# STATE OF NORTH CAROLINA
# UTILITIES COMMISSION
# RALEIGH
## DOCKET NO. W-218, Sub 363

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

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| In the Matter of<br>Application by Aqua North Carolina, Inc., 202 MacKenan Court, Cary, North Carolina 27511, for Authority to Increase Rates for Water and Sewer Utility Service in All of Its Service Areas in North Carolina | )<br>)<br>)<br>)<br>)<br>) | ATTORNEY GENERAL'S BRIEF |

The North Carolina Attorney General's Office (the "Attorney General") respectfully submits this brief in opposition to Aqua North Carolina, Inc.'s ("Aqua's") Application for Rate Increase filed in the above-captioned docket. First, Aqua's proposed System Investment Charge ("SIC charge"), which would result in expedited rate increases for Aqua customers in the future, is not in the public interest and should not be approved by the Commission. This charge or mechanism would allow Aqua to implement periodic rate increases with reduced review and scrutiny at a time when its customers have already been hit with a number of rate increases during challenging economic times. Second, there is insufficient evidence to support the return on equity proposed by Aqua and the Public Staff in their stipulation. The return on equity evidence in the record does not properly take into account consumer interests and impact on consumers. Therefore, the Commission should not adopt the proposed ROE of 9.75%.

## ARGUMENT

### I. Aqua has not shown that the proposed SIC automatic rate increase mechanism is in the public interest.

**Procedural Background**

In this rate case proceeding, Aqua originally requested a rate increase of 19.15% or $8,611,429.00. (See Application Appendix 1 p 15.) That request has been reduced to 5.2% and $2,457,041.00 via the stipulation between Aqua and the Public Staff. (Stipulation p 5.)

Aqua has also proposed a SIC charge, a mechanism that would allow it to implement expedited rate increases in the future. The new SIC charge, if approved by the Commission, would allow Aqua to impose periodic rate increases to reflect certain costs it incurs, while bypassing the more typical ratemaking procedures that usually need to take place before a utility can recover costs and increase rates. Specifically, Aqua's proposed mechanism would allow rate increases every six months and a total rate increase of up to 5% without the need to apply to this Commission for a general rate case using the normal ratemaking procedures. (T 1 p 80) The mechanism would allow Aqua's rates to increase by increments beginning as soon as July 1, 2014, with additional increases taking place every six months until Aqua has increased rates by 5% total. (Fernald Exhibit 3) This increase would be on top of any rate increase the Commission might approve in this docket, such as the rate increase contained in the stipulation between Aqua and the Public Staff.

Moreover, Aqua's SIC charge proposal allows only 45 days for review before rate increases may take effect. The SIC charge proposal does not provide for customer notice and hearings. (Fernald Exhibit 3)

Relevant to this issue, the Commission has initiated a rulemaking proceeding dealing with rate adjustment mechanisms such as the SIC mechanism proposed by Aqua but has not yet approved final rules. The Public Staff, Aqua, and Utilities, Inc. have jointly filed a motion requesting Commission approval of rules, proposing specific rules for water utilities (as new Rule R7-39) in Exhibit A and for sewer utilities (as new Rule R10-26) in Exhibit B. *See* Joint Motion filed November 8, 2013 in Docket No. W-100, Sub 54, admitted here as Attorney General-Kopas Cross Examination Exhibit Number 1.

With respect to how the rulemaking procedure interacts with the SIC charge proposed by Aqua in this rate case proceeding, Aqua and the Public Staff say the following in paragraph 11.A of their Stipulation:

> The Stipulating Parties acknowledge that the rulemaking establishing the procedures for implementing the Water System Improvement Charge (WSIC) and Sewer System Improvement Charge (SSIC) mechanism is pending before the Commission in Docket No. W-100, Sub 54 (WSIC / SSIC Rulemaking), and the final rules on the WSIC / SSIC mechanism have not yet been approved. The Stipulating Parties agree that approval of the WSIC / SSIC mechanism in this proceeding and the WSIC / SSIC Rulemaking should be coordinated, and, therefore, recommend that this docket be held open, or that the Commission adopt an alternative procedure in this docket, so that the Company can make the requisite filings and, upon receiving approval, implement the system improvement charges under the rules adopted by the Commission without having to make an additional rate filing. The Stipulating Parties' agreement to support holding the record open for the purpose of implementing the WSIC / SSIC mechanism after final rules have been approved is not intended to delay in any way a decision by the Commission on the ratemaking part of this case.

> Further, the Stipulating Parties agree that this docket is the appropriate forum for a decision by the Commission on the Company's request to implement a WSIC / SSIC mechanism based on a finding that the WSIC / SSIC is in the public interest.

Given that Aqua and the Public Staff contend that this docket is the appropriate forum for the Commission to determine whether the proposed SIC charge is in the public interest and their request that the Commission's "approval" of the SIC mechanism "be coordinated" with the rulemaking proceeding so that Aqua can implement the SIC "without having to make an additional rate filing," the Attorney General's Office provides the following arguments regarding the SIC charge. Given that it remains to be seen if the Commission will approve proposed rules and it is unclear what the final version of those rules might provide, the Attorney General's Office reserves the right to brief this issue further if such rules are adopted or if Aqua's SIC Charge proposal changes.

