STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 13-W-0295 - Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of United Water New York Inc. for Water Service.

STAFF BRIEF ON EXCEPTIONS

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I. Introduction

On July 23, 2013, United Water New York, Inc. (UWNY or the Company) filed for a major rate increase as defined under Public Service Law (PSL) §89-c(10)(c). After the filing of testimony, an evidentiary hearing was held on February 13, and 14, 2013. The parties filed two rounds of briefs before the issuance of the Recommended Decision (RD) on April 8, 2014.

While disagreeing with some terms of the RD, Staff generally supports the RD's conclusions regarding Management and Service Company (M&S Company) fees (except as discussed below), Employee Levels, Federal Income Tax, Rate of Return, and Capital Structure; and urges the Commission to adopt those aspects of the RD unchanged for the reasons stated in both the RD and Staff's briefs. For those issues on which Staff differs with the RD's terms, Staff respectfully submits its exceptions.

II. M&S Company

A. Allocation Formula

Staff takes exception to the RD's rejection of Staff's M&S expense adjustment to account for the unfair allocation of administrative, purchasing, insurance and general services costs between regulated and unregulated United Water subsidiaries. This misallocation is the result of a three factor formula (number of employees, O&M expense, and number of customers) and the decision to arbitrarily designate some unregulated subsidiaries as having a single customer. The RD states that based on the

evidence presented, it cannot be determined if the three factor formula currently being used results in an inequitable distribution of costs (RD 18).

The Commission should reject the RD's recommendation and adopt Staff's proposed $.214 million adjustment to address the issue of cost allocation of general and administrative fees. Staff arrived at this figure by eliminating the number of customers as a factor and allocating the costs based on the number of employees and O&M expense (Tr 1099-1100). Staff has shown that, under the M&S Company methodology, if an unregulated affiliate does not provide customer billing or collection services for those systems it operates, it is considered to have only one customer (Staff IB 6). Since the number of customers is one-third of the three factor formula, this clearly results in a lower amount being allocated to these unregulated subsidiaries and, by necessity, a higher amount charged to regulated subsidiaries, such as UWNY.

The general administrative costs allocated using the formula, are not attributable to individual companies, and therefore, are unrelated to the number of customers served by those companies. Additionally, any costs related to billing and collection services have a separate cost allocator and are not included in these general and administrative costs (TR 1099). Basing one-third of the allocation formula on the number of customers, and defining some unregulated subsidiaries as having only one customer, inevitably leads to an arbitrary shifting of costs to regulated subsidiaries.

Based on Staff's analysis, and the Company's failure to provide an adequate alternative interpretation,

Staff's proposed $.222 million adjustment should be adopted.

B. Inflation Index

Staff takes exception to M&S Company expenses being set at the level of the allowance for the final year of UWNY's most recent rate plan (12 months ending August 31, 2013) escalated by 3.7 percent (RD 18).

The 3.7 percent inflation rate reflects the increase in costs expected to occur between the Test year (12 months ending March 31, 2013) and the Rate year (Stella Testimony 3-4),[1] not the shorter sub-period identified in the RD. As of the date of the RD – April 8, 2014 – the expected inflation for the sub-period is only 2.8 percent. The RD erred in mismatching the expense base period to the 3.7 percent expected inflation rate contained in the record. The RD should be amended to reflect the correct inflation rates of 2.8 percent.

III. Economic Obsolescence

Staff takes exception to the RD's treatment of the Company's failure to make past Economic Obsolescence (EO) filings with the New York State Office of Real Property Tax Services (ORPTS). In considering the issue, the RD weighs the Company's proposed 7% and Staff's 15.19% adjustments before recommending an EO level of 10% (RD 26). The RD states that "[r]atepayers very likely have been funding an excess level of property taxes as a result of the Company's failure to seek and obtain the EO awards (RD

[1] Staff Witness Stella's testimony was omitted from the hearing transcript for this case. Citation is made to the testimony filed on November 8, 2013.

26)," but does not "find Staff's updated calculations based on statements of the Company's witness during cross-examination to provide any greater certainty of what the EO level should be than the award UWNY received based on its EO calculation (RD 27)."

Given the Company's past failure to make EO filings, the process of determining the appropriate level of current property tax expense is inherently speculative. It does not, however, follow that a figure not supported by the record should be adopted as a compromise between the parties' positions.

