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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application)
of The Ohio-American Water Company)
to Increase Rates for water service) Case No. 79-1343-WW-AIR
provided to its Entire Service Area)

OPINION AND ORDER

The Commission, coming now to consider the above-entitled application filed pursuant to Section 4909.18, Revised Code; the exhibits filed with the application; the Staff Report of Investigation issued pursuant to Section 4909.19, Revised Code; the testimony and exhibits introduced into evidence at the public hearing commencing October 29, 1980 and concluding November 4, 1980; having appointed its Attorney Examiner William F. Brown, pursuant to Section 4909.18, Revised Code, to conduct the public hearing and to certify the record directly to the Commission; and being otherwise fully advised in the premises, hereby issues its Opinion and Order.

APPEARANCES:

Messrs. Bricker and Eckler, by Sally W. Bloomfield, 100 East Broad Street, Columbus, Ohio, on behalf of the applicant.

William J. Brown, Attorney General of Ohio, by Judith B. Sanders and Marsha Rockey Schermer, Assistant Attorneys General, on behalf of the Staff of the Public Utilities Commission of Ohio.

William A. Spratley, Consumers' Counsel, by Michael L. Haase and Richard P. Rosenberry, Associates Consumers' Counsel, 137 East State Street, Columbus, Ohio, on behalf of the Residential Customers of the Ohio-American Water Company.

Messrs. Bell and Clevenger, by Samuel C. Randazzo, 21 East State Street, Columbus, Ohio, on behalf of Intervenors Marion and Tiffin, Ohio, and Hopewell and Clinton Townships, Seneca County, Ohio.

HISTORY OF THE PROCEEDING:

The Ohio-American Water Company (hereinafter referred to as the Applicant or the Company), the Applicant in this case, is an Ohio corporation engaged in the business of providing water service to consumers within Ohio. The present entity is the result of the merger of The Ohio Cities Water Company and Ohio American Company into the Marion Water Company. The name of The Marion Water Company was changed to Ohio-American Water Company effective January 1, 1980. The merger and reorganization was approved by this Commission in Case No. 79-821-WW-AIS, November 21, 1979. Ohio-American Water Company is a subsidiary of American Water Works Company, which is a holding company with operating subsidiaries in twenty states.

Ohio-American Water Company consists of four divisions and they are: Ashtabula District, Lawrence County District, Marion District, and Tiffin District. With the exception of Lawrence County, the other three districts operate their own water treatment plants. The Lawrence County District purchases all of its water from the Huntington Water Company, Huntington, West Virginia, subsidiary of the American Water Works Company.

The rates currently in effect were approved by local ordinances or by this Commission at various times from April, 1974 to November, 1976.

On December 14, 1979 the Company filed its Notice of Intent to File an Application For an Increase in Rates, with a request to establish a date certain of June 30, 1979, and a test period for the twelve months beginning January 1, 1979, and ending December 31, 1979. The Commission approved the requested date certain and test year by Entry dated January 3, 1980. Subsequently, by Entry dated April 9, 1980, the Commission accepted the Company's application as of March 14, 1980.

In accordance with the provisions of Section 4909.19, Revised Code, the Staff of the Commission conducted an investigation of the matters set forth in the application. A written report of the results of the Staff's investigation was filed on August 18, 1980, and served as provided by law. Objections to the Staff Report were timely filed by the Company and the Intervenors.

On October 29, 1980, in accordance with the Commission's Entry of September 24, 1980, the public hearing of this matter commenced at the offices of the Commission, 375 South High Street, Columbus, Ohio. On the first day of hearing, Applicant submitted proof of publication made pursuant to Section 4909.19, Revised Code, and the Commission's prior entry, and members of the public were afforded the opportunity to make statements relative to the application. The hearing continued until November 4, 1980. At the conclusion of the hearing, the attorney examiner established a briefing schedule which called for briefs to be filed by all parties on December 2, 1980, with an optional reply brief on December 5, 1980. At the request of the Applicant, and with the agreement of the other parties, the examiner granted an extension of the briefing schedule to December 9, and December 12, 1980, respectively. The recorded transcript of the proceeding and the exhibits admitted in evidence have been certified to the Commission by the examiner for its consideration.