**Legal Background: The Commission Must Determine Whether the Proposed SIC Charge is in the Public Interest.**

Aqua has proposed the SIC charge mechanism pursuant to recently enacted legislation codified at N.C. Gen. Stat. § 62-133.12 that governs rate adjustment mechanisms based on a water utility's reasonable and prudently incurred investment in eligible water and sewer system improvements.

N.C. Gen. Stat. § 62-133.12(c) defines "eligible" improvements for these purposes as meaning only "improvements" that are "found necessary by the Commission to enable the water or sewer utility to provide safe, reliable, and efficient service . . . ." The mechanism must provide for audit and reconciliation procedures including refunds for over-collections, N.C. Gen. Stat § 62-133.12(e),

and it must limit rate increases such that the cumulative charges under the mechanism do not exceed five percent (5%) of the total annual service revenues approved in the utility's last general rate case. N.C. Gen. Stat. 62-133.12(g).

Significantly, the framework under N.C. Gen. Stat. § 62-133.12 also provides that a water utility may only implement such a rate adjustment mechanism if the mechanism is considered "in a general rate proceeding" pursuant to N.C. Gen. Stat. § 62-133, and is specifically found by the Utilities Commission to be in "the public interest." N.C. Gen. Stat. § 62-133.12(a). In other words, the Commission must review and approve of these types of mechanisms on a case-by-case basis. N.C. Gen. Stat. § 62-133.12 does not constitute a blanket authorization of such mechanisms.

**The Proposed SIC Charge is Not in the Public Interest.**

Aqua has proposed the SIC charge at a time when its customers are already struggling with high rates. As discussed in more detail below, approving a mechanism that would allow Aqua to impose expedited automatic rate increases on its customers, with reduced review and scrutiny, is not in the public interest.

Because rate adjustment mechanisms are designed to result in periodic rate increases for consumers with less scrutiny and review than are involved with a rate case proceeding, the Commission should examine requests for approval of such mechanisms carefully, especially in a challenging economy and especially where customers have already been subjected to a number of recent rate increases by the utility.

Aqua is a monopoly provider of water and sewer services and, as such, its rates, services, and operations are affected with the public interest and governed by the regulatory procedures that apply to utilities under Chapter 62. It is a declared public policy goal of the State of North Carolina to promote utility service that is *economical,* as well as adequate and reliable. N.C. Gen. Stat. § 62-2(3) (emphasis added). Our Supreme Court has stated, "[t]he primary purpose of Chapter 62 of the General Statutes is not to guarantee to the stockholders of a public utility constant growth in the value of and in the dividend yield from their investment, but is to assure the public of adequate service at a reasonable charge." *State ex rel. Utilities Comm'n v. General Telephone Co.,* 285 N.C. 671, 680, 208 S.E.2d 681, 687 (1974). Further, the legislative intent of Chapter 62's ratemaking provisions is that the Commission "fix rates as low as may be reasonably consistent with the requirements of the Due Process Clause of the Fourteenth Amendment to the Constitution of the United States, those of the State Constitution, Art. I, § 19, being the same in this respect." *State ex rel. Utils. Comm'n v. Duke Power Co.*, 285 N.C. 377, 388, 206 S.E.2d 269, 276 (1974).

In the absence of other mechanisms, a utility must generally petition the Commission to increase rates and the request is reviewed in a formal rate case. In such a case, the utility submits evidence and testimony that is subject to cross-examination. The ratemaking case occurs in public proceedings, at hearings. G.S. § 62-134. After public notice to the utility's customers and upon investigation and audit of the utility's application, with input from the public and

interested parties allowed at hearings, the Commission considers evidence of the need for the proposed rate increase by applying the formula for fixing rates set forth in N.C. Gen. Stat. § 62-133. At the end of the process, the Commission reviews the evidence and issues a decision.

In general, the traditional ratemaking process is supposed to balance the competing interests of utility investors and utility ratepayers by reviewing *all* elements of a utility's costs before approving a change in rates.

> In a traditional model of ratemaking, regulators establish rates after a review and approval of the utility's total revenue requirement measured during a historical "test year." Rather than attempting to perfectly predict the utility's future costs or to guarantee recovery of any individual cost item, the traditional model acknowledges that over a period of time some costs are likely to increase while others decrease. Through a contemporaneous examination of all costs-including both increases and decreases-regulators can calculate the net change and establish rates at a just and reasonable level.
>
> The traditional model strikes a balance between shareholders' and ratepayers' interests by allowing the utility to present its case for a rate increase while affording ratepayers an opportunity to vet the utility's claim and to identify offsetting cost savings, which regulators can use to mitigate the potential increase…. [In time, if] cost increases and decreases fail to offset each other and the utility collects too much or too little revenue, the utility will file a proceeding to increase its rates, or ratepayers will seek relief by initiating a review of the utility's rates. The traditional model never guarantees full recovery of any given cost-let alone recovery of the full revenue requirement or a profit. Earning the authorized rate of return depends upon the utility's prudent management and efficient operation.

