. Some, like the Clean Water Act and its
15 associated regulations, become more stringent to reflect the results of continuing
16 scientific research into the dangers of pollutants to human health and the
17 environment. The increasing pressure also reflects the state of Missouri's
18 commitment to forcing utility providers to provide safe and reliable water
19 resources to customers. Addressing these realities requires huge upfront capital
20 investment with delayed and uncertain recovery of revenues necessary to recoup
21 those investments, usually from an entity with largely depreciated assets. Banks
22 cannot loan huge sums of money to entities with little equity in the form of net

1 book value, existing environmental issues, and without a guarantee on
2 recoupment.

3

4 **Q. DID YOU ATTEMPT TO ACCESS TRADITIONAL LENDING SOURCES?**

5 A. Yes. I made numerous attempts to secure debt and equity financing from
6 multiple sources, all of which were rejected.

7

8 **Q. HOW LONG HAVE YOU BEEN INVESTIGATING FINANCING OPTIONS FOR**
9 **SMALL WATER AND WASTEWATER SYSTEMS?**

10 A. I have been working on raising capital toward the acquisition and recapitalization
11 of small water and wastewater utilities since 2011. I was initially turned down by
12 eleven tradition commercial banks as a part of this process. I then approached a
13 number of mezzanine finance entities, which also declined to participate. I next
14 had our investment banker utilize the then equity partner's experience to seek
15 debt financing and ultimately accepted the debt offer that led to the financing for
16 Hillcrest.

17

18 **Q. HAVE YOU MORE RECENTLY SOUGHT TRADITIONAL DEBT FINANCING?**

19 A. Yes. I have continued to approach banks, as the business continues to build.
20 However, so far, these efforts have continued to be rejected by the banks. I have
21 also continued to try to attract other financing from multiple other investment
22 banks and mezzanine finance groups and have been unsuccessful.

23

1 **Q. IN ADDITION TO FAILING TO FULLY CONSIDER THE IMPOSSIBLE**
2 **FINANCING MARKET FOR A SMALL WATER AND WASTEWATER UTILITY,**
3 **DID THE STAFF MAKE SOME TECHNICAL MISTAKES IN ITS**
4 **CALCULATIONS?**

5 A. Yes. The Staff makes a number of mistakes in its hypothetical debt rate
6 determination in assigning Hillcrest an approximate B to B- rating for an 9.88%
7 debt rate.

8
9 **Q. PLEASE DESCRIBE THOSE MISTAKES.**

10 A. The first mistake Staff makes in assigning Hillcrest an approximate B rating is
11 that for a sale of actual Approximately B rated debt there has to be a large
12 enough issuance to attract buyers. Institutional buyers of Approximately B rated
13 debt require a minimum market size of \$25MM-\$50MM. There simply is no
14 market for approximately B rated debt instruments below \$25MM, especially one
15 that would be \$1.25MM. There are no buyers and thus no market for a 9.88%
16 approximately B rated debt below a minimum of \$25MM. It is not only
17 hypothetical, it could not exist as a normal course for capital markets, and thus
18 should not be made applicable to Hillcrest.

19 The second mistake Staff makes in assigning Hillcrest a hypothetical debt rate of
20 an approximately B rated public utility is the credit rating itself. By doing so, Staff
21 is implying a credit worthiness that does not exist. Regardless of the rating
22 agency, none of the categories applicable to Hillcrest from a B1 to a B3 or B+ to
23 a B- rating on any rating agency's scale apply to Hillcrest.

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Q. WHY NOT?

A. In general, lower B credit ratings have approximately the following general standards, “An obligor is MORE VULNERABLE than the obligors rated 'BB', but the obligor currently has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments.” See **Schedule JC-4** (Bond Credit Rating). The existing utility with the existing rate base and rates could not raise any debt much less meet the financial commitments any potential or hypothetical debt payments would entail. The existing utility could not even keep up basic maintenance tasks with its existing operational revenues, much less pay any additional obligations as implied by the Staff’s hypothetical debt rate. Thus Staff’s credit rating is not applicable.

