NORTH CAROLINA UTILITIES COMMISSION
RALEIGH

DOCKET NO. W-1300, SUB 60

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

IN THE MATTER OF:
APPLICATION BY OLD NORTH STATE WATER COMPANY, LLC FOR AUTHORITY TO ADJUST AND INCREASE RATES FOR PROVIDING WATER UTILITY SERVICE IN ALL ITS SERVICE AREAS IN NORTH CAROLINA

PRE-FILED REBUTTAL TESTIMONY

OF

JOHN MCDONALD

ON BEHALF OF

OLD NORTH STATE WATER COMPANY, LLC

February 22, 2022

Q. PLEASE STATE FOR THE RECORD YOUR NAME, POSITION WITH OLD NORTH STATE WATER COMPANY, LLC, AND YOUR BUSINESS ADDRESS.

A. My name is John McDonald, and I am the Managing Member of Old North State Water Company, LLC (ONSWC or Company). My business address is 3212 6th Avenue South, Suite 200, Birmingham, AL 35222.

Q. HAVE YOU PREVIOUSLY PROVIDED TESTIMONY IN THIS PROCEEDING?

A. Yes, I filed direct testimony on June 29, 2021.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my rebuttal testimony is to respond to the following issues raised by the Public Staff: (1) water quality for certain systems; (2) separate rates for systems with purchased water; (3) a reduction in the base charge; (4) certain Public Staff concerns about the in-service dates of water systems and the billing of customers before Commission approval; (5) cost of capital for ONSWC; (6) change in the actual capital structure for ONSWC; and (7) the appropriate method for calculating whether a refund to customers is owed in regard to temporary rates. Other issues are addressed in the rebuttal testimony of ONSWC witness Laurie Oakman.

Q. WHAT IS YOUR RESPONSE TO THE TESTIMONY OF WITNESS JUNIS ON WATER QUALITY AND SERVICE?

A. After reviewing customer statements and North Carolina Department of Environmental Quality (DEQ) records, Public Staff witness Junis first concludes that ONSWC water quality generally meets the standards of the Safe Drinking Water Act and is satisfactory; however, there have been instances of deficient monitoring frequency, reporting, and public notice of water quality issues. He notes that with the termination of the previous contract operations firm, and replacement with direct operations employees beginning in October of 2020, ONSWC has seen a significant decrease in water quality complaints.

I believe this is a fair conclusion. There have been past issues with water quality, partly due to high levels of manganese and iron in the groundwater where our wells are located, and partly because the former contract operations firm did not perform up to expectations. I am committed to making ONSWC responsive to any ongoing and future concerns regarding water quality and service quality. In fact, ONSWC has installed green sand filters on one system, Twin Lake Farm, sequestration on a second system, Blaney Farms, and has completed engineering for sequestration for a third system, Brook Meadows. Construction will follow shortly. We worked with the developer at Fish Hawk to correct the water quality by installing a third Hydrus 36"x72" Iron and Manganese filter. We continue to monitor water quality in these systems to ensure a high level of water quality. ONSWC anticipates a radiological filtration system at Olde Mill Trace will be required and we have

completed engineering and are working on a cost sharing agreement with the developer to install those filters when the water quality threshold is crossed. Last, we have engineered and are waiting on construction to interconnect two water systems - Avalyn and Kingston Manor - to alleviate low pressure issues. To show the results of ONSWC efforts, I agree with witness Junis' recommendation that ONSWC file at least a year of quarterly reports "including, if applicable, a customer complaint log, water quality testing analysis results, and a description of actions the Company has taken and/or planned that provide updates on the water quality issues described by customers in the Fish Hawk Ranch, Olde Mill Trace, and Blaney Farms systems."

Q. WHAT IS YOUR RESPONSE TO THE TESTIMONY OF WITNESS JUNIS ON PURCHASED WATER RATES?

A. ONSWC initially proposed uniform rates for all its North Carolina water systems. This approach will simplify rate proceedings, compared to having separate rate cases or a single rate case with separate calculations for every system. It will reduce the risks of a small system shouldering very large costs for capital improvements, as uniform rates act like an insurance pool by spreading such costs across all systems. I believe these benefits can still be achieved while accepting the recommendation of witness Junis to allow adjustment of rates through the North Carolina statute that provides for expedited proceedings to pass through the rate

increases of third-party suppliers of purchased water. The recommendation of witness Junis applies to the Blawell system, for which ONSWC purchases water from the Town of Stedman, and the Rocklyn system, for which ONSWC purchases water from the City of Winston-Salem. ONSWC agrees to modification of its requested rate structure so that the new rates will be uniform, except that going forward the Company will be able to seek pass-through rate increases for purchased water for the Blawell and Rocklyn systems.