Lino Mendiola, "The Erosion of Traditional Ratemaking Through the Use of Special Rates, Riders, and Other Mechanisms," 10 Tex. Tech. Admin. L.J. 173 (2008) at 173-74 (citations omitted).

In other words, in a rate case, a utility is generally required to "net" all costs and benefits of operation at the time rates are set so as to avoid cherry-picking individual cost increases that may be offset by other cost decreases.

Commentators have opined that adjustment mechanisms that allow the recovery of certain costs without consideration of other costs and factors (sometimes called "single-issue ratemaking") skew "the balance that traditional ratemaking strikes between ratepayers and shareholders." *Id.* at 180 Such mechanisms often fail to take into consideration offsetting cost decreases as well as other offsetting factors and they shift risk from the utility's investors to ratepayers. *Id.* at 180-181. Further,"[t]hrough the use of these mechanisms, regulators …reduc[e] the incentive that utilities have to actively manage costs and to operate efficiently in order to maximize their return." *Id*. at 180.

For these types of reasons, commentators have said "consumers should be concerned about the shift toward utilities collecting more costs outside of the traditional rate structure." AARP Report, Increasing Use of Surcharges on Consumer Utility Bills (May 2012) at p. 1. (See link at: http://www.aarp.org/content/dam/aarp/aarp_foundation/2012-06/increasing-use-of-surcharges-on-consumer-utility-bills-aarp.pdf.) Some commentators have pointed out that when recovery of utility costs is allowed in such circumstances, review of the costs recovered is usually done on a much more limited basis than the review done in a rate case. Also, by allowing a utility to recover costs in such a way, the utility may effectively be guaranteed the recovery of such costs, therefore diminishing the utility's incentive to control expenses. Id. at 3.

Commentators have also raised concerns that such mechanisms violate the "matching principle," a principle of accounting and ratemaking that involves matching revenues with related expenses and investments in the time period they occur. For example, capital investments can produce efficiencies and reduce some costs or enable new revenues. If the cost of the capital expenditure is recovered automatically via a rate adjustment mechanism such as a SIC, accompanying efficiencies and cost reductions that are gained may not be captured – or reduced – via the automatic rate increase to consumers. Id. at 9. In other words, rate adjustment mechanisms have the potential to be a one-way street where the utility is allowed to recover costs but consumers do not receive the benefits of any accompanying savings.

Accordingly, the West Virginia Public Service Commission rejected such a mechanism proposed by WVAWC, a West Virginia water utility, in light of "current economic conditions" and "especially given the relatively high cost of water service" of WVAWC. *Virginia-American Water Company Rule 42T Application to Increase Water Rates and Charges,* WV PSC Case No. 10-0920-W-42T, Commission Order on the Request for Increased Rates and Charges (April 18, 2011) at p. 1, 7. (See link at: http://www.psc.state.wv.us/scripts/WebDocket/ViewDocument.cfm?CaseActivityID=319347&NotType='WebDocket'.) In that matter, the Commission stated that it was "skeptical of what will inevitably be viewed by the public (and probably WVAWC ) as automatic and additional rate increases that the DSIC will visit on WVAWC's customers." *Id.* at 7. The Commission urged the utility to

"conscientiously control costs" during these troubled economic times. *Id*. at 1. The Commission responded to the utility's arguments that it was having difficulty earning its authorized rate of return, stating:

> The opportunity of earning a fair [rate of return] is … not only a function of Commission approved rates, but also is dependent on the skill and efficiency of utility management. Utilities should stop viewing Commission revenue requirement decreases as an anchor, pulling their return on equity (ROE) down, and start viewing those decisions as a budget target that, if met, will buoy their ROE.

*Id.* at 1.

In the matter at hand, Aqua has not demonstrated that the proposed SIC charge mechanism is in the public interest. Aqua's rates are currently high and its customers have already had frequent and large increases over the past 5 years.

For example, in public testimony, David Baxter, an Aqua customer who recently moved from Concord to Charlotte, testified as to the large difference in rates. In Concord, he paid approximately $30 to $35 per month for water and sewer whereas the rates he pays Aqua are much higher: about $100 per month for water and sewer. (Charlotte T p 96) He also testified that the quality of the drinking water supplied by Aqua is so poor that he has to buy his drinking water for from the store. He indicated he would have liked to have known about the high costs and poor quality – as well as the prospect of ongoing rate increases – at the time that he moved, inferring that the information would have affected his decision to move to his new neighborhood. He expressed frustration that Aqua is a monopoly provider, so he does not have a choice about who provides his service. *Id.*

Other consumers raised similar concerns about the high cost of Aqua's service. (Charlotte T p 85, Raleigh T p 90, Wilmington T p 45) Also, other consumers have complained that the quality of service – and the quality of the water being provided - is poor. (Charlotte T p 85, Fayetteville T p 9, Raleigh T p 24)

Aqua's rates are high even though, as the North Carolina Treasurer's Office has pointed out, Aqua has received public loans from the state. (See attached letter from North Carolina Treasurer Janet Cowell to the North Carolina Utilities Commission, dated January 27, 2014.)