The RD states that the Company's failure to pursue EO adjustments has resulted in ratepayers "very likely ...funding an excess level of property taxes (RD 26)" and identifies the deficiencies in the Company's position while concluding that, "the 7% economic obsolescence award recently granted to UWNY does not fully capture the EO level that the Company should be entitled to (RD 27)." The RD does not, however, accept Staff's adjustment of 15.19%.

Staff argues that, given the Company's responsibility for the current uncertainty regarding EO adjustments, once it is determined that the Company's 7% figure is insufficient; Staff's proposed adjustment should be employed. This position is strengthened by the Company's failure to address the specific adjustments Staff made to reach its conclusion. The Company's choice to base its counterargument on the relative authority of the Commission and ORPTS to determine EO adjustment levels leaves Staff specific conclusions unchallenged.

Staff's calculation corrects two errors made by the Company in its filing to ORPTS. The first error is

related to "Paid In Capital." The Company brought forward $5,786,850 as total "Paid In Capital." During cross examination, UWNY's Mr. Michaelson admitted that this was only a small portion of the Company's total "paid in capital" (Tr 602-603), that "Paid In Capital" is a form of equity (Tr 604), that "cash transferred from parent" was not an interest-free loan (Tr 604) and the parent expected a return on its "cash transferred from parent" (Tr 604).

In the ORPTS EO model total capitalization is made up of equity, debt and deferred taxes. The deferred tax component is priced at a zero cost rate, or considered free financing. Had the Company properly accounted for all its "Paid In Capital," the total capitalization amount increases significantly and the portion attributable to deferred taxes (free-financing) decreases from approximately 22% of total capitalization per the ORPTS filing (Exh 88, p 12) to about 17% of total actual capitalization (Staff IB, Attachment A, p 4). Since the flawed filing made to ORPTS had more free-financing capitalization than the Company actually had per its books, this error had the effect of artificially decreasing the required (allowed) rate of return and thereby decreasing its EO award.

The second error relates to the proper accounting related to the taxes associated with Allowance for Funds Used During Construction (AFUDC). Since AFUDC was recorded below-the-line, its tax effects should have also been recorded below-the-line. In its filing with ORPTS, to correct for the tax effects related to AFUDC, the Company made an adjustment to Net Income by taking the full amount of AFUDC and multiplying it by the effective tax rate. During cross-examination Mr. Michaelson admitted that the

tax expense related to "AFUDC avoided interest" should be zero (Tr 610-611). He also admitted that the "equity return component" is not deductible for tax purposes (Tr 611-612). So the only component of AFUDC that will generate an income tax expense is "equity gross-up" portion of AFUDC (Tr 611-612). Had the Company properly accounted for the tax effects of AFUDC in its report to ORPTS, the adjustment to Net Income would just be the equity gross-up amount which would be $2.6 million in 2012, $1.2 million in 2011 and zero for 2010, 2009 and 2008, per the Company's PSC Annual Reports for those years. A concomitant adjustment related to this Income Statement adjustment would also be required for the Balance Sheet account - Allowance for Accumulated Deferred Income Tax.

While the Company has characterized Staff's changes to its proposed adjustment as Staff being "unable to settle on its own purely hypothetical EO award (UWNY RB 18-19)," the reality is that Staff has worked to identify the degree to which ratepayers have been needlessly overcharged in the past and establish the correct EO adjustment for the rate year. As new information, such as Mr. Michaelson's testimony, became available, Staff adjusted its position accordingly. While the Company may deride this uncertainty, it is the result of its own inaction and such criticism should not sway the outcome in this proceeding.

As the only on-the-record alternative to the Company's 7% proposal, Staff's 15.19% EO adjustment should be adopted by the Commission.

IV. Employee Health and Welfare Expense

The Company had proposed increasing the base year expense for employee medical benefits by 27.69%, while Staff, following established Commission practice, would increase the expense only by the rate of inflation, 2.26% (RD 36). The RD, reasoning that medical benefits might be considered a unique cost element, at least utilities the size of UWNY, recommended splitting the parties' position with half the expense increased by 27.59% and half by 2.26% (RD 37). The RD would have the Commission adopt this position on a provisional basis, subject to reconsideration in subsequent UWNY rate proceedings.

