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.
CASE 09-W-0731 -	Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of United Water New York Inc.
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August 26, 2015

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Introduction

On July 28, 2014, the Municipal Consortium (MC) filed in Case 13-W-0295, United Water New York, Inc. – Water Rates, a rehearing petition of the Commission's June 26, 2014, rate order for United Water New York (UWNY). In its petition for rehearing, the MC claimed that the Commission committed an error of law in granting a rate increase to UWNY despite acknowledging that UWNY was not managed in an efficient and economical manner.[1]

In particular, the MC took issue with UWNY's management of property taxes. The MC alleged that the Commission erred in not initiating a prudence investigation of UWNY's failure to seek Economic Obsolescence ("EO") Adjustments to reduce its property tax burden creating an unjust and unreasonable rate for UWNY's customers.[2] In an Order issued February 10, 2015, the Commission denied the MC's request for rehearing noting that rates are set prospectively and that, despite UWNY's demonstration that it had belatedly applied for and received an award of

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[1] Case 13-W-0295, United Water New York, Inc. – Water Rates, Petition for Rehearing and/or Clarification, at p.2 (filed July 28, 2014) (Rehearing Petition).

[2] Ibid. at 3.

only 7%, the Commission had imputed an EO offset of over 15% in its June 2014 Rate Order.[3] As for any retroactive analysis of UWNY's failure to apply for the EO award, the Commission stated that UWNY's "property taxes from past years are subject to a reconciliation mechanism that was established in its prior rate plan…DPS Staff's audit of UWNY's proposed reconciliation of past periods is ongoing. If, in the course of that audit, DPS Staff were to find that UWNY acted imprudently with respect to its taxes, DPS Staff could recommend to the Commission that adjustments to the reconciliation be made to account for such imprudence."[4]

During its audit, Staff examined not only UWNY's property tax reconciliation filing, but those of United Water New Rochelle (UWNR) and United Water Westchester (UWW collectively, the Companies) as well. This report contains the results of Staff's analysis, which indicates Staff's belief that the Companies acted imprudently with respect to their failure to apply for EO adjustments relative to their respective property taxes. Accordingly, Staff plans to recommend that the Commission impose an adjustment to the Companies' property tax reconciliation filings.

Background

Pursuant to their prior recent rate plans, UWNY (Case 09-W-0731), UWNR (Case 09-W-0824) and UWW (Case 09-W-0828), which are still in effect for the current reconciliation, the Companies are all allowed to reconcile any amounts paid in property taxes in excess of the forecast included in rates. Under each respective reconciliation mechanism, the Companies may recover 85% of the difference of their actual incurred property taxes greater than the targeted amount used to set base rates. Conversely, ratepayers would receive 100% of the benefit if the company's actual property taxes are below this same specific target level. If, however, the company demonstrated that such lower amount was a result of company action, then such company would be eligible to retain 15% of the difference from the original target amounts. After each reconciliation, any identified difference is recovered or paid through a surcharge or surcredit amortized over a twelve-month period.

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[3] See Case 13-W-0295, United Water New York, Inc. – Water Rates, Order Regarding Petition for Rehearing at 9-10 (issued February 10, 2015) (Order).

[4] Order at p. 11.

Each company is required to submit its property tax reconciliation within 60 days after the end of each rate year. The property tax reconciliations are filed as part of the Companies' Revenue Adjustment Clause (RAC) filings. UWNY submitted its filing on September 16, 2013 for the rate year ending August 31, 2013; and its latest filing on August 13, 2014 for the nine months ending May 31, 2014.[5] UWNR and UWW filed their RAC filings on December 10, 2013 for the rate year ending October 31, 2013. UWNR submitted its latest filing three months late on April 9, 2015 for the rate year ending October 31, 2014. UWW submitted its latest filing four months late on May 13, 2015 for the rate year ending October 31, 2014. Because of its ongoing review of the EO questions, as described herein, Staff contacted the Companies to explain that we were not yet ready to respond within the specified review period and that the Companies should therefore not implement their proposed reconciliation surcharge/credits until Staff has concluded its review and provided the Companies clear guidance on its conclusions. All six property tax reconciliations that have been filed resulted in an under-collection. The chart below shows the total under-collection amounts after 15% sharing, excluding interest and prior period balances, that the Companies are asking recovery of in each property tax reconciliation filing under consideration.