Under these circumstances – where Aqua's rates are already high and its customers have been hit with rate increases in recent years - rate increases proposed by Aqua in the future should receive appropriate review and scrutiny, not less.

It is also telling that in this matter Aqua first requested an overall increase of 19.15% or $8,611,429.00 (see Application Appendix 1 p 15). Later, via the partial stipulation with the Public Staff, it reduced its request to an overall increase of 5.2% or $2,457,041.00, roughly 29% of the initial request. See Stipulation at 5.

Likewise, in the prior general rate case for Aqua, it first sought an overall rate increase of 19.2% or $8,305,012. (*See* Application filed January 21, 2011 *In the Matter of application for Adjustment of Rates and Charges by Aqua North Carolina, Inc. for all its North Carolina Systems* at p.3.) Later, the Commission

allowed a much reduced overall rate increase of $2,272,770. (*See* Notice of Decision and Order issued September 13, 2011, at p. 18 (rates effective on issuance). The fact that Aqua has a history of requesting rate increases that are later reduced also shows that future rate increase requests by Aqua deserve appropriate review and scrutiny, as opposed to less.

As noted above, the time for review under the SIC mechanism is only 45 days, much less than the review that takes place in a typical rate case. According to the Public Staff's comments about the 45 day review process as envisioned in the proposed rules, the 45-day time frame will be "workable" because the utilities are required to provide detailed information in their "three year plan" at the time that a SIC mechanism is proposed (as part of a general rate application), and must also file information at that time about proposed rate increases and adjustments, and testimony and other evidence demonstrating that the mechanism is in the public interest. See paragraph 14 of the Joint Motion on p 4 and paragraph (c) of the proposed rules.

However, Aqua has not complied with the detailed filing requirements envisioned in the proposed regulations. David Furr, Director of the Public Staff Water & Sewer Division, testified that he reviewed Aqua's three year improvement plans for water and sewer that were filed as Appendix A in Aqua's pre-filed testimony in this rate case "in order to formulate the Public Staff's preliminary evaluations whether the listed projects were eligible … projects as defined in G.S. 62-133.12(c) and (d)." (T 3 pp 75-76) Even after additional information was sought in discovery requests, and Aqua's responses were

reviewed, however, "the detail provided for many of the proposed projects is still materially inadequate to permit an evaluation to determine whether the Public Staff considers the planned projects to be … eligible." Id. As a result, Mr. Furr stated that the Public Staff would request more detailed descriptions of all improvement projects expected to be completed in the initial period subsequent to the rate case hearing. (T 3 p 76) In other words, the detailed information needed to expedite review of the proposed projects *was not* provided by Aqua in order to obtain approval of the SIC mechanism as envisioned in the proposed regulations. This undermines the notion that the abbreviated 45 day review is workable.

As noted above, rate adjustment mechanisms pose concerns for consumers. These concerns are, if anything, more acute here given the fact that Aqua already has high rates. The proposed SIC charge mechanism will allow rate increases to be approved based on "single issue" type ratemaking that fails to consider other factors that tend to offset the need for an increase. By contrast, traditional ratemaking is not skewed by the focus on specific cost items; rather as stated earlier, "[t]hrough a contemporaneous examination of all costs – including both increases and decreases – regulators can calculate the *net* change and establish rates at a just and reasonable level." 10 Tex. Tech. Admin. L.J. at 173. In fact, it is likely that to the extent system improvements are prioritized efficiently, there will be operating cost savings that result from the improvements. For instance, when a length of leaky water distribution line is replaced, less water is pumped and wasted, and less emergency calls will occur. However, such

reduced operating costs will not be reflected in rates as an offset to the investment in the water line until another general rate case occurs.

Likewise, the proposed SIC mechanism has the potential to improperly distort Aqua's business or investment decisions. The special treatment of certain costs may discourage investments in projects that are efficient and economical but not eligible for the favorable accelerated rate recovery. Thus, the new mechanism can have the unintended result of distorting business decisions.

Furthermore, the SIC mechanism will transfer business risk from investors to ratepayers by providing for frequent increases to the utility's "budget" and by adjusting the SIC charge for the "experience modification factor" rather than setting a budget through a general rate case and then letting the utility's investors assume the risks and benefits of investments and efficient operations.

Aqua's justifications for the SIC mechanism lack merit. As a utility that has received a monopoly from the state, it is Aqua's duty to provide appropriate water quality at a reasonable price for consumers. While it may be true that Aqua needs to make improvements to its systems to improve service and water quality, this does not, in and of itself, demonstrate that it is in the public interest for the Commission to approve a new SIC charge that will result in periodic rate increases for Aqua consumers. All eligible and appropriate system improvements by Aqua are potentially recoverable under traditional ratemaking provisions. (T 1 p 134)

Aqua indicates, vaguely, that the SIC mechanism may postpone the need for a rate case but makes no binding promises or obligations in that regard. (T 1

p 86) In any event, the advantage of postponing a general rate case is illusory for customers if their rates increase anyway in an expedited fashion, and with less oversight.

