

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the Matter of Lake Region Water & Sewer)	
Company's Application to Implement a General)	File No. WR-2013-0461
Rate Increase in Water and Sewer Service.)	

**REPLY BRIEF OF THE
OFFICE OF THE PUBLIC COUNSEL**

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COMES NOW the Office of the Public Counsel (Public Counsel) and states for its Reply Brief as follows:

1. Capital Structure

It is Public Counsel's position that Lake Region's actual capital structure should be utilized in this case and that the actual capital structure at the end of the test year was 68.90% debt and 31.10% equity. Lake Region has a similar position with a slightly different actual capital structure calculation because it does not agree with Public Counsel's recommended availability fee adjustments. Staff notes that it has calculated Lake Region's actual capital structure to be 100% debt, but recommends that a hypothetical capital structure of 75% debt and 25% equity should be utilized for Lake Region in this case.¹ In its Brief, Staff argues that Missouri Courts have determined that the Commission has the discretion to order the use of a hypothetical capital structure and to assume a hypothetical debt for a utility to ensure that rates charged by the utility are just and reasonable.²

While it is true that the Commission does have this discretion, it does not mean that applying a hypothetical capital structure is just and reasonable in this case. Applying a

¹ Post-Hearing Brief of Staff, pg. 21-22.

² *Id.*

hypothetical capital structure to every small water and sewer system with more than 75% debt without making a determination that it balances the needs of the utility and the customers is not a reasonable position for Staff to take. Staff's position that small water and sewer systems should be treated as having at least 25% equity may help to prop up a troubled system that has no equity and is need of cash flow. However, such treatment should only be approved by the Commission on a case-by-case basis. There is no evidence that this internal policy of Staff is just and reasonable to be applied automatically, especially where Staff's actual capital structure calculation of more than 75% debt differs from the calculations of other parties. Staff's internal policy to automatically apply a 75% debt and 25% equity capital structure may actually be detrimental to the utility, as in this case where both Public Counsel and Lake Region calculate an actual capital structure that exceeds 25% equity. This is not just and reasonable.

Staff states it does not want to ignore the extremely leveraged state by allowing an equity ratio that is not consistent with how the company is truly capitalized because doing so would encourage companies to take on too much financial risk to attempt to achieve higher returns – putting the utility, and in turn the customers to whom it provides service, at a greater risk.³ But in reality, Staff's proposal would result in just that encouragement. Allowing a company to have its debt ratio limited to 75% would protect the company from any down-side to having a debt percentage above 75%. No matter what choices the company makes, Staff's policy will see to it that the company always has at least 25% equity on which to collect a return. Knowing Staff's policy will protect them, companies would be encouraged to take on higher financial risk – putting the utility, and in turn the customers to whom it provides service, at a greater risk. This is exactly what Staff says it fears. Therefore, it is not just and reasonable for the Commission to

³ Post-Hearing Brief of Staff, pg. 25.

support Staff's internal policy of automatically applying a hypothetical capital structure of 75% debt and 25% equity to Lake Region.

Based on Public Counsel's recommended availability fee adjustments, the inclusion of additional CIAC in the Shawnee Bend Sewer and Shawnee Bend Water rate bases is warranted. Therefore, at the end of the test year the rate bases of the three utilities consist of Horseshoe Bend Sewer - \$1,274,431, Shawnee Bend Sewer - \$0, and Shawnee Bend Water - \$752,941 for a total rate base of \$2,027,372. Since this rate base is supported by the Alterra Bank loan of \$1,396,731, Lake Region's actual capital structure at the end of the test year is 68.90% debt and 31.10% equity. Therefore, the Commission should order that that Lake Region's actual capital structure of 68.90% debt and 31.10% equity should be utilized in this case.

2. Return on Equity

It is Public Counsel's position that Lake Region's current Commission authorized return on equity of 8.50% be authorized again by the Commission in this case. In its Brief, Lake Region claims that Public Counsel provided no analysis that Lake Region's current return on equity of 8.50% is reasonably consistent with current market costs, or that it is reasonable, or that it will maintain Lake Region's financial integrity when the rates determined in this proceeding are in effect.⁴ Lake Region states that Public Counsel's argument is based on the fact that capital market costs have not increased since Lake Region's last rate case.⁵ That is correct. The capital markets haven't increased – they have actually declined. Lake Region claims there is no evidence that shows that the return on equity in the last rate case was based on Lake Region's

⁴ Post-Hearing Brief of Lake Region, pg. 55.