Company Requested Under-Collection Amount			
	UWNY	**UWNR**	**UWW**
RY 3	$ 1,169,924	$ 1,615,684	$ 370,365
RY 4 / Stay-out	$ 2,350,534	$ 1,950,916	$ 494,686
Totals	**$ 3,520,458**	**$ 3,566,600**	**$ 865,051**

For four of the reconciliation filings, Staff sent a letter to the Companies approving their RAC filings, but notifying them that their property tax reconciliation is still under review and that collection was not authorized pending completion of Staff's review and Commission action accepting Staff's calculation of final reconciled differentials.[6]

[5] UWNY new rates established in case 13-W-0295 did not go into effect until June 2014. The Company stayed out for nine months causing the truncated reconciliation period.

[6] A letter has not been sent to the UWNR or UWW for the rate year 4 property tax reconciliations as they are still under review. A similar letter is expected to be sent to the Companies for these reconciliations.

Economic Obsolescence

During the recent UWNY rate case (13-W-0295), Staff discovered that, unlike most other New York utilities, none of the Companies have been making annual EO filings with the New York State Office of Real Property Tax Services (ORPTS). Under ORPTS regulations, EO is defined as the loss of value of property caused by impairment in desirability or useful life resulting from factors external to the property.[7] An ORPTS' EO award reduces a utility's special franchise net assessment, resulting in lower special franchise property taxes. Since the Companies did not make their first EO filing with ORPTS until October 2013, no EO award is reflected in the actual property tax expense for five of the six property tax reconciliations under review with the sixth reconciliation containing only a partial EO award covering a very small portion of property tax expense.[8] Staff calculates the Companies' actual property tax expense would have been about $4 million lower than what the Companies reported in the reconciliations. Factoring in the sharing provision allowed in each of the rate plans, ratepayers could have saved over $3.4 million had the Companies properly filed for an EO award. The chart below shows the breakout the Companies' property tax reconciliation filing.

Savings to Ratepayers			
	UWNY	**UWNR**	**UWW**
RY 3	$ (1,524,344)	$ (91,619)	$ (247,735)
RY 4 / Stay-out	$ (1,210,845)	$ (35,429)	$ (343,723)
Totals	**$ (2,735,189)**	**$ (127,048)**	**$ (591,458)**

The chart below indicates the impact on the return on equity (ROE) net of tax if the Companies were disallowed recovery of these property tax amounts.

Basis Point Effect on ROE (Net of Tax)			
	UWNY	**UWNR**	**UWW**
RY 3	(83) BP	(8) BP	(101) BP

[7] 20 NYCRR §8197-2.8.

[8] UWNY's reconciliations for the periods ending August 31, 2013 and May 31, 2014, UWNR's reconciliation for the period ending October 31, 2013 and UWW's reconciliation for the periods ending October 31, 2013 and October 31, 2014 do not contain any EO award in their actual property taxes. UWNR's reconciliation for the period ending October 31, 2014 contains $757,325 worth of property taxes that include an EO award.

RY 4 / Stay-out	(66) BP	(3) BP	(140) BP
Totals	**(167) BP**	**(11) BP**	**(241) BP**

When a utility receives an EO award from ORPTS, its special franchise assessment will decrease. Such decrease, however, does not result in a dollar for dollar reduction in the tax bills. A reduction in assessed special franchise values requires locales to increase the tax rate applicable to all property to maintain an equivalent level of tax revenue to fund the municipality's budget. The figures in the charts above incorporate a 10% adjustment to offset the predicted effect of any tax rate increases on the Companies' property that likely would have occurred as a result of lower assessment values on special franchise property.[9]

