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INDIANA UTILITY
REGULATORY COMMISSION

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

APPLICATION OF AMERICAN SUBURBAN UTILITIES, INC., FOR AUTHORITY TO INCREASE RATES AND CHARGES THROUGH THE SMALL UTILITY PROCEDURE PURSUANT TO IND. CODE § 8-1-2-61.5 AND 170 IAC 14-1-1 ET SEQ.	)))))))	**CAUSE NO. 45649-U**

REPLY TO OUCC'S PROPOSED ORDER

The Office of Utility Consumer Counselor's ("OUCC") proposed order is *122 pages* long. Not only that, the OUCC proposes this Commission issue an order *confidentially,* something counsel for American Suburban Utilities, Inc. ("ASU") doubts this Commission even possesses the statutory authority to do. Through the end, the OUCC has turned this into an unnecessarily long and complex proceeding.

The bulk of the OUCC's order is the double recitation of facts, most of which are unnecessary to support any of its findings.[1] Further, the OUCC's proposed order distorts and misstates the record, makes unfounded and illogical conclusions, incorrectly and/or incompletely cites many legal authorities, and otherwise fails to comply with the standard for Commission decisions. While the OUCC's proposed order recites points from the OUCC's testimony, the proposal largely evades the law and relevant testimony from ASU. Many of the OUCC's proposed order findings on key issues lack analytical and evidentiary support. A large number of

[1] *See* IURC GAO 202-05 II. E. "Proposed orders shall: 1) Provide facts used to support the findings and cite those facts, providing the exhibit name/designation and page number; 2) Limit the recitation of facts to those that are the substantive evidence upon which the findings that support the ultimate conclusion(s) are based; 3) Not include any new evidence or arguments not supported by the evidence in the record; and 4) Not include settlement agreements entered into after the record is closed."

inaccuracies will be discussed below (although the list is not exhaustive). Unlike the OUCC, the Commission must weigh the totality of the probative evidence, including the substantial evidence refuting the OUCC's contentions: "[W]e, as an administrative agency, are not free to simply ignore undisputed evidence."[2] As such, the Commission should promptly issue an order along the lines filed by ASU on September 30, 2022.

I. The OUCC has been openly hostile towards ASU and the small utility process.

ASU has stated many times that it approached this case amicably with the intent to settle; this is why the small utility process was chosen. The OUCC has in the past advocated for small utility filings as a way of controlling rate case expense.[3] The Commission detailed its policy regarding small utility filings in *Switzco*, finding:

> While we acknowledge Petitioner's position that a fully litigated proceeding was necessitated because of the number and type of issues the OUCC raised, it is not apparent to us that the issues in this Cause merited the controversy they yielded in this litigated proceeding. We encourage Switzco (and other small utilities) to consider the Small U process in the future.
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> Further, the rules governing the Small U process are designed to foster collaboration by relaxing ex parte standards. Potentially, only if an impasse is reached, will extensive professional services be needed. Although the Commission will not require Switzco to use this process, it is important Switzco and its Board of Directors understand that the Small U process, unlike this proceeding, enables our staff and the OUCC to work directly with small utilities. This process is designed specifically to help small utilities avoid costly regulatory proceedings, The Small U process encourages, we believe, more amicable dialogue and information exchange than seems to have occurred in this Cause.

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[2] *Indiana Mich. Power Co.,* Cause No. 39314; 1993 WL 602559 (IURC Nov. 12, 1994) at *4.
[3] *See* IURC Cause No. 45117 the verified direct testimony of Edward T. Rutter.

Petition of Switzerland County Natural Gas Company, Inc. Cause No. 45117, at 17-18, (IURC April 17, 2019).

Collaboration is a two way street and depends upon the OUCC as a willing participant. As the Commission went on to say in *Switzco*: "[p]arties may certainly disagree, but we encourage handling small utility rate cases with greater communication and collegiality, mindful of the relatively small number of ratepayers who bear the impact of doing otherwise."[4] The OUCC's unreasonable positions and hostile regulatory environment, which are on full display in the proposed order, belie collaboration and should give any small utility great pause before choosing the small utility filing process.

When the OUCC filed its case-in-chief, it became clear to ASU that the OUCC was not interested in collaboration but, in fact, was preparing for open hostility and lengthy litigation. As the evidence of record reflects, during the course of this case, none of the OUCC witnesses visited ASU's offices, service area or treatment facilities. In lieu of site visits, where informal discussion and collaboration could be accomplished, the OUCC conducted the entirety of their inquiries to ASU through formal written discovery sent from OUCC attorneys to ASU attorneys. The record reveals at least 24 sets of written discovery.[5]

The OUCC's lack of site visits is one example of how its approach is contrary to the Commission's instructions for collaboration. The OUCC recommended disallowance of a "fishing boat" and came to this conclusion after conducting written discovery. The more collaborative approach would have been a site visit where discussion could be had about why ASU needed a small $801 boat as part of its maintenance operations. The OUCC could have seen first-hand how

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[4] *Id*. at 19.
[5] *See* OUCC Exhibit CX-31.

the boat is used. Apparently ASU missed this issue in putting its rebuttal case together, but the amount is immaterial. The point is that customers of small utilities should not bear the cost of preparing rebuttal testimony on even small issues where misunderstandings could have been avoided in the first instance through collaboration. Another example is office rent. Even though the OUCC did not even visit the office to understand the operations and working conditions of ASU's office and its staff, the OUCC disallowed the majority of ASU's office rent. The OUCC's witnesses conducted their investigation and reached their opinions through formal written discovery while remaining at their desks in Indianapolis. The OUCC's choice of formal written discovery as opposed to informal collaboration led them to many misconceptions and erroneous conclusions. While ASU understands that the OUCC found it difficult (if not impossible) to understand the complete operations of ASU by simply reading written words, ASU does not believe that it should be punished or given a greater burden of proof because of the OUCC's choice to not avail themselves of all possible avenues of discovery and collaboration. The findings and conclusions within the OUCC's proposed order appear to shift the burden of going forward to ASU on many issues in which the OUCC stated that they did not have adequate support or evidence. Much of that support ("explanations"/"evidence") could have been accomplished and provided through the informal collaborative effort that the Commission envisioned with the establishment of the small utility filing procedures. The OUCC is requesting the Commission to create greater burdens for petitioners in small utility filings because of the OUCC's choice of a single approach to discovery - written formal discovery passed from attorney to attorney.

Before getting to the issues that ASU raised in its initial brief and to some of the other unreasonable positions taken by the OUCC, a word must be dedicated to return on equity. There is a range of reasonableness for the return on equity, and ASU trusts the Commission to find the appropriate point on that spectrum. ASU would note that recent Commission orders for Duke Energy Indiana,[6] Indiana Michigan Power Company,[7] and CenterPoint Indiana South[8] had findings of 9.7%; CenterPoint Indiana North at 9.8%[9]; and Northern Indiana Public Service Company at 9.85%.[10] This history reveals returns on equity are trending up, which is not surprising with market trends.

More importantly, ASU is plainly riskier than these other utilities.[11] Compared to these energy utilities, ASU operates in a regulatory environment created by the OUCC which is openly hostile. Consider the facts. In 2000, ASU's residential rate was $47 per month. In the ensuing 22 years, ASU has built *two* new treatment plants and installed millions of dollars of interceptor lines. Its net original cost rate base has increased more than six times, from less than $3,500,000[12] to $21,355,002.[13] Even with this growth, ASU remains a small utility, by statute. Yet ASU's residential rate today is only $58.23.[14] ASU would daresay that its rate today is among the lowest in the state, especially if compared to similarly sized utilities. *And the OUCC wants to lower it.* The OUCC can only reach this result by advocating positions that are unmoored to facts or law, as will be explained further herein. The prospects of settlement in such an environment are nonexistent, and so every case must be fully litigated. ASU cannot even file a small utility filing without the OUCC turning it into full-blown contention. ASU can only speculate as to the OUCC's ultimate aim, but this behavior is consistent with a desire to drive ASU to financial failure.