⁵ *Id.*.

current market cost of equity at that time.⁶ However as Lake Region points out, its last rate case was based on a global settlement.⁷ Lake Region itself agreed to the 8.50% return on equity so Lake Region must have been comfortable that its market cost of equity at that time would be sufficiently included. If 8.50% had been detrimental to Lake Region, logically Lake Region would not have agreed to that percentage. Just because higher numbers have been dangled in front of Lake Region by Staff, does not make 8.50% unreasonable. It just means that 8.50% is not as high as what Lake Region and its shareholders would like. But, 8.50% return on equity was reasonable in the last case and has been proven to be reasonable today to support Lake Region's financial integrity and access to capital markets.

It is Lake Region's position that the appropriate return on equity for Lake Region is 13.89% as recommended by Staff. Lake Region states that it found Staff's methodology to be reasonable because it was transparent and measured a fair return on equity based on an estimate of the utility's investment risk.⁸ And why wouldn't it when Staff's methodology produced returns that far exceed the returns that Lake Region's rates are currently based on. But, Staff's proposal has no basis in the reality that is Lake Region. Staff's 13.89% proposal is based on a hypothetical capital structure which does not exist and is not supported by the evidence.⁹ Since Staff seems to think that the 8.50% return on equity it agreed to in the past case is somehow not nearly enough today, Staff resorted to an extrapolation of returns for large publicly traded companies. However, Lake Region is not a large publicly traded company and has no resemblance to one. Lake Region is not publicly traded at all. But, that fact made absolutely no difference to Staff. Staff suspended reality and forged ahead with very little thought at all to the customers.

⁶ *Id.*

⁷ *Id.*

⁸ Post-Hearing Brief of Lake Region, pg. 51.

⁹ Staff Exhibit #3; Staff Exhibit #7; OPC Exhibit #4.

Staff's methodology is not just and reasonable and in no way represents the actual facts of Lake Region. While Lake Region may be categorized as a small utility, it has had no problems obtaining financing under its own name as evidenced by the recent financing case, Case No. WF-2013-0118. Nor is Lake Region operating under any undue financial or operational stress.¹⁰ For its size, Lake Region is a fairly strong well-run utility and any risks it may be encountering do not appear to be insurmountable.¹¹ Also the evidence shows that much of the risk that Lake Region faces is purely shareholder inflicted, not market driven.¹² Staff's methodology may be acceptable as a last resort if a reasonable return cannot be determined in any other way. However, Lake Region currently has a reasonable 8.50% authorized return which should be considered by the Commission before applying Staff's last-resort methodology.

From its Brief, it is clear that not even Lake Region is totally on-board with Staff's methodology.¹³ As a nod to the evidence of the actual capital structure presented by the other parties, Staff alternatively recommended a lower return on equity of 11.93% if the Commission accepts a less leveraged capital structure.¹⁴ But, Lake Region, who accepted Staff's methodology at a capital structure of 75% debt, calls Staff's methodology unreasonable at a capital structure of 60% debt.¹⁵ With visions of a return on equity of 13.89% in Lake Region's head, that is hardly surprising. That just shows it is not Staff's methodology that Lake Region supports, but the bottom line number of 13.89% return on equity. It is Lake Region's burden to prove that the return on equity it is proposing is just and reasonable. By only picking and choosing what it likes and doesn't like from Staff's calculations, and ignoring the fact that it has

¹⁰ Tr. Pg. 163.

¹¹ OPC Exhibit #4.

¹² *Id.*

¹³ Post-Hearing Brief of Lake Region, pg. 56.

¹⁴ Staff Exhibit #7.

¹⁵ Post-Hearing Brief of Lake Region, pg. 56.

done just fine (and even thrived) over the past several years at a return on equity of 8.50%, Lake Region has not met that burden.

Lake Region has not met its burden to prove that a change from its current 8.50% return on equity is just and reasonable. There is no evidence that Staff's recommended 13.89% return on equity, or even its 11.93% alternative return on equity recommendation, is a just and reasonable reflection of shareholder risk. The authorized return on equity of 8.50% as agreed to by all the parties in Lake Region's previous cases was reasonable then and continues to be reasonable today. Therefore, the Commission should authorize a continued 8.50% return on equity as just and reasonable in this case.

3. Availability Fees

It is Public Counsel's position that availability fees should be applied against rate base as contributions in aid of construction (CIAC). Specifically, Public Counsel recommends that the water system rate base at the end of the test year be reduced by the inclusion of additional CIAC in the amount of \$331,330, and that the sewer system rate base at the end of the test year be reduced by the inclusion of additional CIAC in the amount of \$705,843.

