

STATE OF NORTH CAROLINA
UTILITIES COMMISSION
RALEIGH

DOCKET NO. W-354, Sub 360

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

In the Matter of
Application by Carolina Water Service, Inc. of) BRIEF
North Carolina 4944 Parkway Plaza) OF THE
Boulevard, Suite 375, Charlotte, North) ATTORNEY
Carolina 28217, for Authority to Adjust and) GENERAL'S
Increase Rates for Water and Sewer Utility) OFFICE
Service in All of its Service Areas in North)
Carolina, Except Corolla Light and Monteray)
Shores Service Area)

The North Carolina Attorney General's Office ("AGO") respectfully submits this Brief in opposition to the application for a general rate increase filed by Carolina Water Service, Inc. of North Carolina ("Carolina Water" or the "Company") in the above-captioned docket. In this Brief, the AGO focuses on three issues with Carolina Water's rate increase proposal:

First, Carolina Water's proposal for a new rate adjustment mechanism based on changes in consumption is not authorized by statute and is unjustified;

Second, ratepayers should promptly enjoy the benefits of Carolina Water's cost savings resulting from recent changes in the federal tax law; and

Third, Carolina Water's proposed 10.8% to 11.2% range for rate of return on equity is unjustifiably high and adds nearly \$1.8 million to the annual cost of service unnecessarily.

- I. CAROLINA WATER'S PROPOSAL FOR A NEW RATE ADJUSTMENT MECHANISM BASED ON CHANGES IN CONSUMPTION IS NOT AUTHORIZED BY STATUTE AND IS UNJUSTIFIED.

Carolina Water proposes a new rate adjustment mechanism called the Consumption Adjustment Mechanism or "CAM" that would adjust rates outside of a general rate case to account for variations in consumption. Carolina Water claims that the mechanism is justified because it would minimize the revenue impact of variation in consumption. (Tr. Vol. 7, pp. 278-79) However, the proposed mechanism is not authorized by the ratemaking provisions in Chapter 62 and Carolina Water has not justified the approval of a non-statutory rider. Furthermore, the new rider harms consumers by increasing the frequency of changes to rates outside of a general rate proceeding, by shifting business risks from investors to users, and by discouraging water conservation efforts.

Legislation was introduced in the General Assembly in 2017 that – if adopted – would have authorized the creation of a rate adjustment mechanism for water and wastewater utilities based on changes in consumption – if the Commission should find such a mechanism to be in the public interest. However, the legislation was not enacted. (Tr. Vol. 7, pp. 312-13)

In light of the General Assembly's failure to authorize this rate adjustment mechanism, the Commission should reject Carolina Water's request that it approve such a mechanism anyway as an exercise of discretion. As the Public Staff noted, the Company's proposal asks the Commission to intervene and create a rate mechanism that the legislature declined to authorize. (Tr. Vol. 7, p.

313) ¹

North Carolina appellate courts have approved non-statutory riders in very limited circumstances that are not presented here. Cases upholding riders which adjust base rates outside of general rate cases have been limited to circumstances involving (1) highly variable and unpredictable expense or volume levels, (2) of significant magnitude, (3) that are beyond the control of the utility. *State ex rel. Util. Comm. v. Edmisten*, 291 N.C. 327, 230 S.E. 2d 651 (1976); *State ex rel. Util. Comm. v. Public Service Co.*, 35 N.C. App. 156, 241 S.E.2d 79 (1978); *See In re Public Service Company of North Carolina*, G-5, Sub 356, Order Approving Partial Rate Increase p. 11 (Sept. 25, 1996) (holding that absent extraordinary circumstances, current law does not allow riders). The evidence adduced in this case does not compel the new mechanism.

According to Mr. D'Ascendis, who testified for Carolina Water, there is not any statistically significant change in investor-required return before or after the implementation of such a "decoupling" mechanism (i.e. a rate adjustment mechanism for changes in consumption). (Tr. Vol. 7, pp. 108-109) There are many things affecting publicly traded companies, and this one factor is not measureable. *Id.*

¹ The AGO also opposes the Company's alternative proposal for a significant change in rate design that would shift more costs to the base monthly charge. Customers were not given notice of the alternative proposal and have opposed increases to base monthly charges. Such a shift in cost recovery is not justified and would have a discouraging impact on conservation efforts. Also see reasons discussed by Public Staff witness Casselberry at Tr. Vol. 7, p 315.

