

**STATE OF NORTH CAROLINA  
UTILITIES COMMISSION  
RALEIGH  
DOCKET NO. W-218, Sub 497**

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

In the Matter of	)	
Application of Aqua North Carolina, Inc.,	)	BRIEF OF THE
202 MacKenan Court, Cary,	)	ATTORNEY GENERAL'S OFFICE
North Carolina 27511, for Authority	)	
to Adjust and Increase Rates for	)	
Water and Sewer Utility Service in	)	
all Service Areas in North Carolina	)	

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

First, Aqua'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 Aqua's cost savings resulting from recent changes in the federal tax law;

Third, Aqua's 10.8% rate of return on equity recommendation is unjustifiably high and adds nearly \$2 million to the annual cost of service unnecessarily;

Fourth, although Aqua has invested in infrastructure to improve quality of service, the assessment of civil penalties, Notices of Violations, and Notices of Deficiency received from 2016 to 2018 from the Department of Environmental Quality are evidence that Aqua is not consistently operating and maintaining its

systems in a reasonable and prudent manner in providing its services to its customers.

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

Aqua 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. Aqua claims that the mechanism is justified because it would minimize the impact of "significant" swings in per-customer consumption patterns. (Tr. Vol. 5, pp. 43-45) However, the proposed mechanism is not authorized by the ratemaking provisions in Chapter 62 and Aqua 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. (Becker AGO Direct Cross Examination Ex. 1/ Ex. Vol. 5, pp. 12-13).

In light of the General Assembly's failure to authorize this rate adjustment mechanism, the Commission should reject Aqua'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 *step in and allow* a rate mechanism that the legislature declined to authorize. (Tr. Vol. 12, p. 161)

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).

Aqua relies on a 2016 report on a study of Aqua North Carolina's water customers, performed by the Environmental Finance Center at the UNC School of Government, for support of the CAM proposal. The report indicated that there is a downward trend in average water use. According to Aqua, the report found there was initially a significant decline relative to test year consumption but usage stabilized more recently. (Tr. Vol. 5, p. 44) The variations in usage are considered "a hindrance" by Aqua to its ability to earn its allowed return on equity. (Tr. Vol. 5, p. 62) Such variations are not of a sufficient magnitude to justify an extraordinary rate mechanism.

Moreover, the 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 Aqua serves. (Tr. Vol. 5, pp. 45-46, 57) Aqua 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. (Tr. Vol. 12, p. 162)

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. Aqua contends that having the collar means that the mechanism would address only “significant” changes in per-customer consumption. However, Public Staff witness Junis questioned the significance of a 1% variation in average consumption, as a 1% change could occur from a relatively small departure from normal habits, such as by shortening a daily shower by less than a minute. (Tr. Vol. 12, p. 161)

Furthermore, the new rider harms consumers by increasing the frequency of changes to rates outside of general rate proceedings. In a general rate case, Aqua 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 Aqua to shift normal business risk associated with a single factor from its investors to ratepayers. Aqua’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 AQUA'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 Aqua 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 have five impacts on rates as proposed by Aqua or resolved by agreement between Aqua and the Public Staff:

1. Operating expenses will reflect the federal income tax rate reduction from 35% to 21%;
2. The amount of tax expense that was over-collected in rates from January 1, 2018 until new rates take effect will be returned to ratepayers as a bill credit over a period of one year;

3. The excess accumulated deferred income taxes associated with the change in the North Carolina income tax rate will be returned to ratepayers in a rider to rates over a 3-year period;
4. The *unprotected* excess accumulated deferred income taxes associated with the reduction in the federal income tax rate will be returned to ratepayers in a rider to rates over a 3-year period; and
5. The *protected* excess deferred income taxes associated with the reduction in the federal income tax rate will be returned to ratepayers in rates over a period of 20 plus years reflecting the period required by federal tax provisions.

See Partial Settlement Agreement and Stipulation filed 17 September 2018 at 9.

The AGO supports the prompt adjustment of rates to reflect the tax reductions both through the reduction in operating expenses and the return of excess deferred income taxes. In the recent Duke Energy Carolinas rate case in Docket No. E-7, Sub 1146, the AGO recommended a return of excess deferred taxes over a period of two years or less, so that ratepayers are able to benefit as soon as possible from the amounts they are owed.<sup>1</sup> Although two years is preferable, in light of the resolution of the issue as proposed by Aqua and the Public Staff, the Attorney General does not oppose the return of excess deferred taxes over a three-year period under the circumstances of this case.