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[6] *Duke Energy Indiana, LLC,* Cause No. 45253 (IURC 6/29/2020), at 59.
[7] *Indiana Michigan Power Co.,* Cause, No. 45576 (IURC 2/23/2022), at 23.
[8] *Southern Ind. Gas & Elec. Co.,* Cause No. 45447 (IURC 10/16/2021). at 16.
[9] *Indiana Gas Co.,* Cause No. 45468 (IURC 11/17/2021), at 15.
[10] *Northern Ind. Pub. Serv. Co.,* Cause No. 45621 (IURC 7/27/2022), at 20.
[11] ASU's PO at 6, 16.
[12] *American Suburban Utils.,* Cause No 41254 (IURC 4/14/1999), at 17-19.
[13] Cause No. 45649-U ASU's PO at 13.
[14] TD 50542 (IURC June 28, 2022).

Whatever the OUCC's motive, it is not consistent with protecting the long-term best interests of ASU's customers which the OUCC is charged to represent.

As noted, ASU trusts the Commission to find the appropriate place on the ROE spectrum and ultimately reach reasonable results in this case. Whatever result that may be, a message needs to be sent: This hostile environment created by the OUCC must stop. A utility the size of ASU needs to operate in a regulatory environment where it can work cooperatively with the consumer advocate to achieve balanced results that are in the long term best interests of both ASU and ASU's customers.

II. The OUCC continues to take unsupported and illogical positions regarding ASU's capital structure, wages and benefits, equipment ownership, and the plain language of Cause No. 44272 (the "Preapproval Case").

In ASU's Brief in Support of Proposed Order, ASU identified four issues making up most of the chasm between the OUCC and ASU and noted that the OUCC could cite no authority for any of its positions. While the OUCC's proposed order includes citations to orders and cases, they do not support the OUCC's positions. In short, the statement in ASU's brief remains true. When these four issues are discarded as they should be, the differences in this case become manageable.

A. <u>Hypothetical Capital Structure</u>. The OUCC's proposed order begins with an "Explanation of a 'Hypothetical Capital Structure' Generally".[15] However, the OUCC does not cite any Indiana authorities for its "explanation" when there are plenty explaining what a hypothetical capital structure is and why it is prohibited.[16] In its zeal, the OUCC actually goes so far as to suggest that *Public Serv. Comm'n of Ind. v. Indiana Bell Tel. Co.,* 235 Ind. 1, 130 N.E.2d

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[15] OUCC's PO at 51.
[16] *See, e.g.,* ASU's PO at 14-15.

467 (1955) is a tax case and not a hypothetical capital structure case.[17] The OUCC is, to put it mildly, wrong. "We find no substantial evidence which might be properly considered to establish that a rate of income of 5.84% on a fair value of $94,792,091 is sufficient to attract new capital to *appellee*." *Indiana Bell*, 235 Ind. 1, 26, 130 N.E.2d 467, 479 (1955) (emphasis in original). This Commission has previously and correctly recognized that *Indiana Bell* stands for both propositions that hypothetical capital structures and imputed hypothetical tax savings therefrom are impermissible:

> Hypothetical capital structures such as those proposed here by the OUCC and IG have long been held to be contrary to Indiana law. In *Pub. Service Comm'n of Ind. v. Ind. Bell Tel. Co.*, 235 Ind. 1, 130 N.E.2d 467 (Ind. 1955) ("*Indiana Bell*"), the Indiana Supreme Court reviewed a rate order for a telephone utility (Indiana Bell) which had a 100% equity capital structure but was a subsidiary of a holding company (AT&T) that had a 50% equity and 50% debt capital structure. *In the case below, the Commission reduced the utility's rate of return to reflect the parent company's cost of capital and imputed to the Indiana utility tax savings that would exist if its capital structure were two-third equity and one-third debt*. 235 Ind. at 29, 130 N.E.2d at 480. The Indiana Supreme Court held the Commission's order *was unlawful* *in both respects*. Using the parent company's capital raising ability as a measure of a reasonable return was improper because Indiana Bell was "an Indiana corporation having its own separate identity even though a part of the general Bell System." 235 Ind. at 26, 130 N.E.2d at 479. The Court explained:
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>> Appellee is an Indiana corporation, a separate and distinct utility as defined by statute and it is the duty of the Commission to establish for it a schedule of rates which will produce a fair and non-confiscatory return upon its used and useful intrastate property, whether its stockholders are one or many, and without regard to its relationship to other companies.

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[17] "The Court of Appeals [sic] found that the Commission's determination was arbitrary and assumed a saving under a capital structure which did not exist. The capital structure was not discussed as a means of determining a fair return but instead the case was about what was *actually paid* in taxes." OUCC's PO at 52-53 (emphasis in original, citation omitted).

> The fact that appellee has not used its own credit with which to raise additional capital is immaterial, and its ability to do so cannot be measured by the yardstick of the ability of the parent company to raise additional capital. The intrastate properties and operations of appellee are the ones to be considered in fixing a fair rate of return upon its used and useful property and not those of the entire Bell System.
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> The acts of appellants in considering the cost of money to the parent company, A.T. & T., and the "entire Bell System" rather than considering only the properties and operations of appellee is in violation of [Ind. Code § 8-1-2-6] and is unlawful.

235 Ind. at 28-29, 130 N.E.2d at 480. Similarly, the Court held the imputed tax savings adjustment was arbitrary and unlawful because it assumed "a tax saving under a capital structure which did not exist." 235 Ind. at 29-30, 130 N.E.2d at 480.

Northern Ind. Pub. Serv. Co., Cause No. 43526 (IURC 8/5/2010), pp. 18-19 (emphasis added).

After flippantly casting aside nearly 70 years of bedrock Indiana ratemaking law, the OUCC then moves outside the state in search of authority to serve its narrative. The OUCC has now introduced a new theory not espoused by its witness -- double-leverage -- in order to support its position. It cites Iowa as allegedly being one of "several" states as well as a 1974 Public Utilities Fortnightly article[18] in so doing.[19]

The OUCC should have first looked to Indiana, which has explicitly rejected the double leverage adjustment:

> Public's witness Brock proposed in his prefiled testimony that the Commission utilize a capital structure that treated a portion of Petitioner's common equity capital as if it were debt and preferred equity having cost rates equivalent to the embedded debt and preferred equity costs of CWC, Petitioner's parent company. Petitioner's objection to the admission of this part of Mr. Brock's testimony and exhibits was sustained by the presiding

[18] Double Leverage: Indisputable FACT or Precarious THEORY?, Public Utilities Fortnightly (5/9/1974), at 26
[19] OUCC's PO at 51-52.

> Administrative Law Judge at the hearing on May 2, 1990 based on Indiana Supreme Court decisions which require the Commission to utilize Petitioner's actual capital structure and capital costs. Public's appeal to the full Commission was denied on the same date. The Public argued strenuously that its proposal dealt only with the cost of Petitioner's equity capital and not its proportion of equity capital and therefore its proposal was not a hypothetical capital structure and was admissible. Whether the Public's proposal was to change the percentage of equity or the cost of equity, the result would be identical because the significant input into the calculation of Petitioner's overall cost of capital is the product of those two variables. The result of the computation is the same whether one artificially raises the utility's percentage of debt or artificially lowers the utility's cost of equity. While the Public may disagree with the Indiana Supreme Court decision in *Public Serv. Comm'n of Ind. v. Indiana Bell Tel. Co.*, 130 N.E.2d 467, and while other jurisdictions may give weight to such evidence, this Commission is a creature of statute and is bound by the Court's interpretation of those statutes. In this instance, our guidance could not be clearer.

Indiana Cities Water Corp., Cause No. 38851, 115 PUR4th 470, 478 (IURC 7/5/1990), at 9-10. *Accord Terre Haute Gas Corp.,* Cause No. 38515, (IURC 3/8/1989), 1989 WL 1786434.