Nor is the new mechanism justified by extreme variability or trends, either. Witnesses for Carolina Water and the Public Staff did not agree about the significance of evidence regarding changes in consumption and whether the evidence indicates a problem of a magnitude requiring a new rate adjustment mechanism. (Tr. Vol. 8, pp. 9-11, 182-83) Public Staff witness Casselberry testified that a trend toward declining consumption is not well established at this point because not enough years of data are available for a valid comparison. (Tr. Vol. 8, p. 11) Further, she pointed out that the trend may level off as appliances that are more conservative in water use have been on the market for some time. (Tr. Vol. 8, p. 9) A late-filed exhibit that she prepared at the Commission's request indicates that average usage goes up and down and is not consistent in the direction of change when viewed by service area. See Casselberry Late Filed Exhibit No. 1.

Furthermore, the proposed mechanism is designed to make rate adjustments for changes in *per customer* consumption without consideration of other factors that tend to offset the impact, such as growth in the number of customers that Carolina Water serves. (Tr. Vol. 7, p. 314) Carolina Water is a growing company, and as it increases its customer count, its revenues collected in usage rates taking into account growth may fully offset any reduction in per-customer consumption. *Id.* Thus, any mechanism that boosts rates relating to changes in per-customer consumption should also credit customers for increased growth in customer count. (Tr. Vol 7, p. 314)

The CAM proposal would trigger a rate adjustment based on a collar: *i.e.*,

if the actual average monthly consumption per bill is higher than plus 1% or lower than minus 1% of the average monthly consumption established in the last rate case. Public Staff witness Casselberry expressed serious concerns about the proposed 1% threshold. She testified that a 1% variation could occur from a relatively small departure from normal habits, such as by shortening a daily shower by less than a minute. (Tr. Vol. 7, p. 3313)

Finally, contrary to Carolina Water's contention that the mechanism would balance the interests of the utility and consumers since it may result in upward or downward adjustments to rates, the new rider is harmful to consumers because it increases the frequency of changes to rates outside of general rate proceedings. In a general rate case, Carolina Water would be required to "net" all costs and benefits of operation at the time rates are set to take into consideration offsetting cost decreases as well as other offsetting factors. Instead, by authorizing changes in rates targeted to variations in per-customer consumption, the Commission would allow Carolina Water to shift normal business risk associated with a single factor from its investors to ratepayers. Carolina Water's incentives to actively manage costs and to operate efficiently in order to maximize the Company's return will be reduced if risks are shifted in that manner. Finally, consumers will tend to be discouraged from investing in water conservation measures if their efforts are met with an offsetting rate increase.

In sum, the new rate adjustment mechanism should be rejected because it is not authorized by statute, is not justified, and is harmful to consumers.

II. RATEPAYERS SHOULD PROMPTLY ENJOY THE BENEFITS OF CAROLINA WATER'S COST SAVINGS RESULTING FROM RECENT CHANGES IN THE FEDERAL TAX LAW.

Recent reductions in federal and state corporate income tax rates result in lower operating expenses for utilities, with a favorable impact on the cost of public utility service, and produce an excess accumulation of funds for deferred income taxes that may be returned to ratepayers. The Commission determined in a recent order in a generic proceeding that the issue of how to reflect the changes in federal tax rates in new utility rates would be determined for Carolina Water in this general rate case proceeding. See *Order Addressing the Impacts of the Federal Tax Cuts and Jobs Act on Public Utilities* in Docket No. M-100, Sub 148 issued 5 October 2018 at 69. The Attorney General supports rate adjustments to flow through the benefits of tax changes to ratepayers as soon as possible.

The changes in tax rates proposed by Carolina Water result in five impacts:

- First, the federal income tax rate reduction from 35% to 21% is reflected in the Company's proposed operating expenses.
- Second, the Company proposes *not* to return the amount of tax expense that was over-collected in rates from January 1, 2018 until new rates take effect.
- Third, the Company proposes that the return of excess accumulated deferred income taxes associated with the reduction in the *state* income tax rate be modified in this case and treated similarly to the Company's proposal for *unprotected* federal excess deferred taxes.
- Fourth, the Company proposes to use the *unprotected* excess accumulated deferred income taxes associated with the reduction in the federal income tax rate as an offset to existing deferred asset balances, instead of returning it to ratepayers.
- Fifth, Carolina Water proposes to return the *protected* excess deferred income taxes associated with the reduction in the federal income tax rate through rates over the period required by federal tax provisions, which it shows to be a 45-year period.