In its Brief, Lake Region claims that the Commission announced unequivocally that it would not assert jurisdiction over availability fees in future actions until and unless a formal rule was promulgated.¹⁶ Lake Region claims that since a formal rule was not promulgated, the Commission cannot now assert jurisdiction over availability fees.¹⁷ However, in Lake Region's last rate cases, the Commission actually did determine that it should assert jurisdiction over the availability fees associated with Lake Region:

¹⁶Post-Hearing Brief of Lake Region, pg. 13.

¹⁷ Post-Hearing Brief of Lake Region, pg. 7.

Because the utility had, at different intervals, direct use of or access to this revenue stream, and because the fees can be defined as a commodity falling under the definition of utility service, **the Commission concludes that it should assert jurisdiction over availability fees.**¹⁸ [emphasis added]

The Commission then determined that it would be unreasonable to utilize its jurisdiction to impute revenue to Lake Region based on the availability fees already collected:

After considering all of the possible revenue scenarios, the relevant law, and the Commission's prior policy and practice on ratemaking treatment of availability fees, the Commission determines that the substantial and competent evidence in the record as a whole supports the conclusion that it would be unjust and unreasonable to impute additional revenue to Lake Region derived from the availability fees already collected.¹⁹

However, the decision to not utilize its jurisdiction to impute revenue for Lake Region in no way negated the jurisdiction of the Commission entirely. The jurisdiction of the Commission is set out in RSMo §386.250. There is a nexus between the service provided by Lake Region and the availability fees. Lake Region provides a costly commodity, water and sewer availability, through the utility's plant and infrastructure for which undeveloped lot owners are required to pay. Therefore, this decision to assert jurisdiction over the availability fees was reasonable then and remains reasonable today.

Similarly, the Commission's decision to forego the time and expense of promulgating a rule, and instead deal with availability fees on a case-by-case basis in no way negated the jurisdiction of the Commission over those availability fees. Based on its statutory authority, the Commission has and does exert jurisdiction over availability fees, even without a formal rule specifically on availability fees. As Staff notes in its Brief, very few utilities charge availability fees and the facts are significantly different from case-to-case.²⁰ Ozark Shores, an affiliate company of Lake Region, charges availability fees which are added into the general revenue

¹⁸ Report and Order, *Lake Region Water & Sewer Company*, Case Nos. SR-2010-0110 and WR-2010-0111, pg. 103.

¹⁹ Report and Order, *Lake Region Water & Sewer Company*, Case Nos. SR-2010-0110 and WR-2010-0111, pg. 107.

²⁰ Post-Hearing Brief of Staff, pg. 12.

stream for use in determining Commission approved rates.²¹ Peaceful Valley also has availability fees in its Commission approved tariffs and collects the availability charges as general revenue to reserve access to its water service.²² Until recently, I.H. Utilities also had availability fees in its Commission approved tariffs and collected the availability fees as general revenue.²³ The Commission has properly applied its jurisdiction to deal with the issue of availability fees on a case-by-case basis for these utilities. Therefore, the Commission should continue to apply its jurisdiction in order to address the issue of availability fees connected to Lake Region.

Lake Region claims that the Commission lacks subject matter jurisdiction over the billing and collection of fees designed to recover the costs of a developer's investment in water and sewer assets that have been donated to a private utility; therefore, the Commission has no authority to consider Staff's or OPC's proposals concerning an allocation or application of such fees to Lake Region's operations in this case..²⁴ While that claim is highly debatable, the Commission most certainly has jurisdiction over Lake Region and the setting of just and reasonable rates which take into account costs that have already been recovered by the developer of Lake Region or by any other entity. If costs have already been recovered through another means, it is not just and reasonable to require customers to pay for those costs to be recovered a second time.

Lake Region claims that it does not charge availability fees and has no rights to the availability fees.²⁵ Lake Region states that to believe that Lake Region has rights to collect availability fee revenue is perfect fiction, and to adjust Lake Region's rates for service based on

²¹ Joint Stipulation of Undisputed Facts.

²² *Id.*

²³ *Id.*

²⁴ Post-Hearing Brief of Lake Region, pg. 31 & 33.