Even if the OUCC's 1973 Iowa Utilities Board decision mattered in Indiana, Iowa is not one of "several" states imposing this adjustment. Importantly, the OUCC does not cite a more recent decision from Iowa moving away from the double leverage adjustment*:* "The Board finds the arguments against the application of double leverage for Iowa-American to be persuasive and will no longer apply the adjustment to Iowa-American." *Iowa-American Water Co.,* 2017 WL 818588, at *19 (Iowa U.S.B. 2/27/2017). In this Order the Iowa Utility Service Board notes that it had been one of perhaps only two states that still recognized it, hardly "several." *Id.*

The Public Utilities Fortnightly article, quoted by the OUCC in support of their position, (attached hereto as Attachment 1) in fact reaches the *opposite* conclusion from what the OUCC implies:

> What started out to be an objective evaluation of the double leverage concept has resulted in total rejection of its use in utility regulation. This is the conclusion at which this writer has arrived.
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> Double Leverage, PUF (5/19/1974), p. 30.

The OUCC's misuse of selective language within an article to support a position that is in opposition to the article's own conclusion is troubling and will be discussed later in this brief. This is particularly concerning given the fact that this new theory and evidence was only raised in the OUCC's proposed order and, therefore, no OUCC witnesses were made available and subject to cross-examination on this incorrect usage of a quote from a published article.

The only Indiana authorities cited by the OUCC do not support the OUCC's hypothetical capital structure.[20] *Indiana-Am. Water Co.* merely affirmed the Commission's rejection of a small company size adjustment to the cost of common equity on the basis that Indiana American was affiliated with a larger corporation and was therefore less risky than small companies.[21] *City of Muncie* is a tax case that led to the standard that when participating in a consolidated tax return a utility cannot simply compute tax expense as if it filed as a stand-alone entity. *City of Muncie* is what gave rise to the now common "Muncie Remand Method" for computing income tax expense.[22]

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[20] OUCC's PO at 53 citing *Indiana-Am. Water Co. v. Indiana Off. of Util. Consumer Couns.*, 844 N.E.2d 106, 125 (Ind. Ct. App. 2006) and *City of Muncie v. Pub. Serv. Comm'n*, 177 Ind. App. 155, 159, 378 N.E.2d 896, 899 (1978).
[21] The OUCC's PO at 55 goes on to state *Indiana-Am. Water Co.* supports additional findings: "This case in no way takes an arbitrary number to place in the capital structure, but instead is using debt recognized by ASU, specifically shown in the Indiana Finance Authority's applications as ASU and assuring that debt is reflected in ASU's capital structure. This is precisely in line *with Indiana-Am. Water Co. v. Indiana Off. of Util. Consumer Couns.*, 844 N.E.2d 106, 122 (Ind. Ct. App. 2006). If the Commission were to allow all utilities to simply form shell companies and borrow money for a utility's capital by pledging the utility's assets as collateral, the effects of such a ruling could be devastating to utility regulation. It could immediately lead to all utilities forming shell companies and lead to unbalanced capital structures with substantial rate increases. For these reasons, the Commission agrees that the $12.7 million should be included in ASU's debt." The OUCC is completely mischaracterizing what *Indiana American* holds.
[22] *Muncie Water Works,* Cause No. 34571, 44 PUR4th 331 (PSCI 9/16/1981).

After misstating the law, and utility publications, the OUCC's proposed order then proposes several findings regarding the capital structure that are inconsistent with the evidence. The OUCC's proposed order states: "[…] what ASU is actually paying, what debt is recognized by ASU."[23] Also stating: "[…] ASU recognizes this debt as its own obligation. ASU was a 'loan guarantor,' a 'loan party' to the debt, and ASU encumbers its assets for the debt."[24]

The record evidence is that this debt is *not* ASU's debt:

> Q. Mr. Dellinger claims that the debt is "functionally" the debt of ASU. Is this correct?
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> A. No, his conclusion is not correct. I would note that Mr. Dellinger has attached to his testimony certain audited financial statements of ASU. See, e.g., Pub. Ex. No. 1, Attachments SD-4 through 6. All of these financial statements were audited, and each of the CPA opinions was "clean," meaning "the financial statements referred to above present fairly, in all material respects, the financial position of AMERICAN SUBURBAN UTILITIES, INC. as of December 31, [2016-2019], and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America." Attachment SD-4, p. 3, Attachment SD-5, p. 3, and Attachment SD-6, p. 3. The financial statements for 2020 were not audited but were reviewed, and it too contains the conclusion of the CPA that there are not "material modifications that should be made to the accompanying 2020 financial statements in order for them to be in accordance with accounting principles generally accepted in the United States." Attachment SD-7, p. 3. These declarations are important, because they mean that the financial statements have been either audited or reviewed by an independent accountant and that they are prepared in accordance with generally accepted accounting principles, otherwise known as "GAAP." None of these financial statements show the L-3 Corporation debt as a liability of

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[23] OUCC's PO at 53.
[24] OUCC's PO at 53, 54.

> ASU. This is correct because the L3 debt is not ASU's debt per GAAP.

Pet. Ex. 2 at 5-6. Mr. Dellinger is not an accountant.[25] Ms. Stull is an accountant, but she did not testify on this issue.[26] The evidence of record also shows that OUCC witness Ms. Carla F. Sulivan has a Master's degree in accounting and finance; however, the OUCC did not offer testimony from Ms. Sullivan about the proper reading of ASU's audited financial statements.[27] Mr. Dellinger's incorrect reading of the ASU's financial statements and the OUCC's desire to make this ASU's debt does not make it so and cannot change the record.

Further, the guaranty is a non-issue and the OUCC cites no Commission authority and no record evidence establishing that a negative pledge is an encumbrance. The OUCC states "ASU is guaranteeing the loan and encumbering its assets in the negative pledge."[28] Despite the OUCC's efforts to keep this evidence out of the record, ASU is *not* guaranteeing the loan – that guaranty has been eliminated when the OUCC expressed its concerns about it. Pet. Ex. 2 at 16 (revised). Further, notably absent from the OUCC's proposed order is a quotation of the language in the negative pledge that allegedly "encumbers" ASU's assets. The negative pledge states: "[…] the Company hereby covenants and agrees with the Bank that, except for Permitted Encumbrances (as defined herein): (a) it will not assign, transfer or convey any of the Property; (b) it will not pledge, assign or grant a security interest in, or lien on, any of the Property; or grant any deed of trust or mortgage lien with respect to the Property, with any person or entity other than Bank without the express prior consent of Bank, in each such instance. . . . ." Pub. Ex. 1 Att. SD-3 at 87. The bank

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[25] Pub. Ex. 1, Appendix A.
[26] Pub. Ex. 3, Appendix A.
[27] Pub. Ex. 2, Appendix A.
[28] OUCC's PO at 54.

has no claim whatsoever on ASU's assets. Quite simply, the negative pledge is not an encumbrance under the standard announced by the Indiana Supreme Court in *Underwood v. Fairbanks, Morse & Co.,* 205 Ind. 316, 185 N.E. 118, 124 (1933).

The OUCC, with no supporting evidence, newly argues for piercing the corporate veil and cites a contract dispute case in support.[29] The cited case does not support the OUCC's contention. It has nothing to do with utility regulation, nor does it allow for another's debt to be used in a utility's capital structure.