As discussed below, the AGO does not object to the First and Fifth impacts, but objects to the Second, Third, and Fourth.

First, the federal income tax rate reduction from 35% to 21% is reflected in the Company's proposed operating expenses. (Tr. Vol. 7, p. 285) This proposed impact is not disputed.

Second, the Company proposes *not* to return the amount of tax expense that was over-collected in rates from January 1, 2018 until new rates take effect. (Tr. Vol. 8, p. 178) That amount has been booked as a regulatory liability as required by the Commission's order in Docket No. M-100, Sub 148, and will amount to about \$1.26 million for the calendar year. (Tr. Vol. 7, p. 286) If not allowed to keep the amount as an addition to its profits during 2018, Carolina Water asks the Commission to allow the amount to be used as an offset by the Company to existing deferred asset balances. (Tr. Vol. 8, p. 178)

Carolina Water's argument that it should be allowed to keep the amount that was collected since January 1, 2018 lacks merit. The Commission considered arguments in its *5 October 2018 Order Addressing the Impacts of the Federal Tax Cuts and Jobs Act on Public Utilities* in Docket No. M-100, Sub 148, and concluded that it is "appropriate to require an immediate reduction in the base rates (for the expense piece) of affected utilities to reflect the 21% federal corporate income tax rate mandated by the Tax Act, *effective January 1, 2018.*" *Id* at 55-56 (emphasis added). The Commission explained that "the federal corporate income tax rate reduction mandated by the Tax Act is material and substantial," and concluded that "ratepayers should not be forced to continue

paying base rates that were set to recover a 35% federal corporate income tax rate that has been reduced to 21% until the utility's next general rate case proceeding." *Id.*

There is no justification for allowing Carolina Water to retain the amount collected after the tax rate change occurred on January 1 when the tax rate was reduced. The Public Staff has proposed that the amounts over-collected for taxes since January 1, 2018 be returned in a rider over a one-year period with carrying costs calculated using the weighted cost of capital approved in this case. (Tr. Vol. 8, p. 102) The AGO agrees with the Public Staff's proposal.

Third, the excess accumulated deferred income taxes associated with the change in the North Carolina income tax rate was addressed in the Company's last general rate case. (Tr. Vol. 7, p. 288) The Company proposed in rebuttal testimony that the return of state excess deferred income taxes be modified in this case and treated similarly to the Company's proposal for unprotected federal excess deferred taxes. (Tr. Vol. 8, p. 178)

The AGO does not support such a change and agrees with the recommendation from Public Staff witness Boswell that no adjustment be made to the provision for return of state excess deferred taxes from what was proposed and approved in prior rate cases. (Tr. Vol. 8, pp. 95-96, 101) The Company's vague proposal would offset the excess deferred state income taxes against either unknown future regulatory assets or known regulatory assets that have been reviewed and approved with particular treatment in previous cases, and it is not appropriate to override such prior determinations or to set aside ratepayer funds

for possible future uses. (Tr. Vol. 8, pp. 94-96).

Fourth, the Company's initial proposal was to return *unprotected* excess accumulated deferred income taxes associated with the reduction in the federal income tax rate to ratepayers over a 5-year period. (Tr. Vol. 7, p. 284). However, in rebuttal testimony the Company proposed instead that the money be used as an offset to existing deferred asset balances. (Tr. Vol. 8, pp. 179-180)

The AGO recommended a return of unprotected excess deferred taxes over a period of two years or less in the recent Duke Energy Carolinas rate case in Docket No. E-7, Sub 1146, so that ratepayers are able to benefit as soon as possible from the amounts they are owed.² Likewise, the AGO recommends a two year period in this case. The Public Staff proposal in this case would return the unprotected excess taxes over a three-year period, as was done under the settlement reached in the recent Aqua rate case. (Tr. Vol. 8, pp. 94, 101) However, Public Staff witness Boswell testified that, although the Public Staff has proposed a three-year period in this case, a two-year time frame is feasible and is within the range that the Public Staff has proposed in other cases. (Tr. Vol. 8, p. 104) The time frame has not been specified in the partial settlement in this case, and the AGO supports a return of the excess deferred taxes as soon as possible, but in no event longer than the two years -- because ratepayers will benefit immediately from the use of the amounts they are owed.