Staff takes exception to the recommendation that the Commission deviate from its established practice regarding employee medical expenses. The Commission first established its treatment of employee medical expenses in 1984, where it determined that, "including [employee medical expenses] in the pool of expense to which an inflation factor is applied will save time and effort, avoid unnecessary litigation and provide a reasonably accurate estimate of this expense."[2] The practice was reaffirmed in 1994, where the Commission determined that "[t]he treatment of medical insurance costs as one factor in a large pool of expenses subject to inflation should produce a reasonable result, because some items will increase at a rate greater than inflation and other items

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[2] Case 28695, Rochester Telephone Corporation - Rates, Opinion No. 84-27, Opinion and Order Determining Revenue Requirement and Rate Design (issued October 12, 1984), 24 NY PSC, page 5350.

at a lower rate.[3]" Since that time, the Commission has consistently adhered to its position, despite repeated challenges by utilities.[4]

The Company, while recognizing the Commission's practice, argues that its employee medical costs "are increasing at an average rate of 12.5% per year (UWNY IB 18)" and that Staff's position "does not reflect current expense trends and its quite unfair when applied to a small utility such as UWNY (UWNY IB 18)." UWNY's argument may appear valid if employee medical costs are considered in a vacuum, but this ignores the theory behind the Commission's practice. As stated in Case 07-G-0772, employee medical costs are grouped with a variety of other cost drivers because,

> Actual inflation for items to which the general inflation index is applied will exceed the index for some and fall below the

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[3] Cases 92-E-1055 and 92-G-1056, Central Hudson Gas & Electric Corporation – Rates, Opinion No. 94-3, Opinion and Order Determining Revenue Requirement and Rate Design, (issued February 11, 1994), p 16.

[4] See, e.g., Case 07-E-0523, Consolidated Edison Company of New York, Inc. – Electric Rates, Order Establishing Rates for Electric Service (issued March 25, 2008), p 42 (stating, "[w]e are satisfied that the standard practice is proper and rational within the complete ratemaking context and that the Company is being treated fairly"); Case 93-E-1123, Long Island Lighting Company – Rates, Opinion No. 95-8, Opinion and Order Adopting Recommended Decision with Modifications (issued July 3, 1995), p 43 (stating, "we generally prefer that the inflation rate approach be used to estimate medical insurance costs"); and Case 07-G-0772, Corning Natural Gas Corporation for Gas Service – Rates, Order Authorizing Rate Increase (issued December 13, 2007), p 20 (stating, "[f]or decades, we have included health care costs in an expense group to which an overall inflation index is applied and consistently rejected any such change to this approach").

> inflation index for others. Selecting the health and hospitalization expenses because their inflation rate is likely to be higher than the index, ignores the likelihood that many items in the general inflation pool will likely have inflation rates below that of the inflation index.[5]

If employee medical benefits are to be treated as a unique cost element, then for consistency's sake, the other items subject to general inflation must be subject to individual analysis as well, to ensure the Company does not unjustly benefit from drivers that historically increase at a rate lower than inflation.

The Company makes the argument that it should be exempted from the policy because is too small absorb the increases in employee medical benefits, which the RD apparently accepts (RD 37). However, in 2007, the Commission allowed only inflation for the employee medical expense of Corning Natural Gas Corporation,[6] which served only 14,400 customers.[7] Since UWNY's currently serves 74,000 customers (RD 1), the Company's position is not valid.

In the present case, UWNY provided no argument that was not considered and rejected by the Commission in the past and there is no basis for abandoning the Commission's established practice. Furthermore, where a practice is as firmly established and unchanged as this, citing that practice is sufficient to overcome a utility's unoriginal proposal to do otherwise. Therefore, the RD's

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[5] Case 07-G-0772, supra, Order Authorizing Rate Increase (issued December 13, 2007), p 20.

[6] Case 07-G-0772, supra, Order Authorizing Rate Increase (issued December 13, 2007), p 14.

[7] Ibid., p 2.

observation that "[t]he only stated basis for the disallowance proposed by Staff and MC is Staff's observation that the Commission found this type of expense amenable to inclusion in the inflation pool in a 2008 Con Edison electric rate decision (RD 36)" is not a valid critique of Staff's opposition. The reason the Commission established its treatment of these expenses was to resolve the issue for all cases and allow parties to "apply their resources more productively to other matters.[8]" Staff should not be required to re-litigate the merits of the issue simply because the Company stubbornly refuses to acknowledge the Commission's determination. Since the Company has provided no valid basis for an exception to the Commission's established practice, Staff's position should be adopted.