Critically, the OUCC fails to support its theory of ASU's capital structure in the most practical sense. The core of the OUCC's argument is that: (1) there is a wealth transfer to Mr. Lods; (2) that ASU is using dividends to fund the debt service of L3 loans; and that (3) ASU's owner did this without the OUCC's knowledge. Yet the OUCC wholly failed to offer evidence in support of these contentions. While the OUCC continues to make the unfounded and false statement that dividends were used to make L3's debt service payments, the OUCC has been unable to find an actual dividend to ASU's owner Mr. Scott Lods.[30] ASU is not hiding the ball from the OUCC. The OUCC was able to find and eliminate from the test year immaterial amounts for a fishing boat ($801) and a stationary bike ($854).[31] As explained in ASU's proposed order, the OUCC proved that L3 made a loan payment of $590,000 during ASU's test year. Pub. Ex. 1, Att. SD-3 at 15. If an almost $600,000 dividend from ASU to Mr. Lods had been issued to provide the funds for this payment, the OUCC should have easily been able to find it. The OUCC did not

[29] OUCC's PO at 53.
[30] ASU's PO at 5, 15-16.
[31] OUCC's PO at 71.

find it because it does not exist, not because ASU is hiding it. The clear evidence within the case supports the fact that Mr. Lods has done nothing but increase his investment in ASU over the time periods discussed by the OUCC.[32] If the OUCC had stated the facts of the case correctly, they would have instead stated that, over the years discussed, Mr. Lods has apparently been transferring his personal net worth to ASU to fund its daily operations and capital needs; to the benefit of ASU's ratepayers.

Finally, even if the facts and the law were as the OUCC presents, the OUCC grossly understates the cost rate of debt that would result from attributing L3's debt to ASU. As explained by Mr. Skomp, and ignored by the OUCC, if one were to assume that ASU dividends had been the source of debt service payments by L3 and if that were relevant to the cost of capital of ASU, it must be the full cost that is borne for that debt; not just the simple recitation of a current rate of interest. As explained by Mr. Skomp, the hypothetical capital structure created by the OUCC must take with it the associated cost of insurance, fees, and, most importantly, income taxes. Pet. Ex. 2 at 16-19. He explained that if L3 must depend upon ASU dividends to make a $1,000,000 debt service payment, ASU would be required to issue a dividend of $1.58 million, resulting in a true cost of that debt of 7.41%. Substituting the L3 principle and interest payments of the $590,000 and $351,432 during ASU's test year would produce a true cost of the debt of 7.14%, as reflected in the attached workpaper which performs the same calculation using actual amounts from the record. As Mr. Skomp explained in his testimony, these computed interest costs do not include the calculation of the cost of state income taxes which would drive the cost rate even higher. Also this

[32] *Id*.

analysis does not account for the fact that interest rate on the L3 debt is variable and tied to the Secured Overnight Financing Rate ("SOFR"),[33] which has soared[34] since the test year.[35]

As a side note to the OUCC's discussion of the relationship between ASU and L3, the OUCC continues to ignore the undisputed evidence of record that the initial establishment of this relationship was at the request of the OUCC (*See* Pet. Ex. 1-R at 10-14). As Mr. Skomp testified, this was not something Mr. Lods wanted to do, but was required by the OUCC if ASU was going to be able to settle that case. In a very cavalier manner in their proposed order, the OUCC simply casts this away as not being relevant or reflective of what is happening today.[36] The OUCC refuses to acknowledge that ASU's relationship with L3 today is a direct reflection of decisions the OUCC made in past cases. The OUCC should not be allowed to require something be done in one case then complain about it being done in future cases. The undisputed evidence of record is that Mr. Lods is not using dividends from ASU to fund any of the operations of L3; in fact, Mr. Lods is continuing to increase his investment in ASU in each and every year referenced by the OUCC. The OUCC's own evidence shows that Mr. Lods is personally liable, with all of his net worth (not just ASU), for the debt of L3 (as well as the debt of ASU). While ASU may agree in part with the OUCC's assertion that a discussion of how L3 came to be created is irrelevant to this Cause, ASU's

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[33] Pet. Ex. 2, Att. JRS-R9 (revised), at 3.
[34] The SOFR rate as of December 31, 2020 (the last day of the test year) was 0.07%; on October 13, 2022, the rate was 3.04%. https://fred.stlouisfed.org/series/SOFR.
[35] Neither party has contended that the calculation from the settlement reached between the OUCC and ASU during Cause No. 41254 continues to apply. This is likely because in the last rate case, the Commission approved a debt issuance by ASU which brings ASU's capital structure more into balance. If the settlement were to have continuing application, it would need to be adjusted to reflect three things: First, that the agreement was entered when ASU was essentially 100% equity – to apply the 50/50 to the equity portion now would shift the structure to way too much debt (a split would need to be more like 75/25 to keep with the original intent to achieve 50/50). Second, as Mr. Skomp explained in response to Mr. Dellinger, the coupon rate on these variable rate loans is nowhere near the all-in-cost of the loans. Third, as these are variable rate loans tied to SOFR the cost of this debt has risen and is surely to continue to rise as SOFR continues to rise
[36] OUCC's PO at 55.

agreement is based on a belief that all discussions of L3 are irrelevant to this Cause because the Commission should look to the capital structure of ASU only. The Commission should deem all discussion of L3 as irrelevant and issue an appropriate order in this Cause based on ASU's financial statements and capital structure.

B. <u>Wages and Employee Benefits</u>. The OUCC continues to claim ASU is unjustified in adjusting its 2020 test year for wages and benefits when ASU explained that the proposed amount for wages and benefits was based on ASU's actual employees and that the test year was unrepresentative and thereby needed to be adjusted due to the effects of the pandemic.[37] The OUCC's proposed order correctly states: "The use of a historical test period is the generally accepted method for setting rates for the future by taking the actual results for the particular test year and *adjusting for any extraordinary and nonrecurring items and for all known and measurable changes*. *Cap. Improvement Bd. of Managers of Marion Cnty. (Convention Ctr.) v. Pub. Serv. Comm'n*, 176 Ind. App. 240, 257–58, 375 N.E.2d 616, 630 (1978) citing *In re Vermont Gas Systems, Inc*. (1973), 100 P.U.R.3d 202." (Emphasis added). Because the global pandemic was extraordinary and because current employee levels and salaries are a known and measurable change, ASU appropriately adjusted its test year wages and salaries to reflect actual employees under normal operating conditions. The OUCC's suggestion that there be no adjustment to the expense levels during a pandemic is against the simple reading of the generally accepted method for setting rates; as stated within their own proposed order.

Furthermore, the payroll records that Ms. Sullivan attaches confirm that a significant upward adjustment is needed. Attachment CFS-2 to her testimony is the Payroll Register for 2020

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[37] OUCC's PO at 87; ASU's PO at 17.

and 2021. The total hours for 2021 were almost 4,500 higher than they were in 2020. Attachment CFS-2, p. 2 (28,190 hours v. 23,829 hours). That is an increase of almost 20% and does not account for wage increases.

C. <u>Equipment in Rate Base</u>. The OUCC proposes to reduce ASU's rate base on the opinion of an OUCC accountant who has performed no analysis to support her recommendation and has not been shown to have any experience operating a utility, let alone a sewer utility.[38] There is no way for Ms. Stull to know without an analysis or expertise that "most of the equipment the OUCC recommends removing is either heavy equipment typically used in construction projects or specialized equipment that would not be used on a regular basis."[39] Notably, no OUCC witness testified that they even inspected this equipment. Mr. Parks, who is a professional engineer and does have some experience in sewer utility operations, is not the OUCC witness who offered this opinion. This OUCC adjustment is simply a wholly unsupported reduction to rate base.

Mr. Mix is a licensed professional engineer with over 25 years of experience.[40] Mr. Mix explained the equipment's usefulness, especially during the night, on weekends, and on holidays.[41] The OUCC refuses to acknowledge the reality of its recommendations. Should the Commission disallow the equipment as the OUCC's recommends, then ASU must dispose of the equipment and rely on subcontractors and rented equipment for daily operations as well as in times of emergency. Ms. Stull curiously provided no opinion on the practicality of running a utility in this manner and provided no cost allowance for this type of operation within her adjusted expenses. This is understandable since, as mentioned earlier, Ms. Stull testified that she performed no

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[38] ASU's PO at 11; Pub. Ex. 3, Appendix A.
[39] OUCC's PO at 69.
[40] Pet. Ex. 3, Attachment AAM-R1.
[41] ASU's PO at 9, 12; Pet. Ex. 3 at 43-44.

analysis to support her conclusion; therefore, there was no analysis that was performed that would allow her or the Commission to appropriately account for such a drastic change in ASU's normal operations.