As to Carolina Water's proposal *not* to return unprotected excess deferred

² See Brief of the Attorney General's Office filed 27 April 2018 in Docket No. E-7, Sub 1146 at 141.

income taxes to ratepayers and instead apply the excess to unspecified asset balances, the proposal should be denied as it is unjust and unreasonable. It is inappropriate to override prior determinations about the amortization of regulatory assets. (Tr. Vol. 8, pp. 94-96) Further, Carolina Water has not shown that any harm will fall to customers by the prompt return of the funds, and it is time for Carolina Water to stop relying on excess revenues from its customers to maintain the overly flush cash flow that was provided under former tax deferral policies. The alternative of not returning dollars to consumers who struggle to pay their bills, or to consumers who would use their money for different purposes if given the opportunity, results in an undue burden on ratepayers and communities in North Carolina.

Fifth, Carolina Water proposes to return the *protected* excess deferred income taxes associated with the reduction in the federal income tax rate through rates over the period required by federal tax provisions, which it shows to be a 45-year period. (Tr. Vol. 8, p. 179) The Public Staff does not dispute the 45 year time frame based on its investigation, and explains that federal tax provisions do not permit regulators to flow back the excess deferred income taxes immediately and instead require a flow back that is ratable over the life of the timing differences that gave rise to the excess. (Tr. Vol. 8, p. 100) Based on the federal requirements and the Public Staff's investigation, the AGO does not object to this proposed impact.

III. CAROLINA WATER'S 10.8% TO 11.2% RANGE FOR THE RATE OF RETURN ON EQUITY RECOMMENDATION IS UNJUSTIFIABLY HIGH AND ADDS NEARLY \$2 MILLION TO THE ANNUAL COST OF SERVICE UNNECESSARILY.

Carolina Water requests a rate of return on equity ("ROE") of between 10.8% and 11.2% – an excessive rate that is substantially higher than the 9.6% ROE that Carolina Water stipulated to accept in the last general rate case.³ Carolina Water has not met its burden of proof that an ROE of between 10.8% and 11.2% fixes a reasonable return given the low cost of equity capital in current markets. Market data show that the 9.2% ROE recommended by the Public Staff is more than sufficient to attract the investment dollars needed for adequate service and is fairer when balancing the interests of investors and ratepayers. By adopting the ROE recommended by the Public Staff or finding that a lower ROE is supported by the Discounted Cash Flow studies performed by both expert witnesses, the Commission will provide Carolina Water an opportunity to achieve a reasonable rate of return for its investors but will not burden ratepayers by excessive rates, a result that will keep dollars in our local communities.

The impact of the ROE fixed in this case is significant. The difference between the Public Staff recommendation of 9.2% and Carolina Water's ROE recommendation amounts to approximately \$1.8 million per year, well over half of the total difference in the positions of the parties regarding Carolina Water's annual cost of service. See Settlement Ex. 1, p. 2 line 52.

³ See Order Approving Stipulation, Granting Partial Rate Increase, and Requiring Customer Notice in Docket No. W-354, Sub 356 (8 November 2017) ("2017 Rate Case Order") at 9.

North Carolina law requires the Commission to fix a rate of return that is fair to the utility's investors and its customers. N.C.G.S. § 62-133(a), § 62-133(b)(4). "Chapter 62's ROE provisions cannot be read in isolation as only protecting public utilities and their shareholders. Instead, it is clear that the Commission must take customer interests into account when making an ROE determination." *State ex rel. Utilities Comm'n v. Cooper*, 366 N.C. 484, 495, 739 S.E.2d 541, 548 (2013). The statutory intent is that the Commission should establish rates as low as possible, consistent with Constitutional requirements. *State ex rel. Utilities Comm'n v. Duke Power Co.*, 285 N.C. 377, 388, 206 S.E.2d 269, 276 (1974).

Two cases that explain the constitutional standard for rate of return are *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). The Court recognized that a fair ROE should be 1) comparable to the returns that investors expect on other investments of similar risk; 2) sufficient for assurance of confidence in the company's financial integrity, and 3) adequate in order to maintain and support the company's credit and to attract capital. *Id.*

The burden of proof in the case is upon the utility to show that its proposed rates are just and reasonable. N.C.G.S. §§ 62-75; 62-134(a).