V. Cost of Debt

The RD adopted Staff's proposed cost of debt of 5.05%, which was not opposed by the Company, but stated that the figure should be updated to reflect the outcome of an intended private placement issuance of $45 million by UWNY. The Company has informed Staff (IR-295 ALC-26) that the debt offering did not occur and there are no firm plans for a future issuance. Based on this information, Staff calculates that the Company's rate year cost of debt should now be 5.07%.

The updated customer deposits rate, as prescribed by the Commission, effective January 1, 2014 is 1.25%. Given these updates, the RD's capitalization for UWNY for

[8] Case 07-E-0523, <u>supra</u>, Order Establishing Rates for Electric Service (issued March 25, 2008), p 43.

the rate year ending May 2015, should reflect an overall cost of debt of 2.73% and an after-tax and pre-tax rate of return of 6.87% and 9.60%, respectively.[9]

VI. Customer Service Performance Incentive

In its review of Staff's proposed Customer Service Performance Incentive (CSPI), the RD observes the parties' lack of mention of the newly enacted Public Service Law (PSL) §25-a and suggests that the record might benefit from a discussion of the statute (RD 91).

While the section greatly expands the Commission's authority to assess penalties for the failure to comply with the PSL, regulations or a Commission Order, that authority is expressly limited to combination gas and electric corporations. Given this restriction, Staff concludes that PSL §25-a is inapplicable and does not affect the analysis of the CSPI.

The Company may argue that this specific grant of authority to assess penalties against combination gas and electric corporations indicates that the Commission does not generally possess such authority. This, however, is not the case. PSL §25-a emerged as a recommendation of the Moreland Commission on Utility Storm Preparation and Response,[10] in response to the failure of the state's

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[9] See Appendix A for a breakdown of Staff's calculations.

[10] See Moreland Commission on Utility Storm Preparation and Response Interim Report (issued January 7, 2013), p 37 (recommending, "[t]he PSC be statutorily authorized to levy administrative penalties against each utility for violations of PSC orders and regulations or upon a finding that such utility has failed to provide safe and adequate service under a 'reasonable business' standard..."). Available at

combined gas and electric corporations to respond to recent extreme weather events.[11] As such, the section's focus on a specific class of utilities cannot be seen as comment on the extent of the Commission's general jurisdiction. Moreover, PSL §25-a(2)(a)(v) states that "[t]he remedies provided by this subdivision are in addition to any other remedies provided in law," which indicates independent authority exists to enact practices such as the CSPI.

VII. Conclusion

For the reasons stated herein, Staff's proposals and adjustments should be adopted.

Respectfully submitted,

/s/

Joseph Dowling

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http://www.nypa.gov/Press/2013/MAC-Interim-Report1-7-2013.pdf.

[11] Ibid., at 5 (stating, "Governor Andrew M. Cuomo established a commission under the Moreland Act... to study, examine, investigate, and review the response, preparation, and management of New York's **power utility companies** with respect to Hurricanes Irene and Sandy, Tropical Storm Lee, and the December 2008 Ice Storm... (emphasis added)").

Appendix A

UNITED WATER NEW YORK INC.
Updated Capital Structure per Recommended Decision
for the Rate Year Ending May 31, 2015

Capital Structure	Capital	Percent	Cost Rate	Weighted Cost	Pretax Weighted Cost
Long-Term Debt	$147,020,989	53.91%	5.07% [1]	2.73%	2.73%
Short-Term Debt	$0	0.00%	0.00%	0.00%	0.00%
Customer Deposits	$245,444	0.09%	1.25% [2]	0.00%	0.00%
Cost of Debt		54.00%		2.73%	2.73%
Common Equity	$125,449,183	46.00%	9.00%	4.14%	6.87%
Total	$272,715,616	100.00%		6.87%	9.60%

1. The updated cost of long-term debt; reflects the elimination of the UWNY's $45 million debt issuance for December 2013.

2. The customer deposits rate prescribed by the Commission, effective on January 1, 2014.