Q. WHAT IS YOUR RESPONSE TO THE TESTIMONY OF WITNESS JUNIS ON THE RATIO OF BASE CHARGE TO USAGE CHARGE?

A. The ONSWC application proposes a base charge of $27.00 per residential customer per month. Most of the present monthly base (fixed) charges are $15.00, with higher base charges at nine systems, ranging up to $34.14. Witness Junis observes that the present rates have a base charge to usage (variable) charge ratio of 37.25% / 62.75%, and the rates proposed in the ONSWC application would have a ratio of 37.47% / 62.53%. In other words, the Company's proposed rate structure comes close to preserving the ratio of the present rate structure.

Ms. Oakman informs me that when consumption is corrected for an error in our original numbers, the base to usage ratios are: 39.34% base and 60.66% usage under current rates, and 38.94% base and 61.06% usage under the rates we now propose.

Witness Junis recommends a ratio of 30% base charge to 70% usage charge. His reasons are that a lower base charge improves access to water service for customers before they use any water, which I interpret as meaning it improves affordability for customers who use less than average consumption. The other reason advanced by witness Junis is that a lower base charge allows customers to have greater control over their bills by implementing conservation.

I disagree with the Public Staff's recommendation. The ONSWC level of base rate will provide greater revenue stability. This helps the Company with cash flow, which in turn makes it easier to cover regular expenses. At the same time a relatively higher base rate means the customers have less volatility in their monthly bills.

Nor is there anything in the testimony of witness Junis to indicate his lower base charge would move toward better cost causation in rates. By that, I mean a principle of utility ratemaking is that rates should reflect the source of the costs, so that fixed costs that are incurred regardless of usage should be recovered in fixed charges. There is not likely to be a perfect match of fixed charges to fixed costs, and I do not have a cost-of-service study for ONSWC, but in the absence of that information there is no good reason to force the Company to make a major change in the fixed charge ratio it has maintained for years.

Additionally, his water conservation reason would not be very effective. First, there are better tools to encourage conservation, such as irrigation rates and higher rates during times of water shortages such as summer months or droughts. Second, if conservation did increase as a result of setting usage rates to a higher percentage compared to base rates – and that is an open question – then the result would be to reduce ONSWC revenues. Reduced revenues will increase the financial pressure for the next rate case to be filed sooner, and a rate increase would counteract witness Junis' goal of more affordability and control over water bills. Conservation rates should be targeted to the types of usage that are particularly wasteful or that create service problems, not this broad-brush approach that loads more cost recovery into usage rates regardless of the type of usage.

Finally, I note that the base charge approved for most of the water systems owned by Aqua North Carolina is $20.70 per month, as approved in the order dated October 26, 2020, in Docket No. W-218, Sub 526. The base charge stipulated by Carolina Water Service and the Public Staff in Docket No. W-354, Sub 384, on January 3, 2022, is $24.53. These base charges are in between the present and proposed rates of ONSWC, and before making a substantial change in the ratio of base charge to usage charge, it would be best to wait the outcome of Docket No. W-100, Sub 59, which is cited in witness Junis' testimony and which is a more comprehensive review of water company rate design than the testimony in this case.

Q. WHAT IS YOUR RESPONSE TO CONCERNS RAISED BY WITNESS JUNIS ABOUT IN-SERVICE DATES AND THE BILLING OF CUSTOMERS BEFORE COMMISSION APPROVAL?

A. These concerns are raised in pages 21-25 of witness Junis' testimony. His page 23 items 5, 6, and 7 are addressed by Ms. Oakman in her testimony. With regard to the other listed items from witness Junis, he notes that for some water systems, ONSWC has departed from using the Commission's approval of a Certificate of Public Convenience and Necessity (CPCN) or recognition of contiguous extension as the in-service date. These exceptions occur because, as a practical matter, the systems were "used and useful" prior to the CPCN or recognition of contiguous extension dates. By using the earlier date, the Company is not only reflecting the in-service date more accurately in those particular circumstances, but it also benefits customers because depreciation starts earlier so there is less rate base in the present proceeding.