The OUCC also changes its tune in its proposed order, offering a new reason why it believes some of this equipment should be disallowed. They claim now that it should be disallowed because "some" of it was transferred by an affiliate to ASU, that there was no showing of an affiliate contract for this sale, and that there was no assurance that the purchase price was "reasonable."[42] Notably, this was not the reason given by the OUCC's accountant for the disallowance. When asked the reason for her proposed disallowance, Ms. Stull did not testify that she felt the purchase price for the two trucks[43] purchased from First Time Development Corp. was unreasonable.[44] Had this been the basis for Ms. Stull's opinion, ASU would have included in its rebuttal the responses to OUCC data requests showing that the purchase price for these two pieces of equipment was based on independent appraisals. Furthermore, the OUCC is attempting to enforce an affiliate contract provision which applies to "management, construction, engineering or similar contract[s]," and not a one-time sale. Ind. Code §8-1-2-49(1). ASU had the appraisals conducted to assure the purchase price was reasonable. The OUCC should not be permitted to change to a new theory of disallowance that was not and could not have been supported by its witness.

Petitioner would offer a final note to the Commission's consideration of the OUCC's adjustment to eliminate equipment from rate base that ASU uses for the operation and maintenance

[42] OUCC's PO at 68-69.
[43] They are not two camera trucks as she testifies – one of them is a Jet Vac truck. Pub. Ex. No. 2, p.26 and Att. CFS-24.
[44] Pub. Ex. 3 at 14-15.

of its facilities. The OUCC is requesting that the Commission require ASU to drastically change its normal business operations. In lieu of having staff and equipment in-house to perform many maintenance functions, the OUCC is recommending that the Commission require ASU to dispose of this equipment and hire subcontractors or rent equipment to do the work. The OUCC is recommending this drastic change to a utility where the evidence of record shows low, if any, customer service complaints. The OUCC is recommending this drastic change to a utility that has operated for many years on customer rates and charges that are lower than many in the State. The OUCC's accounting witness, with no experience in utility management, is recommending this in a very punitive manner with no analysis of how this may affect future customer service or rates. ASU's engineering witness has testified to his belief that there are major problems with the OUCC proposal and that ASU should be allowed to continue the past management practices that have been beneficial to its customers.

D. The Preapproved Projects. The OUCC attempts to support its misguided interpretation of the Preapproval Case by citing half sentences which misstate what the Commission actually said. The OUCC does not contend that this additional work (all completed by unaffiliated third parties) was not reasonably necessary or that the costs were excessive. Instead, the OUCC cites the following from p. 15 of the Preapproval Case: costs in excess of preapproved amounts would be "addressed as other rate base additions that have not been approved."[45] They then propose that the Commission find extra costs could only be presented in a single future rate case, contending "Cause No. 44676 was that 'future rate case.'"[46]

The entirety of the quoted sentence from the Preapproval Case Order is as follows:

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[45] OUCC's PO at 18, 63.
[46] *Id.*

> The Sewer Projects Stipulation also provides that to the extent actual costs of each of the three sewer projects exceed the agreed preapproved amounts, *inclusion of those additional costs in rate base in future* ***rate cases*** will be addressed as other rate base additions that have not been preapproved; namely, in order to include the excess in rate base for ratemaking purposes, Petitioner will have the burden to demonstrate the excess was reasonable and was prudently incurred.

(Emphasis added). The underlined portion of the sentence clearly supports ASU's position of allowance of the costs. The Commission did not limit ASU to a single future rate case but rather "future rate *cases*." The OUCC left the critical last three words that are dispositive of its interpretation off of its quote. The OUCC engages in a similar tactic when it cites the final sentence of the Commission's discussion of the CE-III in Cause No. 44676: "The total amount to be included in rate base for the CE-III project is $11.5 million. (Emphasis original.)"[47] Earlier in the same section of the Order, the Commission specifically states: "The Commission presumes the Petitioner will request additional rate base for costs above the $11.5 million pre-approval amount for the CE-III plant in future proceedings."[48] The OUCC's use of partial quotes is distorting what the Commission actually wrote in these orders rather than showing candor to the tribunal.

The OUCC further mischaracterizes ASU's position regarding the Preapproval Case, stating that: "ASU claims that the Preapproval Case does not allow disallowing costs."[49] ASU made no such claim. ASU has maintained the Preapproval Case has not limited ASU from seeking Commission approval for the inclusion of costs beyond that preapproved amount established by the Commission in the Preapproval Case. This is consistent with the plain language of the order.[50] Further, the OUCC asserts in its proposed order regarding the Preapproval Case and tree mitigation

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[47] OUCC's PO at 64.
[48] *American Suburban Utils.,* Cause No. 44676 (IURC 11/30/2016), p. 29.
[49] OUCC's PO at 57.
[50] ASU's PO at 13.

that: "However, ASU does not address that the OUCC contends that the cost was already approved and collected in Cause No. 44676." Another untrue statement. ASU rebutted the OUCC's position and explained that the tree mitigation costs were not at issue in the Preapproval Case so they should in no way be limited from seeking to include them in rates.[51] The OUCC further mischaracterizes the language from Cause No. 44676 regarding the phase in of rates. The OUCC asserts this somehow limits ASU's ability to seek recovery of costs in futures rate cases.[52] The Commission here is discussing rates approved in that case, not future rate cases. The OUCC is grasping at straws to attempt to limit ASU's recovery.

The OUCC's use of half-quotes, misquotes or misstatements is openly hostile and has caused this proceeding to be extremely litigious and costly. ASU believes the language provided by the Commission in previous ASU orders is clearly understandable and, as mentioned earlier, ASU can only speculate as to the reason for the OUCC's misrepresentation of the language within the orders. However, this is clearly one of the areas where the Commission needs to send a message to the OUCC that this type of conduct must stop.

III. The OUCC also takes unreasonable positions regarding many of the remaining issues.

A. <u>Consistency of Adjustments</u>. The OUCC picks and chooses when the test year is acceptable, always to the detriment of the utility and consistent with an aim of bringing financial harm to ASU and Mr. Lods. Regarding ASU's sludge removal, the OUCC advocates that the costs associated with hauling the sludge, which occurred during the test year, is not acceptable. But as discussed above, the OUCC continues to argue that wages and benefits be set at test year pandemic

[51] ASU's PO at 7-8, 20.
[52] OUCC's PO at 64.

levels without adjustment and despite its own evidence demonstrating dramatic increases the next year, going so far as to imply that adjustments may not be permitted in small utility filings. The OUCC flips back with pensions proposing an adjustment to reduce the test year level. Also customer growth. The OUCC adjusts revenues to pick up post-test year growth. Notably, it is not as simple as Ms. Stull makes it seem. As Ms. Shafer explained, ASU's customer base fluctuates widely, since much of its customer base is around Purdue University in the City of West Lafayette.[53] Ms. Stull's adjustment ignores this. The point however, is this: adjustments are permitted in small utility filings, as recognized by the Commission's form application, and the adjustment method must be applied consistently (and not just to the detriment of the utility).

B. <u>Main Extension Rules</u>. The OUCC yet again misstates the record when it claims that ASU "did not address" Mr. Parks' recommendation that ASU be ordered to comply with the main extension rules.[54] Witness Shafer absolutely addressed this issue: she quoted the main extension rules; explained that due to ASU's small size, providing a revenue allowance for subsequent connectors for developer-installed main extensions would have a significant impact on rate base growth; and explained that developer-installed main extensions therefore presented abnormal or extraordinary circumstances for a small utility in a growth area, warranting the use of the special contract provision in the Commission's main extension rules.[55] Notably, the Commission's main extension rules provide an avenue for either party to the contract to present a dispute over a special contract for determination by the Commission. 170 IAC 8.5-4-39. As explained by Ms. Shafer, at no point has any developer ever complained about the proposed contract not including a revenue allowance. The OUCC is therefore seeking a declaratory judgment from the Commission regarding

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[53] ASU's PO at 10, 17.
[54] OUCC's PO at 59.
[55] Pet. Ex. 3 at 15-16.

the main extension rule, 170 IAC 8.5-4, when there is no controversy. Why the OUCC would take a position that will cause residential rates in the future to increase in order to provide a financial benefit to developers that they themselves are not seeking is lost on ASU. In any event, the Commission is a creature of statute that can only exercise powers granted to it by statute.[56] The Commission has no authority to order what Mr. Parks seeks, which is a declaration of what terms ASU must offer developers in special contracts. The OUCC's proposition fails.