COMMISSION REVIEW AND DISCUSSION

This case comes before the Commission upon application of Ohio-American Water Company, filed under Section 4909.18, Revised Code, for authority to increase its rates and charges for water service to its jurisdictional customers. Applicant alleges that its existing rates are insufficient to afford it reasonable compensation for the service it renders, and seeks Commission approval of permanent rates which would yield approximately $1,324,904 in additional gross annual revenues, based on the company's test year operations as analyzed herein. It now falls to the Commission to examine the evidence of record in order to determine whether the existing rates are inadequate and, in the event of such a finding, to establish rates which will afford the applicant a reasonable opportunity to earn a fair rate of return.

RATE BASE

The Applicant, Staff and the OCC each offered testimony in support of its respective rate base proposal in this proceeding. The following table compares the Company and Staff estimates of property used and useful in providing service as of the date certain. The few adjustments proposed by the Staff and OCC will be discussed individually below.

JURISDICTIONAL RATE BASE

	Company[1]	Staff[2]
Plant in Service	$21,590,048	$21,478,567
Less: Depreciation Reserve	4,794,778	4,730,444
Net Plant in Service	16,795,270	16,748,123
Plus: Working Capital	506,166	283,471
Less: CIAC	384,855	357,296
Less: Other Items	-0-	-0-
Rate Base	16,916,581	16,126,623

1. Applicant's Schedule B-1
2. Staff Report, Schedule 7

Plant in Service

The plant in service is the surviving original cost of the plant that is used and useful in supplying water to its customers in Ashtabula, Marion, Tiffin, and Lawrence County, Ohio. The Staff excluded certain property from plant in service (Staff Report, Staff Ex. 1, pp. 10-11). Of these exclusions, the Company continues to object only to Account No. 310, 2 acres, Scioto River Intake. Additionally, the OCC objected to the inclusion of a water storage tank in the Marion District.

Scioto River Intake Property

After an on-site inspection of Scioto River Intake Property, Staff witness Coler testified that 2.0 acres, valued at $3,449, is surplus land. The parcel of land controls the Company's water rights to the Scioto River as well as supports the intake structures pumping and piping facilities. Mr. Coler further testified that the exclusion of the parcel "in no way known, deprives the Company control of the water rights, or could create any interference in the efficient operation of its present plant." (Staff Ex. 3, p. 3). Moreover, Mr. Coler stated that the area in which the land is situated is good farming land and there is nothing that he was aware of which precludes the Company from selling or leasing the land (Tr. IV, p. 143).

In his supplemental testimony, Company witness Edgemon stated, "this amount of property is necessary to operate and maintain the facilities and to provide for an adequate buffer area ... Furthermore, we see no practical way to dispose of the disallowed portion of the property." (Co. Ex. 4A, p. 7).

The Commission has previously recognized that there are a number of factors which must be considered in evaluating adjustments involving the elimination of minor portions of land parcels on the theory that the total acreage at a site is above that reasonably required to support a given installation [Ohio Edison Company, Case No. 78-1567-EL-AIR, et al., (January 30, 1980)]. In the recent Cleveland Electric Illuminating Company order, the Commission found the "critical evidence in this area to be the admissions of Applicant's own witness with respect to the Company's specific plans for the future use of much of the area excluded by the Staff" [Case No. 79-537-EL-AIR at p. 7 (July 10, 1980)]. Such is the state of the record in the instant matter. The Company witness did not propose a future use for the land, but stated the land would be needed

as a buffer or that the land was unmarketable. These two arguments have been rejected previously by the Commission, [Ohio Edison Company, Case No. 77-1249-EL-AIR, (November 17, 1978]. In view of Commission precedent and the record, we conclude that the amount associated with this exclusion should properly be assigned to Account 105 (Land Held for Future Use). Applicant's objection to the Staff adjustment should be overruled.

Marion District Water Tank

For the Marion District, the Applicant acquired an engineering depot from the U.S. Army in 1974. Included in this purchase was a water storage tank valued at $47,595*, which is included in the rate base. During the latter stage of discovery and during cross-examination of Company witness Edgemon, the OCC concluded that the tank was not used and useful as required by Section 4909.05, Revised Code and should be excluded from the rate base. However, since the OCC had not formally filed an objection to the inclusion of the water tank in rate base, the Staff objected when this topic was raised. The examiner overruled the Staff objection and admitted evidence regarding the tank.