There was discussion between the Public Staff and ONSWC about what dates would be most appropriate to use as in-service dates. Attached as McDonald Rebuttal Exhibit 1 is a spreadsheet that ONSWC sent to the Public Staff on February 4, 2022, setting out relevant dates and offering to use earlier dates as "in-service" dates. ONSWC has provided the Public Staff with the best information it has on the in-service date possibilities and has accommodated Public Staff efforts

to push those in-service dates to earlier points in time before water was actually being "used" (delivered to) customers.

Witness Junis also observes that ONSWC billed customers "in the formerly pending systems" for some months before receiving CPCN approval or contiguous extension recognition.

My first response is that ONSWC has no desire to ignore the North Carolina utility laws and the Commission's rules and authority. I understand that Commission approval is legally required prior to charging rates, and I commit to compliance in the future.

My second response is that the "formerly pending systems" involved extraordinary circumstances. As shown on McDonald Rebuttal Exhibit 2, there was a considerable lag between the dates when ONSWC applied for the CPCNs or contiguous extension and the dates when they were approved. These applications did not appear on the agenda for Commission staff conference very promptly, and meanwhile the customers needed water service. The customers were not charged more for water than the rates ultimately approved, so they have received fair value for their utility payments. The situation the Company faced was to either (1) not provide customers with water until Commission approval, which would have been a disaster; or (2) provide water without billing, which would mean operating at a loss for months or years because the Company's applications were not being acted

upon; or (3) provide water with billing and hope for swift action on the applications. In this situation, there were no good choices.

Q. WHAT RECOMMENDATIONS DOES PUBLIC STAFF WITNESS HINTON MAKE ON THE COST OF CAPITAL?

A. The Public Staff recommends a cost of debt of 4.6%, a cost of equity of 9.4%, an imputed debt/equity ratio of 50% / 50%, and thus a weighted average cost of capital of 7.00%. Witness Hinton also proposes an alternative in the event that ONSWC does not change its actual capital structure to 50% equity and 50% debt by the date of the evidentiary hearing. The alternative would set rates based on a cost of debt of 6%, a cost of equity of 9.4%, and an actual capital structure of 89.63% debt and 10.37% equity, which would result in a punitive weighted average cost of capital of 6.35%. For comparison, the application of ONSWC requests an 83% debt ratio at a cost rate of 7.34%, and a 17% equity ratio at a return rate of 9.75%, resulting in an overall return (or weighted average cost of capital) of 7.75%

Q. WHAT IS YOUR RESPONSE TO THE TESTIMONY OF WITNESS HINTON ON THE COST OF CAPITAL?

A. The Public Staff recommendations are unfair and unreasonable. However, I do agree with use of a hypothetical capital structure of 50% debt and 50% equity for ratemaking purposes. While the primary need for ONSWC is a fair and reasonable weighted average cost of capital, it appears that use of a hypothetical capital

structure for ratemaking, and the associated costs of debt and equity, can lead to more consistent outcomes across regulated utilities in North Carolina. For instance, the most recent cost of capital for Aqua North Carolina (Aqua) (Docket No. W-218, Sub 526; decided on October 26, 2020) and Carolina Water Service (CWS) (Docket No. W-354, Sub 384; settlement filed on January 3, 2022) both have a debt/equity ratio close to 50% / 50%. Both cases present a rate of return on equity of 9.4%, and their different overall returns are mainly a function of different costs of debt.

My direct testimony relied on the return on equity from earlier Aqua and CWS cases. I acknowledge that the regulatory rate of return on equity has decreased since then. The most recent water/sewer case I am aware of is that of CWS in Docket No. W-354, Sub 384, where the Public Staff and the utility have stipulated to a 7.14% return on equity.