²⁵ Post-Hearing Brief of Lake Region, pg. 33.

a presumption that it has such rights is punitive.²⁶ Lake Region goes so far to say that to the extent the Commission may in fact, or constructively, classify the availability fee revenue as Company revenue, it takes the private property for public use without just compensation in violation of both the United States and the Missouri Constitutions.²⁷ But, the logical and expected results of a voluntary act do not equate to a Constitutional “taking.” The fact is that Lake Region had the right to those availability fee dollars and voluntarily gave them up for reasons known only to its shareholders.²⁸ Public Counsel’s analysis shows that during the calendar years of 1995 through 2013, approximately \$6.6 million of availability fees has been billed and/or collected.²⁹ Staff also estimates that currently the annual amount of availability fee revenues is \$93,136 for Shawnee Bend Water and \$139,704 for Shawnee Bend Sewer.³⁰ Both Lake Region and its shareholders had to know that removing such a significant amount of revenue dollars from the utility coffers would have punitive effects on the utility. Therefore, any punitive results of this voluntary act are completely self-inflicted – not a “taking”. It is not just and reasonable that the customers be required to pick up the pieces and pay for Lake Region’s and its shareholders’ highly questionable business decision.

Additionally, while it may be true that Lake Region (by its own action) has no right to the dollars connected with availability fees, **the reason for collecting the availability fees and what collecting the availability fees was to accomplish did not change.** Lake Region’s highly questionable business decision does not change the fact that availability fees remain a charge for services provided by Lake Region. The parties agree that the purpose for establishing the availability fees applicable to Lake Region’s service area was to recover the investment in the

²⁶ Post-Hearing Brief of Lake Region, pg. 42.

²⁷ Post-Hearing Brief of Lake Region, pg. 35.

²⁸ Joint Stipulation of Undisputed Facts.

²⁹ OPC Exhibit #4.

³⁰ Staff Exhibit #8.

water and sewer systems, not to maintain or repair the existing operations of the systems once they were constructed.³¹ Investment is not a one-time proposition connected only to the original development of Lake Region. Investment is an ongoing process for Lake Region in order to maintain a state-of-the-art system. The evidence shows that availability fees have been and will continue to be collected long after the original investment in Lake Region was recovered. Lake Region's rate base is overstated due to the fact that the full amount of availability fees collected from lot owners within the utility's jurisdictions has not been utilized to offset the cost of the original and subsequent plant investments made by the utility.³² If investment cost is being recovered through the availability fees, it is not just and reasonable for the rates of Lake Region's customers to be set so that investment cost is recovered a second time.

Lake Region points out that under the provisions of the current set of declarations of restrictions, the owners of the properties subject to the availability fee have the means through their property owners' association or independently to terminate the billing and collection of availability fees.³³ But, the Declaration states it is binding until January 15, 2015, after which it is automatically renewed unless 90% of the association lot owners vote to terminate the Declaration.³⁴ There is also no provision that states that once a certain amount of money is collected the availability fees will go away.³⁵ So, other than through gaining a 90% vote for complete termination of the Declaration, the undeveloped lot owners have no way of terminating the availability fees. Anyone would agree that 90% agreement is a huge hurdle to meet even in the best circumstances. But in this situation it will be especially hard to gain a 90% agreement to terminate the Declaration. Customers of Ozark Shores, an affiliate company of Lake Region, are

³¹ Joint Stipulation of Undisputed Facts.

³² OPC Exhibit #3.

³³ Post-Hearing Brief of Lake Region, pg. 33-34.

³⁴ Joint Stipulation of Undisputed Facts.

³⁵ *Id.*.

also members of the association and would vote as lot owners in any action to terminate the Declaration.³⁶ As developed lot owners, Ozark Shores' customers are not subject to paying availability fees. But, Ozark Shores' customers receive a benefit because availability fees are included as general revenue and used in determining their Commission approved utility rates.³⁷ It is highly unlikely that the customers of Ozark Shores will vote to forego this benefit. So the lot owners may have the means, but the likelihood is that availability fees will continue for the foreseeable future just as they were apparently intended.

Even if the billing and collection of availability fees were to be terminated in the future, that would not be an issue for Lake Region and the setting of just and reasonable rates. The termination of availability fees would be taken into account in Lake Region's next rate case. If the Commission accepts Public Counsel's position in this case and availability fees were to be later terminated, there would no longer be a need to reduce Lake Region's rate base to account for availability fees as CIAC. If investment cost was no longer being recovered through the availability fees, the rates of Lake Region's customers would then be set to recover that investment cost just as would be done for any system without CIAC. Even under Staff's proposal to impute revenue to Lake Region, if the availability fees were to be later terminated, Lake Region could just file a new rate case and show that the source of revenue from availability fees was no longer applicable. Lake Region's rates would then be set on its current revenue without imputing revenue from availability fees. Either way, normal ratemaking principals would still apply and just and reasonable rates would be set. Potential future termination of the availability fees is therefore not a stumbling block in the Commission accepting either Staff's or Public Counsel's positions in this case.