The Ohio Supreme Court reviewed the actions of the hearing examiner and of the Commission in Office of Consumers' Counsel v. Public Utilities Commission, 56 Ohio St. 2d 220 (1978) and concluded that:

> In holding that pre-filed objections by a party are intended to present the issues to which evidence should be directed, and a party intervening solely by appearance may not, as a matter of right, broaden such issues, it does not follow that the Commission must woodenly confine the hearing to such issues regardless of circumstances, and that the Commission is without discretionary authority to allow development of additional issues it considers important. The scope of the Commission inquiry properly extends to any matter put in issue by the application and related to the rate changes under consideration. 56 Ohio St. 2d, at p. 227 (Emphasis by the Court).

In view of the record and the above cited case, the Commission agrees that the examiner properly included the issue of the water tower in the proceeding.

The evidence in the record clearly establishes that the tank is not being used by the Company, nor, at the date certain, was it useful. Company witness Harrison, when asked whether this tank had holes in it, claimed that even though it was currently not being used, that it could be used (Tr. II, p. 15). This testimony is a tacit admission that the tank is not used and useful and should be excluded from the rate base.

The remaining issue is the valuation of the tank. As stated above the OCC concluded that the amount in question is $47,595. However, the Applicant in its reply brief points out that this figure includes a reservoir, which had been

*OCC Brief p. 9

eliminated from rate base by the Staff. Excluding the reservoir leaves a tank cost of $29,000, and $21,230 depreciation expense associated therewith. This leaves a total of $7,770 in the rate base representing the undepreciated value of the Marion depot tank (Company Reply Brief, p. 6). After reviewing the record and the briefs, the Commission concludes that $7,770 is the proper figure to be deducted from the rate base for the water tank, which is not used and useful.

Working Capital

Section 4909.15(A)(1), Revised Code provides that a reasonable allowance for working capital should be included in the rate base valuation. The Staff computed its proposed allowance of $283,471 for this item by use of the formula approach as traditionally accepted by the Commission (Staff Ex. 1, p. 13, and Schedule 11). Basically the Consumers' Counsel allowance for working capital differs only slightly from that of the Staff. The first difference involves the position on expenses, discussed elsewhere, and the second difference is due to the Consumers' Counsel's contention that "the inclusion of FICA taxes as an offset to the cash component of working capital" should be made (OCC Ex. 1, A. 32). The Company in its request for a working capital allowance contended through Company witness Edgemon that the Commission should modify the one-eighth of adjusted operations and maintenance expenses component of the working capital formula. The Company argues that, because some of the customers are billed on a bi-monthly basis, an adjustment of one-fifth should be utilized in determining the operations and maintenance expenses for those revenues associated therewith. The Commission has had occasion to address, in detail, the issue of working capital in a number of its recent decisions. [see Dayton Power & Light Company, Case No. 78-92-EL-AIR, (March 9, 1979) and Columbus & Southern Ohio Electric Company, Case No. 77-545-EL-AIR, (March 31, 1978).] In its prior discussions the Commission has acknowledged that a properly conceived and developed lag study would produce the most reliable estimate of the appropriate working capital allowance, but has not encouraged that such studies be undertaken due to the expense and time involved in their preparation. However, the Company believes that the formula approach does not properly take into account the "timing difference between when expenses are incurred and payments are received" because of its bi-monthly billing procedures, it should have supported this claim with a properly conceived lead-lag study examining all timing differences. [Cleveland Electric Illuminating Company, Case No. 79-537-EL-AIR, p. 16 (July 10, 1980)]. Accordingly, the Commission will adopt the Staff's recommendation that the calculation of an allowance for working capital be made on the basis of the formula approach, incorporating a cash component of working capital composed of one-eighth of adjusted operations and maintenance expenses less one-fourth of adjusted operating taxes excluding FICA and deferred federal income taxes.