In sum, pursuant to the proposed SIC charge mechanism, the following, among other things, will occur:

- rate increases will occur more frequently;
- the review process will be shortened, amounting to less review and scrutiny;
- the process will not include customer notice and opportunity to participate in hearings;
- rates will increase based on "single issue" type ratemaking without consideration of other factors that offset the need for an increase;
- the incentive to invest in eligible projects may distort business decisions; and
- the mechanism will transfer normal business risk from investors to ratepayers.

Aqua has not shown that the proposed SIC charge is in the public interest. Therefore, the Commission should not approve Aqua's proposal.

## II. THE COMMISSION SHOULD NOT ADOPT THE RATE OF RETURN PROPOSED IN THE STIPULATION BETWEEN AQUA AND THE PUBLIC STAFF.

The rate of return proposed in the stipulation should not be adopted by the Commission. First, there is insufficient evidence in the record and the Company has failed to meet its burden of proof regarding the statutorily required factors for ROE, specifically the factor that pertains to impact on consumers. Therefore, the Commission cannot establish that the 9.75% ROE is reasonable pursuant to N.C. Gen. Stat. § 62-133. The expert testimony presented to the Commission regarding ROE addresses impact on consumers only, at most, as an afterthought and there is no basis for the Commission to make sufficient findings and conclusions regarding ROE.

Second, if the Commission attempts to establish ROE, notwithstanding the lack of legally sufficient evidence in the record, the Commission should establish a lower ROE, as opposed to the ROE set forth in the stipulation between Aqua and the Public Staff. Even the evidence in the record focusing on shareholder impact and Aqua's ability to attract capital shows that the stipulated 9.75% ROE is excessive. The Commission could better protect consumers by establishing a lower ROE.

A. **There is insufficient evidence in the record to support the ROE proposed in the stipulation by Aqua and the Public Staff.**

When rates are fixed for regulated utilities like Aqua under Chapter 62, "[t]he burden of proof is upon the utility seeking a rate increase to show that the proposed rates are just and reasonable." N.C. Gen. Stat. § 62-75; *State ex rel. Utilities Comm'n v. Central Tel. Co.*, 60 N.C. App. 393, 394, 299 S.E.2d 264, 265 (1983). N.C. Gen. Stat. § 62-133(a) emphasizes that fairness to consumers is a critical consideration and includes a directive that "the Commission shall fix such rates as shall be fair both to the public utilities ***and to the consumer***." N.C. Gen. Stat. § 62-133(a) (emphasis added). N.C. Gen. Stat. § 62-133(b)(4) provides details with respect to establishing the rate of return that a public utility is authorized to earn on its rate base. In making this determination, the Commission is required to:

> Fix such rate of return on the cost of the property ascertained pursuant to subdivision (1) of this subsection as will enable the public utility by sound management to produce a fair return for its shareholders, ***considering changing economic conditions*** and other factors, including, but not limited to, the inclusion of construction work in progress in the utility's property under sub-subdivision b. of subdivision (1) of this subsection, as they then exist, to maintain its facilities and services in accordance with the reasonable requirements of its customers in the territory covered by its franchise, and to compete in the market for capital funds on terms that are reasonable and that are ***fair to its customers*** and to its existing investors.

N.C. Gen. Stat. § 62-133(b)(4) (emphasis added).

Recently, the North Carolina Supreme Court provided guidance for how a utility's ROE needs to be established, taking into account consumer interests, when it held that "in retail electric service rate cases the Commission must make

findings of fact regarding the impact of changing economic conditions on customers when determining the proper ROE for a public utility." *State ex rel. Utilities Comm'n v. Cooper*, 366 N.C. 484, 739 S.E.2d 541, 548 (2013) ("*Cooper*"). Our Supreme Court emphasized that "customer interests cannot be measured only indirectly or treated as mere afterthoughts and that Chapter 62's ROE provisions cannot be read in isolation as only protecting public utilities and their shareholders" *Id.* The same provisions in Chapter 62 also apply to ratemaking determinations for regulated water and sewer utilities and the guidance explained in *Cooper* is instructive in this general rate case.

In *Cooper*, our Supreme Court noted that N.C. Gen. Stat. § 62-133's emphasis on fairness to consumers is a "critical consideration" in rate cases. The Supreme Court confirmed that Chapter 62 is "a single integrated plan" and that its provisions must be construed together so as to accomplish its primary purpose of fixing rates that are fair both to the utility and the consumer. Accordingly, the Court stated that "Chapter 62's ROE provisions cannot be read in isolation as only protecting public utilities and their shareholders. Instead, it is clear that the Commission must take customer interests into account when making an ROE determination." *Id.*

The legislative intent of the rate-setting provisions contained in Chapter 62 is that the Commission "fix rates as low as may be reasonably consistent with the requirements of the Due Process Clause of the Fourteenth Amendment to the Constitution of the United States, those of the State Constitution, Art. I, § 19,

being the same in this respect." *State ex rel. Utils. Comm'n v. Duke Power Co.*, 285 N.C. 377, 388, 206 S.E.2d 269, 276 (1974) ("*Duke Power II*").