³⁶ *Id.*

³⁷ *Id.*

It is just and reasonable that the additional availability fees be included in rate base as additional CIAC paid by lot owners within the jurisdiction of the Lake Region. Therefore, the Commission should order that availability fees collected from owners of undeveloped lots in Lake Region's service territory should be applied against rate base to reduce the Shawnee Bend water system rate base at the end of the test year by the inclusion of additional CIAC in the amount of \$331,330, and to reduce the Shawnee Bend sewer system rate base at the end of the test year by the inclusion of additional CIAC in the amount of \$705,843.

In its Brief, Staff supports an alternative position that if the Commission decides not to impute availability fee revenue to Lake Region, then \$2,000 should be excluded from Lake Region's cost of service in recognition that costs associated with the billing and collection of availability fees should be excluded from Lake Region's cost of service.³⁸ Staff asserts that as availability fee billing for Lake Utility Availability 1 is performed by Ms. Goldsby, and as she is not paid by RPS Properties, her time spent on billing and collecting the availability fees should not be included in the cost of service that Lake Region's ratepayers ultimately pay.³⁹ Public Counsel wholeheartedly agrees and supports Staff's alternative position. Additionally, Public Counsel would ask the Commission to also exclude the \$2,000 from Lake Region's cost of service if the Commission decides not to accept Public Counsel's position that availability fees should be applied against rate base.

4. Legal Fees

It is Public Counsel's position that the test year and true-up legal fees for *Shawnee Bend Development Company, LLC v. Lake Region Water & Sewer* are a non-recurring, unreasonable

³⁸ Post-Hearing Brief of Staff, pg. 17-18.

³⁹ *Id.*

expense that should not be included in the calculation of rates for Lake Region. The evidence shows that all parties agree that the Shawnee Bend Development breach of contract legal costs are not a recurring cost and therefore, should not be included in rates as a normal yearly cost of service item.⁴⁰ Still, Lake Region claims that it acted justly in defending on appeal the trial court's favorable judgment entered in this case, therefore the legal costs should be included in customer rates.⁴¹ In its Brief, Staff states that the fact that the Company ultimately lost the case does not make the decision to proceed imprudent.⁴² However, "acting justly" and not acting "imprudently" does not transform these costs into reasonable costs for customers to bear in rates. Just and reasonable rates require that there be some benefit to the customer in exchange for the rates that they pay. For example a utility may "act justly," and "prudently" install larger plant than necessary to serve its current customers because it is cheaper and easier to do so while construction is going on, with the hopes that the plant will be used and useful for inclusion in rates in the near future. However, the costs for that additional plant are not just and reasonable to be put into rates until additional customers are added who then gain the benefit of that additional plant. It is not only the act of spending the money prudently that makes the costs just and reasonable to be included in rates. It is also the existence of a benefit to the customer. In this situation, Lake Region lost the legal case and therefore there was no benefit to the customers from these legal costs.

Both Lake Region and Staff discuss the why's and what-if's surrounding that legal action.⁴³ But, it makes no difference what could have happened if Lake Region had prevailed – it did not. Lake Region provided no evidence to show that the costs fighting this losing battle

⁴⁰ Staff Exhibit #12; Tr. Pg. 344.

⁴¹ Post-Hearing Brief of Lake Region, pg. 60.

⁴² Post-Hearing Brief of Staff, pg. 28.

⁴³ Post-Hearing Brief of Lake Region; Post-Hearing Brief of Staff.

were just and reasonable for customers to bear in their utility rates. This suit would not have been necessary if not for the actions of Lake Region in its dealings with Shawnee Bend Development Company. Customers have absolutely no say in the utility's decision making process regarding its contracts. The ability to meet (or in this case, breach) the terms of a contract is strictly based on the actions and business decisions of the utility and its shareholders. Lake Region provided no evidence to the contrary. It is just and reasonable that Lake Region and its shareholders bear the risks and the costs of these actions and decisions, not the customers.

The evidence shows that all parties agree that the Shawnee Bend Development breach of contract legal costs are not a recurring cost and therefore, should not be included in rates as a normal yearly cost of service item. Additionally, Lake Region did not meet its burden to prove that these legal costs are just and reasonable one-time costs in the provision of utility service to the customer. The evidence also shows the Appeals Court found, and the Missouri Supreme Court agreed, that Lake Region unreasonably and unlawfully breached its contract with Shawnee Bend Development. It is not reasonable to expect customers to pay these legal costs. Therefore, the Commission should find that the legal fees for *Shawnee Bend Development Company, LLC v. Lake Region Water & Sewer* are a non-recurring, unreasonable expense which should not be included in the calculation of rates for Lake Region.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, emailed or hand-delivered to the following this 7th day of April 2014:

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