Prudence Legal Standard

New York Public Service Law §89-b(1) requires the Commission to set just and reasonable rates for water companies. The Commission has the authority to determine whether a utility's costs of service should be borne by the utilities' ratepayers or its shareholders. Shareholders can, and should, be held responsible for those costs that a utility "imprudently" incurred in carrying out its obligation to provide safe and adequate service.[10] To decide imprudence, the Commission must determine whether "the utility acted reasonably, under the circumstances at the time, considering that the utility had to solve problems prospectively rather than reliance on hindsight" and the burden, ultimately, is on the utility to "justify its conduct.[11]" In the first instance, however, Staff is obligated to demonstrate a tenable basis for imprudence, but once Staff or a third-party raises a prima facie case of imprudence, the utility must show that its conduct was reasonable in light of the all the facts.

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[9] Staff is using 10% in its calculations to be consistent with what the Commission adopted in the last UWNY rate case, which was not contested by the Company. After further research, this amount has been shown to be very generous and tax rates would probably only increase by less than 1%.

[10] See Matter of Long Island Lighting Co. v. Public Srv. Comm'n of State of N.Y., 134 A.D.2d 135 (3d Dept. 1987) (stating, "It would be neither just nor reasonable for a utility's customers to bear the cost of inefficient management or poor planning").

[11] Ibid., pp. 143-144.

Awareness of Economic Obsolescence

As shown on page 5 of Attachment 1, the concept of EO in property tax law, with its corresponding filing requirements, has existed since at least December 16, 1983, although some changes have occurred throughout the years.[12] In October 2000, ORPTS issued a notice of proposed rulemaking pursuant to the State Administrative Procedure Act (SAPA) to revise the EO regulations (see Attachment 2). ORPTS' proposal, in part, amended the then-existing 9 NYCRR §197-2.8, replacing the "paying property" test for EO with a general definition, greatly expanding the applicability of the EO provision. It also stated that economic obsolescence would no longer be limited to the paying property test but could be a loss of value from external factors.

Through ORPTS' outreach process, a draft of the proposed EO definition revision was mailed to all special franchise property owners to solicit comments. In January 2001, a notice of adoption was issued (see Attachment 3 for a copy of the notice) and published in the State Register indicating that the new ORPTS rules were in effect. Attachment 4 contains Sections 8185-1.1 (76) and 8197-2.8 of the New York Codes, Rules and Regulations (NYCRR) which provide the current definition and application for EO allowances.

The foregoing clearly establishes proper notice to the Companies of the change in the applicable EO definition on which a reasonably prudent utility would have followed up to insure that it was not unjustly and unreasonably burdening its ratepayers. Every year ORPTS sends a letter to each state utility reminding them of EO application filing requirements. Attachment 5, pages 9 and 10, shows a copy of the 2013 letter sent to the Companies. As can be seen in Attachment 5, the end of ORPTS' letter includes a section regarding requests for functional and economic obsolescence. There, the letter informs the receiving utility of the date by which a filing needs to be submitted. The section also contains a link to ORPTS' website for additional helpful information.[13]

The website link connects to a web page titled "Economic Obsolescence" that describes, in full detail, the requirements to file for an EO award. The webpage also references ORPTS developed templates for each utility industry. Specifically, the webpage and templates indicate that, by using information from its respective NYPSC annual report, a utility can calculate

[12] See Attachment 1 for original text of 9 NYCRR §197-2.8.

[13] http://www.tax.ny.gov/research/property/valuation/economicobsolescence.htm

its historic five year average return calculation and file for EO. Attachment 6 to this memorandum contains a copy of the ORPTS webpage. At the top of this webpage there is another link titled "Inventory," where the mentioned templates can be found.[14] On this second webpage, under the section "Requests for Functional and Economic Obsolescence," there is a subsection called "Economic Calculation Templates." There, ORPTS provides links to the EO templates that utilities can use to calculate an award amount and then submit the calculation directly to ORPTS as an application for an EO award. As seen on page 2 of Attachment 7, which provides a copy of the webpage, a utility can easily access these templates. The link to this webpage is also provided in the annual reminder letter sent to utilities.