Aqua's evidence in this rate case regarding customer impact was not significantly or meaningfully different from the evidence that Duke presented in the rate case that was reversed and remanded in *Cooper*. A review of the transcript and evidence shows that, while Aqua presented extensive evidence with respect to many of the factors listed in § 62-133(b)(4) relating to shareholder impact and Aqua's purported ability to attract capital, it failed to present adequate evidence addressing customer interests and the impact of changing economic conditions on customers. Thus, Aqua failed to meet its burden of proof showing that the stipulated ROE is fair and reasonable to both customers and Aqua's shareholder holding company.

Aqua presented the expert testimony of Pauline M. Ahern, who recommended an ROE based on economic models and provided analysis regarding Aqua's ability to raise capital, viewed from the perspective of investors. Ahern was the only witness who testified as to ROE. In her direct testimony, Ahern recommended an ROE of 11.5 % based on her assessment of "market-based common equity cost rates of companies of relatively similar … risk" (i.e, a proxy group) adjusted for unique financial and business risks she asserted apply to Aqua. (T2 pp 90-91) She concluded that an equity cost rate of 10.6% is indicated based on results of several models applied to the proxy group, and adjusted the rate upward based on her assessment of Aqua North Carolina's greater business risk and the effect of flotation costs. (T2 p 92) In her rebuttal

testimony, Ahern updated her estimate of the ROE, and found it had declined from 11.5% at the time of her initial testimony down to 10.6% (including adjustment for the same factors particular to Aqua). She accepted the 9.75% ROE agreed to by Aqua in the Stipulation with the Public Staff although it is considerably lower than her estimate of what investors require. (T2 p 164-65)

A review of Ahern's testimony demonstrates that she failed to adequately consider or factor in the impact of economic conditions on customers when establishing her ROE recommendation. In her direct testimony she failed to consider the economic conditions affecting customers *at all*. Instead she evaluated economic factors only from the perspective of investors. In her supplemental testimony provided following the Stipulation, Ahern reviewed and updated information provided in testimony that was prepared by experts who testified regarding general macroeconomic conditions last fall in a rate case for Piedmont Natural Gas. (T2 pp 173-79) She agreed with Piedmont's experts that the economy is improving in North Carolina and nationally. (T2 p 173) Her updates indicated some worsening factors since Piedmont's testimony was prepared. (T2 pp 174-77) She testified that unemployment is still at 7.4% in North Carolina, higher than in the nation as a whole, (T p 174) and that the economy has been troubled since the "Great Recession" of 2008-2009. (T 2 pp 168-169)

Ahern's ROE testimony in this regard is flawed and inadequate. First, she did not factor in customer impact in her models or recommendations in any meaningful way. (T2 pp 112-141) Describing how she used models to estimate

ROE, she testified, "it is important to use market-based models because the cost of common equity is a function of investors' perception of risk, which is embodied in the market prices they pay." (T 2 p 112) In other words, she limited her assessment to the effect on investors.

Second, the fact that she did not mention the economic conditions affecting customers *at all* in her initial testimony, indicates that the general macroeconomic information she provided later was included, at most, as an afterthought or indirectly. In fact, she did not provide any details in her supplemental testimony about how she updated her calculations or estimates in any fashion. (T2 pp 164-65)

In sum, Ahern's ROE analysis and recommendations were flawed and did not adequately take customer interests and impact into account and do not provide a proper basis for the Commission to make appropriate findings and conclusions regarding ROE.[1]

Given the Supreme Court's recent holding emphasizing that it is not enough to merely consider customer impact in an "indirect" fashion, the expert testimony in this matter does not provide the Commission with a sufficient basis to make an ROE determination. Thus, the record is insufficient to allow the

[1] Ahern's recommendations for two upward adjustments to Aqua's ROE – one based on size and the other based on flotation costs should be rejected as well. Ms. Ahern's testimony about the small size of Aqua North Carolina relative to the other companies in her proxy group ignores that Aqua is a subsidiary of Aqua America. As to the effect of flotation costs on the ROE, our Supreme Court explained the problem with making an adjustment in ROE for such possible costs in *State ex rel. Utilities Comm'n v. Public Staff*, 331 N.C. 215, 218-222, 415 S.E.2d 354, 357-359 (1992).

Commission to render a decision regarding a rate of return that is fair to both customers and investors.

Therefore, the Commission should deny Aqua's request for a rate increase and reject the Stipulation. Without proper evidence in the record, the Commission is unable to render the requisite findings with respect to a fair and reasonable rate of return. As Aqua has failed to meet its burden of showing the proposed rates are just and reasonable, Aqua is not entitled to a rate increase.