FICA Tax

Neither the Company nor the Staff included FICA taxes in the one-fourth tax offset to cash working capital. Consumers' Counsel contends that because the one-fourth tax offset is a composite representing a 90-day lead, a selective adjustment should not be made because the lead for particular taxes is slight. Once again the Commission will not adopt this selective adjustment to the working capital formula. The Commission in countless recent cases has held that selective adjustments to the working capital formula are unjustified unless a detailed study encompassing all factors affecting term cash needs has been undertaken. This Commission has recognized, as far back

as the decision in Columbus & Southern Electric Company, Case No. 77-545-EL-AIR (March 31, 1978), that the accruals for FICA taxes are largely unavailable to the Company to reduce its cash working capital requirement, and has consistently eliminated FICA taxes from the one-fourth tax offset. And we again conclude that the FICA taxes should not be included in the tax offset.

Rate Base Summary

In light of the foregoing discussion of rate base items the Commission finds the statutory rate base as of the date certain to be as follows:

Plant in Service	$21,478,567
Less: Depreciation Reserve	4,730,444
Net Plant in Service	16,740,353
Plus: Working Capital	345,796
Less: Contribution in Aid of Construction	357,296
Less: Other Items	547,675
Jurisdictional Rate Base	$16,181,178

OPERATING REVENUES AND EXPENSES

Operating Revenues

Total operating revenue for the Applicant is $6,112,188 as put forth in Schedule 2 of the Staff Report. The Company filed no objections in regard to operating revenue. Although the OCC did file an objection to this figure, in its brief it recommends the adoption of the test year revenues that were determined by the Staff.

Operating Expenses

The Applicant, the Staff, and the OCC each submitted an analysis of the test year expenses. Specific expense issues used will be discussed below individually.

Labor Expense Adjustment

In view of the remote test year, the Commission must determine what would be the proper adjustment to labor expenses to reflect increases in wages. The Staff recommends that the labor adjustment reflect only the annualization of 1979 actual wage increases as applied to test year labor costs. Additionally the Staff proposed to exclude the cost of overtime wages in its calculations. The Company requests that the labor expense be annualized to the date of the hearing. Previously, the Commission has set forth the standard for annualizing post-test year adjustments in a series of Columbia Gas of Ohio cases. These criteria are: (1) changes are known; (2) they represent fixed legal obligations beyond the control of the company; (3) they can be calculated with certainty which can be readily reconciled with test year analysis of accounts without raising significant questions of mismatching; and (4) a relatively remote test year is employed. Although the Staff did not propose making this post-test year labor adjustment, the Commission finds that it would be reasonable to employ this adjustment in this case. As the Commission has stated in the series of Columbia cases:

> That as long as a major goal of annualization is to create a representative picture of the cost which the utility will incur in the near term future, the recent verifiable, known and measurable data should be used.

[Columbia Gas Of Ohio Inc., Lorain, Case No. 78-1443-GA-CMR (April 30, 1980)]. Therefore, the Commission finds that it will adopt the calculation of those wage adjustments as provided by the Applicant in its Exhibit 5b.

An adjunct to labor expense is the issue of an adjustment for increases in overtime labor expense. Due to the nature of the service performed by a utility, and the fact that the service is provided 24 hours a day, a certain amount of overtime will occur each year.

The Commission has made an adjustment of this type in recent cases. In Dayton Power & Light Company, Case No. 79-372-GA-AIR (May 7, 1980), the Commission stated:

> As the Company has carried its burden in demonstating that the level of test year overtime benefits both the Company and customer, is reasonable, and can reasonably be expected to approximate the level of overtime in the period in which these rates will be in effect, the Commission will adopt the proposed annualization of overtime expenses to year-end levels.

at page 11.

Such is the situation here. The Company demonstrated that during this test period, if overtime hours of existing employees had not been paid it would have been necessary to hire two additional distribution crews in three districts, and, furthermore, because water production facilities are maintained on a twenty-four hour basis, more personnel would be required if the current staff were not able to work on a regular rotating basis which included overtime (Tr. II, p. 121). Actual overtime expenses for the test year were $32,146 (Co. Ex. 5-E). By its evidence, the Company has met the test of the Dayton case, supra, in establishing the levels of overtime and its benefit to both the Company and customers. The Commission will, therefore, approve the Company's proposed adjustment for overtime labor.