Support for fixing Carolina Water's ROE at or below 9.2% (as recommended by the Public Staff) is provided both by witness Hinton's economic studies, and also the Discounted Cash Flow ("DCF") study performed by Carolina

Water witness D'Ascendis. (Tr. Vol. 7, pp. 132, 147) Public Staff witness Hinton's DCF study produces a cost of equity of 8.2% to 9.2% with a central point estimate of 8.7% based on market data for comparable water utility investments. (Tr. Vol. 7, p. 147) Mr. D'Ascendis' DCF study produced a cost of equity of 9.10%, initially (Tr. Vol. 7, p. 32), and produced 9.15% when updated in his rebuttal testimony. D'Ascendis Rebuttal Exhibit No. 1 Schedule DWD-1R p 3. These results indicate that a rate of return on equity of 9.2% is more than sufficient under current market conditions.

Mr. D'Ascendis relied upon recent market data from Value Line, Yahoo, and other widely available publications used by investors to perform his DCF study. See D'Ascendis Direct Exhibit No. 1 Schedule DWD-3 p 1 and D'Ascendis Rebuttal Exhibit No. 1 Schedule DWD-1R p 3. He examined the "yield" to investors using market data about the dividend per share and recent stock prices of comparable companies to evaluate cash flow expectations. And he added a growth factor, which Mr. D'Ascendis measured based on data about the growth in projected earnings made by Value Line and other publications. (Tr. Vol. 7, pp. 32-33) The DCF study performed by Public Staff witness Hinton reached similar results, although the experts relied on different growth factors. (Tr. Vol. 7, pp. 32-33, 146-47)

Mr. D'Ascendis questioned the suitability of the DCF model as a measure of ROE at times when stock prices of companies are high relative to their book values. (Tr. Vol. 7, pp. 200, 226) However, he agreed that - if there is a good deal of confidence in a company and where the company is headed, at least relative

to the risks involved - that tends to produce a stock price that is higher than book value. (Tr. Vol. 7, p. 233) Similarly, those same factors correlate with a lower rate of return requirement for investors. Indeed, the DCF model uses widely available current market data, and provides a good indication of the ROE that investors find adequate.

As to the other models used by Mr. D'Ascendis, the Commission should not rely on his recommendations, based on the following concerns: (1) the record in this case demonstrates that Mr. D'Ascendis' recommendation can change quickly and sharply based on a few changes in assumptions⁴ (Tr. Vol. 7, p 184); and (2) Mr. D'Ascendis' track record in other cases of estimating the ROE; namely, according to a list provided by Mr. D'Ascendis, in eight of the ten cases⁵ in which he testified as to ROE, the authorized ROE agreed to by the utility was substantially lower than the ROE that Mr. D'Ascendis recommended in the case. (Tr. Vol. 7, pp. 221-22); see Public Staff D'Ascendis Direct Cross Examination Exhibit 2.⁶ In fact, the authorized ROE was substantially lower than the bottom of the range that Mr. D'Ascendis recommended. *Id.*

In short, the DCF results produced by expert witnesses for Carolina Water

⁴ See the results of the Risk Premium, Capital Asset Pricing, and Non-Price Regulated Companies Models in D'Ascendis Direct Exhibit No. 1 Schedule DWD-1 p 2 and compare the changes filed approximately one month later in D'Ascendis Rebuttal Exhibit No. 1 Schedule DWD-1R p 2.

⁵ In the other two cases, the ROE was not identified. See Public Staff D'Ascendis Direct Cross Examination Exhibit 2.

⁶ In this case, the ROE was not settled, but just one year ago, Carolina Water accepted an ROE of 9.6%, much lower than the ROE than Mr. D'Ascendis recommends.

and the Public Staff show that a 9.2% ROE is more than sufficient to attract the investment dollars needed for adequate service. By approving a rate no higher than 9.2%, the Commission will have a substantial and beneficial impact on cost of service.

Respectfully submitted this the 27th day of November, 2018.

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CERTIFICATE OF SERVICE

The undersigned certifies that she has served a copy of the foregoing BRIEF OF THE ATTORNEY GENERAL'S OFFICE upon the parties of record in this proceeding by email, this the 27th day of November, 2018.

/s/
Margaret A. Force
Assistant Attorney General