**B. Alternatively, if the Commission attempts to establish an ROE notwithstanding the lack of sufficient evidence in the record regarding customer impact, it should find that the 9.75% ROE contained in the stipulation is excessive and establish a lower ROE in order to better protect consumers.**

If the Commission attempts to make an ROE determination notwithstanding the lack of sufficient evidence in the record regarding consumer impact, then it should reject the 9.75% ROE proposed in the Stipulation. Even the weight of evidence in the record that focuses on shareholder impact shows that a 9.75% ROE is excessive.

The Commission must engage in an independent analysis of the evidence and reach its own conclusion when it fixes a utility's ROE. *Cooper*, 366 N.C. 484, 739 S.E.2d at 547. The Commission cannot simply rely on the ROE percentage proposed in a non-unanimous stipulation. *Id*.

Furthermore, the Commission may not rely on inappropriate considerations as justifications for an excessive ROE, such as arguments that 1) a higher ROE is justified because higher ROEs were adopted in other recent North Carolina cases; and 2) a higher ROE is justified because higher ROEs are

authorized in other states. Such considerations are not valid under North Carolina law. In *State ex rel. Utilities Comm'n. v. Public Staff*, 331 N.C. 215, 415 S.E.2d 354 (1992) ("*Public Staff*"), the Commission, when it determined the ROE for Duke Power, examined the ROE the Commission had allowed AT&T in another case and ROEs that five other utility commissions had allowed in other states. The Court found that such considerations and the Commission's concern about reducing ROE a large amount, as opposed to a gradual amount, amounted to "an improper consideration in determining rate of return" because such considerations appeared to "arise from the Commission's inappropriate desire 'to protect investors from swings in market prices.'" *Public Staff*, 331 N.C. at 225, 415 S.E.2d at 361 (citations omitted). Accordingly, the Court reversed the Commission's order. *Id*. at 226, 415 S.E.2d at 362.

Aqua and the Public Staff proposed an ROE of 9.75% in this case as part of a non-unanimous settlement of all issues in the case. In support of the stipulated ROE, Ahern testified that, although the settlement ROE is well below her recommended ROE, she supports it as a fair and reasonable ROE for several reasons including that it is in line with the ROEs authorized for other water utilities in 2013 and less than what was authorized recently for Duke and Piedmont in North Carolina. (T2 pp 165-66) She indicated that Aqua is willing to forego what models say investors require in order to recognize the impact on customers. (T2 p 189) She continued to posit, however, that 10.6% is the ROE calculated based on her assessment of current market conditions reflecting adjustments for Aqua North Carolina. (T2 p 188)

However, on closer inspection, the evidence in Ahern's testimony and exhibits on direct and through cross examination support the determination that a 9.75% ROE exceeds what is sufficient to attract and keep investors given current market conditions, even when viewed only from the perspective of investors.

Ahern performed a Discounted Cash Flow (DCF) analysis for nine comparable water utilities prior to filing her initial testimony, and the average ROE indicated for the proxy group was 8.98%. (T2 p 193) The median ROE indicated for the proxy group was 7.98%. (T2 p 193) Those results are materially lower than the stipulated ROE of 9.75%. Furthermore, the DCF analysis results were calculated in preparation for Ahern's initial testimony, and her updated assessment closer to the hearing produced a significantly lower ROE recommendation, indicating that market conditions would produce a lower DCF result, not a higher one. (T 2 pp 160, 188)

Ahern expressed doubts about using the DCF method to estimate the ROE that is sufficient for investors, and relied on other methods that produced higher results, but she also testified that the DCF method is relied on by investors. (T 2 pp 114, 220) Further, she testified that the DCF method is the method that is most often relied on by regulatory agencies when they estimate a utility's ROE. (T 2 p 122)

The actual earnings for the companies in Aqua's proxy group also indicate that an ROE of 9.75% is excessive. Ahern compared the actual financial data for the proxy group and, "as shown [on page 2 of PMA-5], during the five-year period ending 2012, the historically achieved average earnings rate on book common

equity for the group averaged 8.74%. (T2 p 112) These actual earnings based on book value, rather than stock market price, measure the utility's return similarly to the way ROE is measured for purposes of ratemaking. *See* N.C. Gen. Stat. § 62-133(b). Ahern commented that the lower actual returns reported by utilities reflect their inability to earn up to the returns that have been authorized by state regulators. (T2 p 191)

Yet, though the actual earnings for water companies have been below the returns authorized by regulators, that has not dampened the attractiveness of water companies for investors. To the contrary water utility stocks have continued to trade in the stock market at stock prices that are well above the book value of their assets. Ahern concedes that the stock prices for water utilities in the proxy group trade in the market at share prices "in the low 200s" or over 2 times their book value. (T p 191) According to Ahern Schedule 11, the average market to book value for the utilities in her proxy group was 199.4 (about 200%) at the time the schedule was prepared. Ahern testified at the hearing that the value was in the low 200s at the time of the hearing. (T2 pp 199-200)

According to "Investopedia," a source familiar to Ahern, when a company is trading for *less than* its book value, it normally means that investors either believe the asset value is overstated or the company is earning a very poor return on its assets. (T p 217) *And significantly here*, when a company has a high price to book value, it is likely to be one that has been earning a very high return on its assets. (See T2 p 217)