C. <u>Retired Assets</u>. The OUCC advocates that its original proposed retired asset figure be approved and ASU's proposed lower figure be rejected. In reaching this position, the OUCC's proposed order states: "While ASU accepted the removal of $692,994 of utility assets from utility plant in service, it did not provide any details regarding how that amount was determined." Once again, the OUCC has simply included an untrue statement in its proposed order. In ASU's rebuttal. Ms. Shafer specifically explained that what was to remain in rate base was discussed by Mr. Mix and/or reflected in Attachment KS-R2.[57] Attachment KS-R2 contains a tab labeled "UPIS to be retired" which clearly delineates the Asset #, Item, Year Purchased, Year Retired, Amount, and the corresponding OUCC schedule.[58] If the basis for the OUCC's untrue statement was that they were unaware of Ms. Shafer's testimony and attachment, the fact that the OUCC may have somehow missed this evidence (like they apparently missed her testimony on the main extension rule) is troubling to ASU and should be troubling to the Commission as well.

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[56] *N. Ind. Pub. Serv. Co. v. U.S. Steel Corp.*, 907 N.E.2d 1012, 1015 (Ind. 2009); *Citizens Action Coalition of Ind., Inc. v. Indianapolis Power & Light Co.*, 74 N.E.3d 554, 562 (Ind. Ct. App. 2017); *Indiana Bell Tel. Co. v. Indiana Util. Regulatory Comm'n*, 715 N.E.2d 351, 360 n.3 (Ind. 1999).
[57] Pet. Ex. 4 at 14.
[58] Pet. Ex. 4, Attachment KS-R2, "UPIS to be retired" tab. ASU will note there appears to be a typo in Ms. Shafer's testimony "$692,994" is meant to be "$693,994" as reflected in the Attachment KS-R2.

D. <u>Kimberly Estates Lift Station</u>. The OUCC, through its proposed order, claims since the Kimberly Estates lift station was previously removed from rates that the Commission need not decide on the matter even though the OUCC acknowledges there is controversy.[59] ASU explained why the Kimberly Estates Lift Station remaining for emergency usage makes more sense, how it came to this conclusion while planning the removal process, and presented evidence that the cost is very small.[60] The OUCC may choose to ignore this evidence, but once again, the Commission cannot. Further, just because the retirement was noted during previous plans does not mean ASU is precluded from making a change. ASU explained why it now maintains the lift station for emergencies. ASU is not precluded from altering its plans especially when it is justified as it is here.[61] But even if the Commission were to accept the OUCC's position, the OUCC has not made the adjustment correctly. As with the force main, the OUCC's adjustments are not properly reflecting the impact on rate base since net original cost rate base is unchanged by a retirement.[62]

Here again, Petitioner believes the question needs to be asked why the OUCC believes it needs to tell ASU how to run its utility and which facilities need to be used to provide quality customer service. While ASU has the normal level of concern from its customers about monthly billings, no evidence of record shows customer service complaints or, as noted earlier, even complaints from developers. ASU has professional engineers on staff and also uses professional engineering firms to help guide the decisions regarding the construction, maintenance and use of

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[59] OUCC's PO at 57.
[60] ASU's PO at 7, 18; Pet. Ex. 3 at 15-16.
[61] *Id.*
[62] ASU's PO at 12-13.

its facilities. The OUCC's witness, Mr. Parks, is making recommendations about eliminating what ASU believes to be necessary plant and equipment without even a site visit to the service area.

E. <u>Emergency Repairs</u>. The OUCC approaches the US 52 emergency repairs as if it was a capital project.[63] The OUCC hangs its hat on the directive from Cause No. 44676 related to projects and plant investment, i.e., capital additions. The US 52 emergency repair was an expense. It is capital projects that were the subject of the Commission's direction to provide more detailed invoices in Cause No. 44676, not expenses.[64] Further, no affiliate was involved in this work. This is the amount an independent contractor charged ASU for an emergency repair. The OUCC's proposed order makes broad sweeping assumptions as to how the emergency repairs should have been conducted. The OUCC ignores that Mr. Mix testified that the repairs were done under the pressure of an emergency and as such, and rightfully, the concentration was on making the repair rather than in accumulating paperwork. An emergency repair must be completed in hours and days, not months and years as is typically the case with a capital project. It is also important to note in contrast, the OUCC provided no evidence to illustrate that Mr. Parks has ever conducted or supervised an emergency repair which could provide the basis of his expectations. Further, Mr. Parks provided no evidence that he had ever even toured the location where the repair took place. Mr. Parks' position simply relies on his conclusion that ASU did not provide enough detailed paperwork for him to make a hind-sight determination from his Indianapolis office about the validity of this expense. The fact is that ASU had to make an on-site determination in real time about the reality of the situation. No evidence has been presented that ASU's management of this

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[63] OUCC's PO at 112.
[64] Cause No. 44676 at 41 (IURC November 30, 2016).

decision was imprudent or that any reasonable alternative action could have been taken under the circumstances to produce a lower expense.

An unfortunate fact of the utility business is that emergency repairs are a recurring normal part of business operations, as maintaining continued customer service is a priority. ASU has demonstrated its ability to manage these situations in real time in a manner that provides quality customer service at reasonable rates. In order to continue this practice, ASU needs to have an appropriate amount of funding within its operating budget. The OUCC's suggestion to remove or unfairly limit these type of costs would severely hamper ASU's ability to manage these situations, to the detriment of its customers.

F. <u>Contractual Services</u>. The OUCC asserts that the costs incurred during the subdocket should be disallowed – not because they were imprudent or that they were excessive. Rather, the OUCC claims that the total amount incurred should not be recovered each year as a pro forma operating expense.[65] These costs fall into two categories: legal expenses and the expenses for Witness Jennifer Leshney. What the OUCC fails to acknowledge is that in rebuttal, ASU proposed to amortize the legal costs over a five year period. Pet. Ex. 4 at 10. As for Ms. Leshney, ASU also proposed to amortize these costs over the same five-year period. The OUCC acknowledges this offer with respect to Ms. Leshney's invoices, but claims that somehow ASU cannot propose on rebuttal to amortize a test year expense which the OUCC has challenged as non-recurring. Again, these were test year expenses, not past losses. When the OUCC claimed they were non-recurring, the OUCC should have proposed a reasonable amortization period. When the OUCC did not do so, ASU cannot be faulted for correcting this on rebuttal.

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[65] OUCC's PO at 105.

The OUCC also disallows the retainer for Ed Serowka and spends considerable space in its proposed order to so. This is a $24,000 per year retainer, $2,000 per month, where ASU receives daily services from a registered professional engineer. There is no dispute that ASU has experienced considerable growth over the years (see the growth in rate base over the past 20 years discussed previously). The OUCC has not presented any evidence that ASU could receive the services that Mr. Serowka provides for less than the cost of this retainer.

G. <u>Other Miscellaneous Issues</u>. The OUCC, through is proposed order and without any supporting evidence, asserts that ASU failed to abide by the settlement terms in Cause No. 44272 as it failed to provide proper notice.[66] Contrary to the OUCC's assertions, ASU filed the Project Status Reports as required by the order until the project was in service.[67] The OUCC also takes issue with a payment made for the West Ridge settlement. The OUCC, through its proposed order, argues without analysis or evidence that Atlas or ASU's insurance should have covered this payment. The OUCC further argues the Commission should not recognize the benefit of the Copper Beach station removal as "that matter not having been presented as part of this case."[68] The OUCC's quoted statement is completely illogical and false. ASU plainly presented the Copper Beach removal as part of the case.[69] How else would the OUCC know ASU was claiming this as a savings? The OUCC cannot simply wish away evidence. The actual cost of the settled claim was less than $50,000. The OUCC provides no analysis or evidence showing that an insurance claim, subject to a deductible and potentially raised insurance rates, was more reasonable than the actions taken by ASU.