Q. WHAT IS THE BASIS FOR YOUR POSITION THAT THE PUBLIC STAFF'S RECOMMENDATION WOULD BE UNFAIR TO ONSWC?

A. The Public Staff recommendation of a 9.4% return on equity for ONSWC mirrors the results in the most recent Aqua and CWS cases. However, witness Hinton proposes a 4.6% cost of debt, which bears no relation to reality for ONSWC. He notes that ONSWC receives all its financing from its parent company, Integra, and that Integra has an actual a debt rate of 6.00%. The cost of debt is a known amount,

unlike estimates of a fair return on equity. The cost of debt is a function of when the debt was issued, as interest rates change from time to time, and the perceived risk to the creditor. ONSWC is a small company compared to CWS and Aqua and has a history of losses. It is therefore riskier for creditors and that means it should expect to pay a higher interest rate on debt. These same factors support a higher return on equity as well has higher debt costs for ONSWC in comparison to Aqua and CWS.

In my direct testimony, I proposed a cost of debt for ratemaking purposes that was higher than the actual cost. The intent was to back into an overall return that was comparable to the overall returns I found for a couple of other recent North Carolina water utility cases. Given my agreement in this rebuttal testimony with witness Hinton on the merits of a 50% / 50% capital structure for ratemaking purposes, and the ability to document actual debt costs, I believe the most appropriate response to the Public Staff position is to start with the 50% / 50% capital structure and actual cost of debt, then develop a rate of return on equity and overall rate of return after examining the most recent North Carolina water utility case, taking into consideration individual differences among the utilities.

Q. GIVEN THAT ONSWC HAS DEBT FROM ITS PARENT COMPANY, HOW DO YOU KNOW THE ACTUAL 6.00% COST OF DEBT IS REASONABLE AS OPPOSED TO EXPLOITATION BY THE OWNER?

A. First, this is an embedded cost of debt, with loans issued from Integra Water to ONSWC at a 6% interest rate so it is necessarily higher than current interest rates. Second, the CWS debt cost cited in witness Hinton's testimony is 5.36%, so it is reasonable that a smaller, riskier company like ONSWC would have a debt cost higher than that. Third, this February I asked a commercial banker at Regions Bank about financing for ONSWC. She stated that ONSWC would need a personal guarantee from me to obtain financing. The reason is their underwriting standards require a reliable secondary source of repayment because of the history of losses for the utility. Fourth, Integra could have provided a higher proportion of equity financing and been able to justify a rate of return on equity that is well above 6%, so 6% is favorable to the ratepayers compared to an equity alternative. For all these reasons, the 6.00% embedded cost of debt for ONSWC is reasonable.

Q. BASED ON THE CURRENT COST OF DEBT TO ONSWC, HOW DOES YOUR COST OF CAPITAL RECOMMENDATION COMPARE TO THAT OF THE PUBLIC STAFF?

A. As noted earlier, I agree with the use of a 50% / 50% capital structure for ratemaking purposes. The actual cost of debt is known and reasonable at 6.00%. Although I believe ONSWC is riskier for an investor than CWS and Aqua due to its lack of financing options outside of its parent company, and its small size, with a 50% / 50% hypothetical capital structure I believe it fair and reasonable to lower

the requested rate of return on equity to 9.4%, in line with CWS and Aqua. This would result in a weighted average cost of capital of 7.70%, which is a slight decrease from the original ONSWC request. An overall rate of return of 7.70% would be higher than the most recent CWS and Aqua cases, which is justified because the history of losses and very limited financing sources for ONSWC make it a materially riskier investment. In my opinion a 9.40% return on equity and 7.7% weighted average cost of capital is more reflective of the true cost of capital for ONSWC than the overall (weighted average) cost rates of 7.00% and 6.35% recommended by the Public Staff.

Q. WHAT IS YOUR RESPONSE TO THE PUBLIC STAFF RECOMMENDATION THAT INTEGRA BE ORDERED TO INFUSE ENOUGH ADDITIONAL CAPITAL TO REACH AN ACTUAL CAPITAL STRUCTURE OF 50% EQUITY AND 50% DEBT?

A. I strongly disagree with that recommendation. Integra has chosen to finance ONSWC primarily through debt for its own purposes. The end result for ONSWC is that it has obtained the financing it needs to fund safe, reliable utility service, and that is what should matter the most to ratepayers. Witness Hinton testifies that this high level of leveraging would make it hard to obtain outside financing. The fact is that outside financing is neither available as a practical matter, nor needed, for

ONSWC. Integra provides the debt and equity for ONSWC and has provided sufficient financing at a reasonable cost.