Unusual and Nonrepresentative Expenses

The Commission utilizes the test year period concept as a basis for setting new rates. The test year concept assumes that the test period expenses are reliable and representative of the time in which new rates will be in effect. [See also, Cleveland Electric Illuminating Company, Case No. 78-677-EL-AIR, p. 18, (May 2, 1979)]. At issue in this proceeding are four expenses which OCC contends should be classified as unusual expenses and hence not be included in the cost of service. They are: (1) Tank Inspection, $900; (2) Arbitration Proceedings, $7,300; (3) Settlement of a Legal Dispute, $1,200; and (4) Amortized Expense for Unusual-Winter-Related Expenditure for 1977.

In regard to the Tank Inspection, OCC witness Miller was under the impression that the $900 expense item was associated

with a tank painting inspection (OCC Ex. 1, p. 17). However, it was discovered upon cross-examination that the inspection was a result of suspected structural damage to a water tank owned by the Company in the Ashtabula District (Tr. II, pp. 133-134). Company witness Harrison stated that it is not the Company's practice to review on an annual basis its water storage tanks especially to the extent of engaging in outside consultants (Tr. II, p. 134). For this item the Commission finds that this is a non-recurring or representative expense and should not be included in the cost of service.

The Staff eliminated the test year portion of the Company's amortized expenses associated with the winter of 1977 on the basis that those expenses were abnormal and non-recurring. Except in exceedingly rare circumstances, the Staff contends that the test year concept should not be corrupted by the inclusion of out of period cost, particularly those costs which are abnormal and non-recurring (Staff Brief, p. 6). The Company's position on this is that it is an expense which recurs regularly and should be included in operating expenses. The record in this case indicates that the severe storm occurred in 1977 that generated the expense at issue and there have not been recurring storms of such a nature every year. Thus, the Commission can only conclude that this was an unusual and non-recurring expense and should be excluded from the cost of service of the Applicant.

With regard to the arbitration expenses and the legal dispute expense, the OCC also contends that these are non-recurring expenses and should be excluded from test year expenses. The record supports that the arbitration and legal fees in question here are not unusual and are representative of the expenses incurred every year by the Applicant. The record reflects that the Company employs union workers and that these contracts come up for renegotiation after one year. The record reflects that for the test year and for 1980 arbitration proceedings involving the Company and unions have taken place. Furthermore, it is certainly reasonable to believe that arbitration expenses will be incurred on a fairly regular basis. Likewise the $1,200 expense connected with the settling of a legal dispute appears to be reasonable and is the type of expense that could be expected to occur every year. The Applicant established that the Ohio-American Company incurs legal expenses every year, although they are not always for the identical type of dispute (Tr. II, p. 133). In view of the record, the Commission must conclude that the arbitration and legal expenses are normal and reoccurring and are properly included in the test year expenses of the Applicant.

Depreciation Expense Adjustment

In the rate base section of this Opinion and Order, an amount for a Marion water tank was deducted from rate base after it was shown that the tank was not used and useful. In light of the evidence which had been adduced regarding this water tank, OCC asked Staff witness Barrington to determine the amount of depreciation expense associated with that water tank and provide it for the record. Mr. Barrington did so and the first expense figure for this item was $1,197. Later Mr. Barrington revised this down to $386. In view of the deduction from rate base, the Commission will also make a corresponding adjustment to depreciation expense in the amount of $386. This would provide an appropriate matching of both rate base and expenses.

Social and Service Club Dues

The Staff Report did not make any adjustment for social and service club dues in this case, and the Company indicated

on Schedule C-6 that it did not include any social and service club dues in test year operating expenses. The Staff then, in response to an OCC objection, excluded an amount of $960 reflecting an additional $100 contribution to a charity and $860 for memberships in the Chamber of Commerce (OCC Ex. 1, p. 16); OCC Ex. 10; and Staff Ex. 5, p. 12 and Schedule 3.17). In support of the exclusions of these amounts associated with the Chamber of Commerce dues, the Staff called Mr. Said Hanna (Tr. II, p. 2). Mr. Hanna presented testimony explaining the rationale behind classifying Chamber of Commerce dues as a below-the-line-item in NARUC Account 426. Mr. Hanna explained that no expense should be granted due to the service nature of the Chamber of Commerce dues and distinguished it from trade associations, which are a normal business expense (Tr. IV, pp. 11-12). [See Dayton Power and Light, Case No. 79-510-EL-AIR (July 31, 1980) p. 25] The record reflects that no evidence has been presented by the Company in support of the donations and dues. Therefore, in view of the record, the Commission will disallow the $960 associated with these expenses from test year expenses.