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[66] OUCC's PO at 58.
[67] Cause No. 44272 at 16; see reports filed April 1, 2015, June 12, 2015, October 11, 2016, August 29, 2017, and May 15, 2019.
[68] OUCC's PO at 58, 66.
[69] ASU's PO at 8, 19-20.

The OUCC takes issue with employee relations expenses, again without any authority that such an expense is unreasonable. The OUCC does not refute ASU's evidence of reasonableness other than to make an illogical jump that Christmas bonuses and team building activities are inherently unreasonable. Notably, these amounts in total are less than 1% of the total wages and salaries and are incurred in perhaps the toughest labor market seen in decades.

The only logical conclusion to the many positions taken by the OUCC is a disdain of the small utility process and for ASU, none more apparent than the OUCC's proposed finding regarding the typographical error in the Atlas Excavating invoice. The OUCC assumes the worst of ASU even though they have no evidence that ASU's simple and innocent explanation is untrue. Further, the OUCC chastises ASU's usage of the small utility filing process, claiming a small utility filing is incompatible with a prior commission order, not that ASU is in anyway statutorily unqualified to file a small utility filing.[70] Nowhere in the Cause No. 44676 Order did the Commission state ASU was precluded from its statutory right to elect to file a small utility proceeding. What the Commission does not say in its order is as important as what they do say.

[70] OUCC's PO at 65-66.

For the reasons set forth in ASU's testimony, exhibits and post-hearing filings, ASU respectfully urges the Commission to adopt the findings in ASU's proposed order and promptly issue an order approving the relief sought by ASU in this Cause.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned certifies that a copy of the foregoing has been served upon the following counsel of record by electronic mail this 14th day of October, 2022:

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In recent years, the concept of double leverage as an approach to arrive at a fair rate of return has reared its head anew. This is not a modern concept at all and in fact is probably as old as regulation itself. Having lain dormant for many years, however, it is interesting to note the increasing frequency of its appearance as an issue in rate cases. The purpose of this article is to explain exactly what is meant by the term, how the concept is used and misused, and what are the long-run implications.

Double Leverage:

Indisputable FACT Or Precarious THEORY?

By JAMES E. BROWN

EXAMINATION of many pages of transcript shows that double leverage has its ardent supporters and equally vociferous opponents. As old as the concept is and as vigorously as its use has been argued, not everyone seems to comprehend fully its meaning. The intent herein is to clarify the concept as it is sometimes used in utility rate regulation. The process of clarification, of course, carries with it the opportunity to express the author's own unbiased and objective view.

What Is Double Leverage?

The thrust of the double leverage concept is that a subsidiary company can use both its own leverage and that of its parent company to generate profits well above those normally allowed by regulatory commissions to an independent, publicly held operating utility. Leverage, basically, is the use of debt capital to earn an overall rate of return in excess of the cost of such capital. These additional earnings over cost inure to the benefit of the stockholders who are thus "levered" above what they might otherwise receive in the absence of debt financing.

A highly levered company is one which employs debt capital to a high degree consistent with normal industry financing. Public utilities, because of their stability, growth, and earnings records are noted as highly levered, meaning that 50 per cent debt or more is not at all uncommon. The remainder of the capital is provided from the sale of common and preferred stock. The investors in such stock benefit from the ability of the utility to earn an overall rate of return on total capital which is in excess of the cost of debt capital.

The use of leverage has also benefited the consumer of utility services. Consider a $100 million utility with 50 per cent debt carried at an embedded cost of 6 per cent and 50 per cent common equity on which the allowed return is 13 per cent. The overall cost of capital is computed as follows:

	Amount	Per Cent Of Total	Cost	Weighted Cost
Debt	$ 50,000,000	50%	6.0%	3.00%
Stock	50,000,000	50	13.0	6.50%
Total	$100,000,000	100%		9.50%

The weighted average cost of capital is 9.50 per cent. Consumer rates could be set, then, at a level which would generate $9.5 million in net revenues, enabling the utility to pay its 6 per cent cost of debt and a 13 per cent return to equity investors. If there were no debt at all, the entire $100 million having been provided by equity investors, a 13 per cent return would require $13 million in net revenues rather than $9.5 million. The use of leverage, in this illustration, saves the consumers $4.5 million per year. The demonstrated benefits of leverage have historically been passed on to consumers in the form of lower utility rates.

The prudent use of leverage has always been the responsibility of management. Regulatory commissions generally have shied away from any infringement upon this management prerogative. Some utilities, such as American Telephone and Telegraph, have in the past seen fit to restrict the use of leverage to a limit lower than that which prevails in the industry. There is no "right" debt-equity ratio. A "consensus" or "average" can be determined for the various utility industries; however, individual managements must make the ultimate decision with respect to leverage. To the extent, though, that leverage is used in accord with sound financial management and individual corporate policy, both stockholders and consumers derive benefits.

Double leverage is merely an extension of the concept of leverage to a parent-subsidiary corporate relationship. Company A, for example, is an operating utility, financed partly with debt capital and partly with equity capital. It uses leverage as explained earlier. The difference is that the common stock of Company A is owned by Company B, the parent company. Where did Company B obtain the funds it invested in the common stock of Company A?

The answer to the above question is that Company B raised its own capital partly through the sale of stock and partly from a debt issue; that is, Company B is also levered. Thus Company A enjoys its own leverage factor—the use of debt instead of all equity capital—plus the leverage factor of its parent company which also uses some debt instead of all equity capital. This is the essence of the meaning of "double leverage."

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How Is Double Leverage Used?

Perhaps the best way to explain how double leverage is used is to extend the earlier illustration. In that example, debt carried a weighted average cost of 3 per cent and equity, with an allowed return of 13 per cent, showed a weighted cost of 6.50 per cent. The total cost of capital, upon which a fair rate of return to investors must ultimately be based, was 9.50 per cent. This is also the percentage figure which is used in establishing the rates paid by consumers.

Now suppose that this same company is a wholly owned subsidiary of Company P whose own source of capital is 60 per cent debt and 40 per cent equity. Also assume that Company P's average cost of debt capital is 5 per cent and that a reasonable return to its stockholders is the same as that allowed its subsidiary, 13 per cent.

The schedule below shows how those who support double leverage would set about to compute the cost of capital to the subsidiary company. It should be noted first that there are two facets to the argument in support of the double leverage concept: (1) the cost of capital to the subsidiary company; and (2) the return on equity to the parent company if double leverage is not used.

The first argument made is that the subsidiary company needs only a 7.10 per cent return on total capital rather than the 9.50 per cent return indicated in the previous illustration. The lower rate of return stems from the fact that the parent company, although making $50 million available to its subsidiary, used considerable leverage itself in raising its capital. Thus, the *real* cost of capital to the subsidiary is the cost of its own debt capital, plus the cost of its parent's debt capital, plus the reasonable return to its parent's levered stockholders.

The second argument made is that if the parent company were allowed to earn a 13 per cent return on its equity investment in the subsidiary,

SUBSIDIARY
Cost of Capital
(Double Leverage Concept)

	Amount	*Per Cent Of Total*	*Cost*	*Weighted Cost*
Debt—Subsidiary	$ 50,000,000	50%	6.0%	3.00%
Equity—Provided by Parent:				
Debt—Parent (60 Per Cent)	30,000,000	30	5.0	1.50
Equity—Parent (40 Per Cent)	20,000,000	20	13.0	2.60
Total	$100,000,000	100%		7.10%

double leverage, there are three additional arguments which can be made against its use in the regulation of public utilities.