The ORPTS templates calculate the utility's historic five year average achieved rate of return on its rate base and compare it to its modified required rate of return for the period. The modified required rate of return will reflect the Commission's return on equity allowance provided in rates during the five year period. If the modified required rate of return exceeds the achieved rate of return, the difference is divided by the modified required rate of return to determine an economic obsolescence factor that, when applied to special franchise assessment values, derives the EO award reduction of such assessment amounts.

Companies' Actions Appear to be Imprudent

Requesting an EO adjustment from ORPTS requires littler resources or effort on the part of a utility. As demonstrated by Attachment 5, New York State utilities receive an annual letter from ORPTS containing a link to its website, where additional information and necessary template can be found. EO adjustments, therefore, are a low cost method of containing property tax expense at no risk to the utility.

Despite the annual letter, the Companies claim that they did not know of the availability of EO adjustments, or the procedure for making a filing.[15] Following up on the Companies' assertion, Staff asked if the Companies read the ORPTS annual inventory reminder letter, described above, and, if so, why did they not follow up on the information provided. In

[14] http://www.tax.ny.gov/research/property/valuation/inventory_new.htm

[15] See Case 13-W-0295, supra, Rebuttal testimony of Timothy J. Michaelson, pp. 10 - 11 (filed December 6, 2013).

response to Staff's inquiry, question 3 in STAFF-4 SEK-4 (see page 2 of Attachment 8 to this memorandum), the Companies state that receiving the annual letters "became routine" and that the receipt of the annual letter only indicated to the Companies that it was time to provide the inventory reports to ORPTS. The Companies' personnel admit that they considered the letters routine and did not act on the information regarding the change in EO language.

Staff believes that it is reasonable to expect utilities of the Companies' size and sophistication to be aware of and understand statutes relevant to their business, to pursue cost-effective opportunities to reduce their expenses, and to read official correspondence from a state agency and act on same. In failing to understand and pursue EO adjustments, the Companies failed to meet the most basic standards of business operation and were, in Staff's view, imprudent. Given that a single call to ORPTS requesting clarification of the annual letter would have corrected the Companies' mistaken impression of the law and allowed them to begin reaping the benefits of regular EO filings, Staff believes its recommended adjustments are justified.

United Water's Defense

When asked by Staff why the Companies have not been filing for an EO award when each of them were eligible, the Companies state in response to question 5 in STAFF-1 SEK-1 (Attachment 9, page 2 that they believed they did not qualify for an EO award since each utility had achieved a net operating income sufficient to meet taxes which were not included in the determination of net operating income, interest on indebtedness and fixed charges as indicated in §8185-1.1 (76) of the rules and regulations. Because the Companies did not satisfy these criteria, the Companies took no further action.

Staff believes that, given the annual letters sent by ORPTS regarding EO filing, it is reasonable to expect the Companies to research the apparent conflict between their reading of the regulations and OPRTS's correspondence. This is especially so since, as taxpayers, the Companies would benefit from any ambiguity in the tax law.[16]

Conclusion

[16] See *Debevoise & Plimpton v. New York State Dep't of Taxation and Finance,* 80 N.Y.2d 657 (1993),

In this case, Staff believes that the facts present a clear case for holding the shareholders responsible for the cost of the lost opportunity to reduce the property tax burden. Here, the Companies' inaction increased the cost of rate-based assets paid for by the ratepayers directly through operation and maintenance costs, depreciation expense and property tax expense, and indirectly through a reasonable rate of return provided on such assets.

It is Staff's position that by not making annual EO filings, the Companies disadvantaged their customers by not providing them with the lowest possible property tax burden .Allowing the Companies to recover this unnecessarily incurred amount through their property tax reconciliation mechanisms would only further harm ratepayers' interests.

Staff has calculated that the Companies' failures to apply for the EO award has resulted in $3,453,695 of property taxes imprudently incurred that ratepayers should not be required to pay under the Companies' property tax reconciliation mechanisms. Staff recommends an adjustment to disallow recovery of $3.4 million of property tax under the Companies' property tax reconciliation mechanisms.