Q. DOES STAFF MAKE ANY OTHER MISTAKES?

A. Yes. The third mistake Staff makes in giving Hillcrest a hypothetical debt rate of an approximately B rated public utility is asset quality. Debt issuance against distressed assets with little to no existing equity cannot be rated in traditional debt markets because Hillcrest’s underlying asset value is negative. Existing environmental and health liabilities and an almost fully depreciated asset base specifically precludes listing Hillcrest in traditional debt ratings. Hillcrest by definition is in default of its basic obligations as a utility due to safety and

1 environmental compliance issues. Hillcrest's debt is unratable in traditional debt
2 markets. Thus the Staff's rating does not apply.

3

4 **Q. WOULD YOU SUMMARIZE YOU'RE THE PROBLEMS WITH STAFF'S USE**
5 **OF A HYPOTHETICAL APPROXIMATELY B RATED PUBLIC UTILITY?**

6 A. In short, the Staff implies a hypothetical market rating for a debt instrument size
7 that does not exist, on a credit rating that does not apply, for an asset that is not
8 able to be rated.

9

10 **Q. WHAT DO YOU ASK THE COMMISSION TO DO?**

11 A. I ask that the Commission use Hillcrest's actual debt rate and loan terms which
12 were part of Hillcrest's previously approved financing case for determining
13 Hillcrest's appropriate rate of return for rate making purposes. The actual debt
14 rate is the ONLY debt rate that was available to a utility of this size, in this
15 circumstance, and thus is the debt rate that should be used for the purpose of
16 setting rates.

17

18 **ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION (AFUDC)**

19

20 **Q. WHAT DISAGREEMENT DOES HILLCREST HAVE WITH THE COMMISSION**
21 **STAFF IN REGARD TO ALLOWANCE FOR FUNDS USED DURING**
22 **CONSTRUCTION (AFUDC)?**

1 A. Staff used the hypothetical debt rate discussed above for its AFUDC
2 determination.

3

4 **Q. WHAT IS AFUDC?**

5 A. AFUDC is essentially the costs of borrowing construction funds from the time the
6 construction loan is funded, until the time the subject project is placed in service.

7

8 **Q. WHAT IS THE APPROPRIATE TREATMENT OF THIS ISSUE?**

9 A. AFUDC should be calculated based on the actual loan terms associated with the
10 money borrowed by the Company.

11

12 **Q. WHY?**

13 A. The loan Hillcrest obtained and utilized to build the MDNR and Missouri Attorney
14 General mandated improvements is the only loan available to it, provides the
15 interest Hillcrest is required to pay, reflects the loan submitted as part of the
16 financing case, and is thus the rate at which AFUDC should be determined.

17 Anything less ignores the reality of what is required to provide safe and adequate
18 service.

19

20 **RATE CASE EXPENSE**

21

22 **Q. DOES HILLCREST HAVE EXPENSES RELATED DIRECTLY TO THE**
23 **PROCESSING OF THIS RATE CASE?**

1 A. Yes. Hillcrest has expenses, such as those related to the individual customer
2 notices it provides. It also has incurred attorneys fees associated with the
3 processing of this case.

4
5 **Q. DOES HILLCREST KNOW WHAT THOSE EXPENSES WILL BE?**

6 A. Not at this time, as the case is far from complete.

7
8 **Q. WHAT DO YOU PROPOSE IN REGARD TO RATE CASE EXPENSES?**

9 A. The Company is incurring rate case expense in order to bring the matters in
10 dispute before the Commission. These expenses are reasonable. Accordingly,
11 an allowance for rate case expense (normalized over three years) should be
12 included in the revenue requirement in this proceeding that includes invoices of
13 Hillcrest's attorney and expenses related to the rate case (such as those
14 associated with customer notices). The Commission should bring these
15 expenses forward to a date that will allow the majority of costs to be captured in
16 the Commission's order, such as a cut-off date of at least one week after the
17 filing of post-hearing briefs.

18

19 **Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

20 A. Yes, it does.