Ahern testified as follows: Utility stocks have a number of appeals for investors. (T2 pp 204-05) The steady dividend yield is attractive. The industry is very stable. It is mature. It has been regulated a long time, and it is in everyone's interest for utilities to remain healthy. These are qualities that Ahern indicated are her take on what a Wall Street article means by a saying that a company is "highly defensive." (T2 pp 204-05) The article (introduced as Attorney General Ahern Cross Examination Exhibit No. 3) labeled Aqua America and another water utility "The Two Best Water Stocks for 2014." (T p 202)

Aqua America, Aqua North Carolina's parent, is not less attractive than other utilities included in Ahern's proxy group. In fact, Aqua America's market to book value is 316.5 (compared to 200 for the proxy group) or about 300% when stock price is compared to its book value. (T p 201)

In sum, even the evidence provided by the Company's economic expert in direct and cross examination testimony and exhibits indicates that the 9.75% ROE proposed in the Stipulation is excessive, even from a standpoint that focuses on Aqua's investors and its ability to attract capital. Accordingly, the ROE of 9.75% proposed in the Stipulation is excessive. If the Commission chooses to adopt an ROE, notwithstanding the lack of appropriate evidence in the record, it should adopt a lower ROE in order to protect consumers.

## CONCLUSION

For the reasons stated above, Aqua's proposed SIC charge is not in the public interest.

Further, there is insufficient evidence in the record to allow the Commission to establish a reasonable ROE because there is insufficient ROE evidence in the record regarding customer interests and the impact of changing economic conditions on consumers. If, notwithstanding the lack of sufficient evidence in the record, the Commission attempts to make an ROE determination, the Commission should establish a lower ROE that better protects consumers because even the evidence that focuses on shareholder impact and Aqua's ability to attract capital shows that an ROE of 9.75% is excessive.

Respectfully submitted, this the 5th day of March, 2014.

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## CERTIFICATE OF SERVICE

The undersigned certifies that she has served a copy of the foregoing ATTORNEY GENERAL'S BRIEF upon the parties of record in this proceeding and their attorneys by electronic mail.

This the 5th day of March, 2014.

/s/ Margaret A. Force
Margaret A. Force
Assistant Attorney General

Mount, Gail





**From:** Robin Hammond [Robin.Hammond@nctreasurer.com]
**Sent:** Monday, January 27, 2014 5:35 PM
**To:** Statements
**Cc:** Andrew Holton; Vance Holloman
**Subject:** Statement of Position - UC Docket No. W-218, SUB 363
**Attachments:** aqua letter_final.pdf

Please accept the attached letter from Treasurer Janet Cowell providing comments on the referenced matter.

Thanks.

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NORTH CAROLINA

OFFICE OF THE TREASURER

JANET COWELL, TREASURER

January 27, 2014

Mr. Edward S. Finley, Jr., Chairman
North Carolina Utilities Commission
4325 Mail Service Center
Raleigh, NC 27699-4325

RE: UC Docket No. W-218, SUB 363

Dear Chairman Finley:

Recent media reports indicate that Aqua NC, Inc. ("Aqua") has requested the Utilities Commission ("Commission") to approve a rate adjustment mechanism pursuant to S.L. 2013-106, Section 2. This request is being considered along with a request for a 19% rate increase on all of Aqua's North Carolina customers. The proposed rate increase mechanism provides for rate increases up to five percent (5%) without a public hearing upon a finding by the Commission that the mechanism is in the public interest. Public comment hearings on the 19% rate increase and the 5% rate increase mechanism have begun. An evidentiary hearing is scheduled for January 27, 2014. These requests have generated much negative reaction from Aqua's customers.

Due to a 2012 change in law, Aqua, as an investor-owned drinking water corporation, is eligible to receive loans and grants from the Drinking Water State Revolving Fund of the North Carolina Department of Environment and Natural Resources ("SRF") under the provisions of GS 159G-31. SRF loan applications must be approved by the Local Government Commission which I chair as State Treasurer. On two recent occasions, Aqua has benefitted from the low financing rates available on SRF loans of public funds. Many local governments and public authorities have benefitted from SRF loans as well. However, it is important to remember that the governing boards of local governments and public authorities are elected by the citizens they serve, or in some cases appointed by boards who are

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elected by the citizens they serve. Therefore, the citizens have a voice in the rate setting process through their elected officials.

The governing board of an investor-owned corporation such as Aqua is chosen by shareholders. Public hearings are the only way citizens have a direct voice in the rate setting process of an investor-owned corporation. While I appreciate and respect the role of the Commission's Public Staff in rate proceedings, I think it is important to require public hearings before additional rate increases are approved. It is particularly important in a case such as this where, already, there has been access to inexpensive public financing and much consternation generated by simultaneous rate increases.

I ask that you continue the requirement for a public hearing on rate increases by investor-owned corporations to ensure that citizens are heard. If these corporations are eligible to receive low cost loans of public funds, it is only fair that this requirement remain in place.

Sincerely,

Janet Cowell

Janet Cowell