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<sup>1</sup> See Brief of the Attorney General's Office filed 27 April 2018 in Docket No. E-7, Sub 1146 at 141.

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

Aqua requests a 10.8% rate of return on equity ("ROE) – an excessive rate that is substantially higher than the 9.75% ROE that Aqua stipulated to accept in the last general rate case.<sup>2</sup> Aqua has not met its burden of proof that a 10.8% ROE 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 Aqua 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 Aqua's 10.8% ROE recommendation amounts to approximately \$1.9 million per year, almost half of the difference in the positions of the parties regarding Aqua's annual cost of service. See Settlement Ex. 1, p. 1 line 39 and p. 2 line 56.

North Carolina law requires the Commission to fix a rate of return that is

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<sup>2</sup> See Order Granting Partial Rate Increase, Approving Rate Adjustment Mechanism, and Requiring Customer Notice in Docket No. W-218, Sub 363 (2 May 2014) at 12-13.

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 Aqua'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 Aqua witness D'Ascendis. (Tr. Vol. 6, pp. 97-98, 187) 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. 6, p. 187) Mr. D'Ascendis' DCF study also produced similar results of 8.81% to 9.09%. (Tr. Vol. 6, pp. 97-98) 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. (Tr. Vol. 6, pp. 100-01) 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. 6, pp. 54-55) The DCF study performed by Public Staff witness Hinton reached similar results, although the experts relied on different growth factors. (Tr. Vol. 6, pp. 54-55, 186-87)

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. 6, p. 99) 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. 6, p. 109) Similarly, those same factors correlate with a lower rate of return requirement for investors.

In short, the DCF model is relied on by investors using widely available

current market data, and provides a good indication of the ROE that investors find adequate. The DCF results produced by expert witnesses for Aqua 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.

- IV. ALTHOUGH AQUA HAS INVESTED IN INFRASTRUCTURE TO IMPROVE QUALITY OF SERVICE, THE ASSESSMENT OF CIVIL PENALTIES, NOTICES OF VIOLATIONS, AND NOTICES OF DEFICIENCY RECEIVED FROM 2016 TO 2018 FROM THE DEPARTMENT OF ENVIRONMENTAL QUALITY ARE EVIDENCE THAT AQUA IS NOT CONSISTENTLY OPERATING AND MAINTAINING ITS SYSTEMS IN A REASONABLE AND PRUDENT MANNER IN PROVIDING ITS SERVICES TO ITS CUSTOMERS.

One of the concerns that the AGO expressed in opposition to the creation of the WISC/SISC rate adjustment mechanism<sup>3</sup> in Aqua's last general rate case was that such mechanisms have the potential to improperly distort Aqua's business or investment decisions.<sup>4</sup> The special treatment of certain costs - such as the speeding up of cost recovery for investments in costly water treatment systems - can tend to discourage attention to and spending on projects or expense items that are efficient and economical but not eligible for the favorable accelerated rate recovery. Unfortunately, there is evidence in this case that - even while Aqua is making strides to address water quality issues by making sizeable investments in infrastructure that qualifies for the WISC rate mechanism - the Company has had problems with consistently operating and maintaining its

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<sup>3</sup> WISC/SISC stands for Water/Sewer System Improvement Charges.

<sup>4</sup> Attorney General's Brief filed 5 March 2014 in Docket No. W-218, Sub 363 at 14.

systems in a reasonable and prudent manner in providing its services to its customers.

Since Aqua's last general rate case, it has incurred civil penalties in the total amount of \$217,366.47 for ten Notices of Violations by the Division of Water Resources at three of its Waste Water Treatment Plants. (Becker AGO Direct Cross Exs. 2, 3, 4/Ex. Vol. 5, pp. 14-95) Aqua's Hawthorne Subdivision Waste Water Treatment Plant received a penalty assessment of \$93,640.39 for four separate release incidents of the unauthorized discharge of sludge into the Upper Barton Creek which drains to Falls Lake in the Neuse River Basin. Those release incidents occurred on December 25, 2016, January 31, March 8-9, and April 7, 2017. (Becker AGO Direct Cross Ex. 4/Ex. Vol. 5, p. 58) The clean-up for these sludge release incidents included the pumping from the stream in February of 9,496 gallons of sludge and water per day for twelve days using two employees each day and four employees on two of those days; in March, Aqua pumped 9,240 gallons of sludge and water from the stream for four days using two employees each day; and in April, a third party reported pumping approximately 7,500 gallons of water, including solids from the stream. (Becker AGO Direct Cross Ex. 4/Ex. Vol. 5, pp. 67-68, 70)