The Public Staff recommendation would force Integra to provide additional funding of approximately $4.1 million to ONSWC to achieve a 50% equity ratio. That assumes the additional equity would be used to retire enough debt to achieve a 50% / 50% capital structure. The infusion would be much more if the Public Staff is recommending infusion of enough equity to equal the current amount of debt. This equity funding is not needed. It would have a cost associated with it. My main objection, however, is that the Public Staff recommendation is an unwarranted intrusion into management decision-making. Because ONSWC is adequately financed at a reasonable cost, there is no justification for it to be ordered to change its actual financing practices. Ratemaking should be focused on what is fair and reasonable to both the utility and the ratepayers, and not turn into a takeover of the actual management function.

Q. ARE YOU AWARE OF ANY PRIOR CASES WHERE A UTILITY HAS BEEN ORDERED TO CHANGE ITS ACTUAL CAPITAL STRUCTURE?

A. No. Because this is such a novel concept to me, and I am not equipped to do in-depth utility regulation research, ONSWC asked the Public Staff in a data request to identify any dockets where the Public Staff had recommended that a utility change its actual capital structure, and to identify any dockets where the

Commission had ordered a utility to change its actual capital structure. While objecting to the data request as overly broad, the Public Staff replied that "upon information and belief, the Public Staff has not previously recommended that a utility be required to change its actual capital structure" and that "upon information and belief, the Public Staff is not aware of the Commission ordering a utility to change its actual capital structure."

Q. IS THERE A DIFFERENCE OF OPINION BETWEEN ONSWC AND THE PUBLIC STAFF REGARDING HOW TO DETERMINE IF REFUNDS ARE OWED FOR BILLS PAID UNDER TEMPORARY RATES?

A. It appears there is a difference. In the ONSWC motion for temporary rates, filed November 29, 2021, in this docket, the Company requested that it be approved to calculate possible refunds by filing "a comparison of bills at the average usage of 4,750 gallons per month in each rate classification under temporary rates and under the final rates." The Company further noted that "the Public Staff may recommend a comparison of bills under temporary rates to what the bills would have been under final rates for every individual customer for each month of the temporary rates."

Q. WHY DOES THE METHOD OF CALCULATING POSSIBLE REFUNDS MATTER TO ONSWC?

A. A separate bill comparison for every customer during the temporary rate period would be very burdensome and time-consuming. For 1,800 customers and three

months of bills, that would be 5,400 manual entries to make in a spreadsheet to do the calculation. Legal counsel advises that the statute places an upper limit of 20% on temporary rates for "any single rate classification." ONSWC presently has five different rates in effect and it is reasonable to interpret this as meaning the Company has five different rate classifications. A review of possible refunds by rate classification would be far more efficient than performing a billing calculation on every individual customer's bills. Moreover, counsel advises that it appears Aqua North Carolina determined by "rate division" rather than individual customer that no refunds were due on billings under temporary rates in Docket No. W-218, Sub 526. Upon information and belief, Aqua just compared its revenue requirement under interim rates with its revenue requirement under the final approved rates, concluded that no refunds were due, and the Public Staff accepted this approach. Similarly, legal counsel notes that the Commission approved refund evaluations for Duke Energy Carolinas and Duke Energy Progress in Docket Nos. E-7, Sub 1214, and E-2, Sub 1219, based on revenues by rate classes, not individual customer bills. ONSWC believes the approach used in the Aqua and Duke Energy cases would be appropriate for the ONSWC refund calculation. I do not believe the method proposed in the ONSWC motion for temporary rates is any better. The method the Public Staff stated it would propose is not consistent with the cases noted above and would create an unnecessary additional burden on ONSWC.

Q. IF APPROVED, WHAT WOULD BE THE IMPACT TO CUSTOMERS FROM THE COMPANY'S UPDATED RATE REQUEST?

A. Under the Company's updated proposal, a typical water residential customer using the corrected 4,984 average gallons/month as shown on Oakman Rebuttal Exhibit 2 would see an increase of approximately $21.70 per month compared to the rates in effect before the temporary increase. This would be about a 53% increase on average.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING PUBLIC STAFF TESTIMONY?

A. Yes. Public Staff witnesses refer to the possibility that they will file supplemental testimony. ONSWC asks that it be allowed to file rebuttal to the supplemental testimony if it contains adjustments or substantive positions that the Company does not agree with. It is only fair for the Commission to hear from both sides on disputed matters.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.