First, investors in any operating utility are entitled to the opportunity to earn a reasonable return on their investment commensurate with the business and financial risks involved, *not* by any parent company nor by its own stockholders, but by the operating utility company itself. It does not matter who owns the stock of the operating company or how the owner obtained the stock or how the owner financed his stock purchase. What does matter is the risk to which the owner's dollars are exposed. If this risk dictates a 13 per cent return, then this return is the one which should be allowed, the complexities of ownership having nothing to do with regulation of rates.

Second, the regulatory process must consider the inescapable fact that operating utilities, regardless of ownership, are separate, individual economic entities with respect to any debt securities issued. Parent companies have no obligation whatever for the debts incurred by a subsidiary company. Bondholders in a subsidiary look to the property *of the subsidiary* and to the earnings *of the subsidiary* as security for their investments. It is not possible legally to make the parent company or its stockholders a party to the debt instrument securing the bonds of a subsidiary operating company. It is thus imperative that the operating company stand on its own feet, earning a reasonable rate of return on its own equity as partial collateral for its own outstanding bonds.

The third argument embraces the old and generally accepted "opportunity cost" principle of economics. This principle holds that the cost of anything is the cost of an alternative foregone—some better opportunity. A holding company, for instance, *could* invest its funds in a Widget subsidiary rather than in an operating utility subsidiary. If the "market" allows a rate of return on such an investment which is reasonable—say, 13 per cent—what reason is there for the holding company to invest in a utility subsidiary so restricted by regulatory authorities embracing double leverage that a 13 per cent return on this particular opportunity is impossible? For example, suppose that the chief financial officer of a holding company is considering two alternatives as a possible investment of his company's funds. Alternative A is the Widget Company, currently earning a rate of return for its owners of 13 per cent, considered fair and reasonable under existing market conditions. The Widget Company is not subject to regulation except by the competitive market in which it operates. Alternative B is a public utility also earning a rate of return of 13 per cent for its current owners. It is, however, subject to regulation by a public service commission which uses the double leverage concept in setting rates.

An investment in Alternative A, yielding a 13 per cent rate of return, could generate a higher rate of return to the holding company's stockholders, depending upon how extensively the holding company can use leverage itself. Alternative B would limit the return to the parent's stockholders to 13 per cent regardless of its use or nonuse of leverage. The choice is clearly Alternative A and not the utility subject to double leverage regulation.

Double Leverage Assumptions

In order to evaluate the case for and against double leverage, it is necessary that the assumptions are both explicit and logically defensible. The supporters of double leverage rarely state their assumptions. Thus, that which is implied must be made explicit if the merits of their argument are to be proven sound or unsound.

One assumption which must be made is that each dollar of common equity capital carried on the accounting records of a subsidiary company was acquired directly from the parent holding company. If this is not true, then the concept of double leverage fails. The common equity capital of the subsidiary must be directly traceable to the parent company if the parent company's cost of capital can have any relevance whatever in setting rates for the subsidiary. Such a relationship, of course, does not exist. The theoretical limitations of double leverage as a workable concept are compounded by the utter impossibility of practical implementation of this concept. This is so for several reasons.

First, it is normal practice, and generally accepted as proper, for operating utility companies to pay only some percentage of profits to their owners as dividends. Some portion is retained by the company as internally generated capital. This portion will vary from company to company but a dividend pay-out ratio of 50 to 75 per cent would certainly be more the rule than the exception. Thus, none of the retained earnings of an operating subsidiary can be traced to the capital raised by a parent company. It follows, then, that the cost of that portion of common equity capital in the subsidiary provided by retained earnings can in no way be associated with the cost of capital to the parent company.

Second, mergers and consolidations muddy up the waters. As is particularly true in the telephone industry today, most systems are the product of financial combinations involving many tiers of former parent-subsidiary relationships. Company A, for example, may have merged with Company B to form Company C. A parent company might then exchange a preferred stock issue for the common shares of the new Company C. How, then, is the cost of equity capital determined for the operating companies when the common equity capital was never raised by the parent for its operating subsidiaries?

Third, a parent company may issue bonds or preferred stock (or even new common stock of its own) to acquire a particular operating subsidiary. As far as the operating subsidiary is concerned, the one subject to the regulation of some state commission, how can its cost of equity capital be computed simply by looking at the overall cost of capital of its parent company? Yet this is what double leverage would have us do.

Another assumption is that the capital of a parent holding company has been invested in operating subsidiaries of identical risk and uncertainty. It is certainly reasonable to expect that the parent company's stockholders might receive a higher return from an investment in one subsidiary which was more risky than another subsidiary. But if the capital of the parent is coming from a common pot, it becomes impossible for the regulatory authorities in one jurisdiction to impute an overall cost of capital applicable to the subsidiary over which it exercises control and ignore the costs associated with capital of the parent's other subsidiaries. These other subsidiaries may be of varying risks and subject to the jurisdiction of various regulatory authorities, some of which may consider double leverage in setting rates and some of which may reject the concept entirely.

Yet another assumption is that the parent holding company has invested its funds in each one of its subsidiaries proportionately. That is, if the various subsidiaries have different debt-equity ratios, then the parent company has contributed equity funds in different proportions. Consequently, the concept of double leverage becomes impossible to implement in any fair and equitable manner, its other limitations notwithstanding.

A final assumption is that identical utility assets, employed in exactly the same use and under the jurisdiction of the same regulatory authority, can somehow possess unequal earning capacities. Law or precedence in many regulatory jurisdictions makes it clear that property value is the proper basis for setting rates. To illustrate, consider a state which requires utility rates to be formulated using an original cost rate base. Assume that there are two utility companies operating in that state, each of which has the same original cost rate base. It can even be assumed that both companies are financed in exactly the same fashion—50 per cent debt and 50 per cent equity. The only difference between the two companies is that one is a subsidiary company while the other is not.

Depending upon how the parent company is itself financed, application of the double leverage concept could result in an entirely different rate structure being allowed to the two operating companies. To refer to an earlier illustration, an overall rate of return of 9.5 per cent was shown to yield a 13 per cent return to equity investors. Using the double leverage concept, this overall rate of return might be lowered to 7.1 per cent. This would indicate a revenue requirement reduction of 2.4 per cent on total capital, a difference of about one-third. It is stretching one's endurance of the regulatory process to imagine such a difference in allowable earnings, and consumer rates, when the legal earnings assets of two companies are the same.

Regulatory Implications

What started out to be an objective evaluation of the double leverage concept has resulted in total rejection of its use in utility regulation. This is the conclusion at which this writer has arrived. Joseph F. Brennan, a public utility consultant, has expressed the same conclusion in a much more gentle manner: "In my opinion, the double leverage concept, properly employed, at best is a tedious, difficult, time-consuming study which merely confirms the overall rate of return obtained by applying the more traditional approach. Frankly, I do not think the double leverage approach is worth all the trouble and its use unfortunately can easily mislead if it is not properly applied." (Missouri Public Service Commission, Application No. 17,471, United Telephone Company of Missouri.)

The implications of double leverage seem apparent. Utility companies, beset with rising labo costs, increased capital costs, and higher materia costs must charge higher prices to consumers o utility services. The regulatory commissions ar charged with the responsibility of holding utilit prices as low as possible while ensuring adequa public service. Both forces are, it would seem charged with impossible tasks in today's econom Rates must be adjudicated, however, so the question cannot be begged.

If utility rates are reduced, or kept lower tha they might properly be, utility earnings will decline. This will result in lower utility stock pric and higher interest rates, making the cost of capit even that much greater than it now is. Rate applications will undoubtedly increase in number a the cost to the consumer will undoubtedly be higl thereby. Double leverage seems to be a cop-o a scapegoat, and a subterfuge. Its use in regulat cannot be defended and is used only by those w are apparently misinformed or who are looki for some means to further their own thing, b political or otherwise.

It is the conclusion here that double leverage untenable in both theory and practice. The ca lations involved are, in the words of Mr. Brenr "tedious, difficult, and time-consuming." But t accomplish very little. Double leverage, as a pr tool in the regulatory bag, should be discarded.