Aqua's Cole Park Plaza Shopping Center Waste Water Treatment Plant received a penalty assessment of \$82,551.08 for four separate incidents of permit and monitoring violations which occurred in August, September, and October 2016. (Becker AGO Direct Cross Ex. 2/Ex. Vol. 5, p. 14) The largest part of the penalty of \$61,000 was incurred "for 132 violations of NPDES (National Pollutant

Discharge Elimination System) Permit NC0051314 ... for failing from September 22, 2016 to February 1, 2017 to properly operate and maintain at all times all facilities and systems of treatment and control” used to achieve compliance with the conditions of the permit. (Becker AGO Direct Cross Ex. 2/Ex. Vol. 5, p. 29) In its response, Aqua determined that “equipment failure” was the predominate cause of the non-compliance during the month of August, and that it “believed that poor filter media performance was the cause of the elevated fecal counts in October and November 2016.” (Becker AGO Direct Cross Ex. 2/Ex. Vol. 5, pp. 20-21)

Aqua’s Governors Club Waste Water Treatment Plant received a penalty assessment of \$41,175.00 for two separate violations of severe and evident odor and serious/loud noise conditions on February 10, February 16, March 23, and April 28, 2017. (Becker AGO Direct Cross Ex. 3/Ex. Vol. 5, p. 40) \$25,000 of the penalty amount was for Aqua’s failure “to take immediate corrective actions to abate the odor, noise and the structurally compromised equalization basin,” and \$15,000 of the penalty amount was for Aqua’s failure to “provide Noncompliance Notification of any process of unit failures ... that render the facility incapable of adequate wastewater treatment.” (Becker AGO Direct Cross Ex. 3/Ex. Vol. 5, p. 49) On April 5, 2017, the Division of Water Resources advised Aqua that “the equalization basin at the Governor’s Club is in danger of further failure(s)” and “[t]he current condition of [sic] equalization basin and your response that a new one will be online sometime during the fourth quarter of 2017 is NOT a satisfactory response.” (Becker AGO Direct Cross Ex. 3/Ex. Vol. 5, p. 53)

Since February 2016 to date, Aqua received 68 Notices of Deficiency from the Public Water Supply Section of the Department of Environmental Quality. These Notices of Deficiencies involved over fifty water systems and approximately 70 different wells with elevated concentrations of iron and manganese, with most reporting manganese above .3 milligrams per liter, a level that the U.S. Environmental Protection Agency Health Advisory suggests has the potential to impact the health of children. (Tr. Vol. 7, p. 63) Although twenty-six of the Notices of Deficiency have been resolved, forty-two are still outstanding, involving twenty-six water systems. (Tr. Vol. 7, p. 90; Crockett AGO Cross Ex. 1/Ex. Vol. 7, pp. 20-21)

This evidence of Aqua's non-compliance with environmental regulations, which laws were established for the purpose of protecting our citizens' health and welfare, as well as protecting our environment, indicates that Aqua is not consistently operating and maintaining its systems in a reasonable and prudent manner in providing its services to its customers.

Further evidence about problems in how Aqua systems are operated and maintained was provided in testimony from public witnesses. For example, Ms. Rebecca Daniel, who lives in Coachman's Trail, testified that water quality and reliability of service has been particularly poor in the past year, although Aqua has already installed a greensand filter for water treatment in her neighborhood at high cost. (Tr. Vol. 3, pp. 28-33) Ms. Melissa Mitchell, who also lives in Coachman's Trail, testified that she has lived in her residence since 1977 and never had an issue with water quality until after Aqua took over the ownership and operation of

the utility. (Tr. Vol. 3, p. 82) Mr. Robert Strazis, who lives in Barton's Creek Bluffs, testified that he bought his house in 2001 and Aqua bought out the utility from Heater Utilities in 2005. He began noticing problems with declining water quality in 2014 and the problems soon became very bad. (Tr. Vol. 3, pp. 138-139)

The evidence of problems with how Aqua operates and maintains its utility systems should be taken into consideration and weighed against Aqua when making a determination as to the adequacy of Aqua's service and the reasonableness of Aqua's requests to continue the WISC/SISC mechanism and add yet another rate adjustment mechanism.

Respectfully submitted this the 30<sup>th</sup> day of October, 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 30<sup>th</sup> day of October, 2018.

/s/  
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Assistant Attorney General