Tank Painting Expenses

The Company included in its test year expenses those costs associated with the painting of tanks throughout its service area. The Company and the Staff agreed that the adjustment for an allowance for those costs is appropriate. The OCC contended that due to the method of amortizing the painting cost over the years of use relative to the rate case frequency, the expenses for tank painting were being recovered twice, or that the Company had used an improper trending method.

A review of the record indicates that there is no double recovery and further that the trending methodology used by the Company is appropriate. Staff witness Hanna testified, "The purpose of including an allowance for the tank painting in the cost of service for rate making purposes is to create a normal and representative cost that is usually and repeatedly incurred by water companies, not necessarily every year but every number of years." (Tr. IV, p. 9). The purpose of this allowance is normalization of cost for the determination of new rates. Once the new rates are in effect, no particular revenue dollar goes to a particular dollar of expense. The Staff is not treating tank-painting expenses as the creation of a reserve for future tank painting expenses (Tr. IV, p. 10). Initially, it appeared that the Company had expended a total of $83,485 in tank painting. However, this is not a complete figure but rather one which includes only the tank painting expenses from the Ashtabula and Lawrence Counties Districts (Tr. II, pp. 67-68). Company witness Harris testified that an additional expense of $27,185 was expended in the Marion District. Thus the record reflects that the Applicant has actually spent $110,670 for tank painting expenses, while having only collected $97,479 for this expense during the test year. Therefore, the Commission must conclude, after reviewing the record, that the tank painting expense itself is a reasonable and normal business expense and, further, that there is no double recovery on the part of the Company.

Rate Case Expense

The Company estimated its rate case expense to be $170,000 and proposed that it be amortized over a two-year period. The Staff accepted the expense figure and also eliminated prior rate case expense of $53,000. The OCC objects to the inclusion of rate case expense in general and in particular the size of the rate case for the Applicant herein. By late-filed exhibit, the Company states its updated rate case expense is $144,715.

The Commission has consistently held that the preparation, filing, and prosecution of a rate case is a normal and necessary feature of utility operation and, as such, must be recognized in the expenses allowed, Columbus & Southern Ohio Electric Company, Case No. 77-545-EL-AIR (March 31, 1978) and East Ohio Gas Company, Case No. 79-535-GA-AIR (July 9, 1980). In keeping with that principal, the Commission will permit the inclusion of a reasonable amount for rate case expense and permit it to be amortized over two years. The late-filed Company exhibit for rate case expense lists the expense at $144,715 as opposed to the originally proposed expense of $170,000. Accordingly, the Commission finds that the reasonable rate case expense to be $144,715 amortized over two years.

Operating Income Summary

Upon review of the record pertinent to this subject and consistent with the foregoing discussion, the Commission finds Applicant's jurisdictional operating revenues and expenses for the test year to be as set forth in the following schedule:

Operating Revenues	$6,769,193
Operating Expenses	
Operation and Maintenance	3,659,178
Depreciation	375,182
Taxes Other than Income Tax	822,672
Federal Income Taxes	331,307
Purchased Water	118,076
Total Operating Expenses	5,306,415
Net Operating Income	1,462,778

PROPOSED INCOME

A comparison of jurisdictional test year operating revenue with allowable jurisdictional expenses indicates that under its present rates, the Applicant realized income available for fixed charges in the amount of $1,222,939 based on adjusted test year operations. Applying this dollar return to the jurisdictional rate base results in a rate of return of 6.95 percent under present rates. This rate of return is below that recommended as reasonable by the expert witnesses testifying on this subject. The Commission, therefore, finds that the Company's present rates are insufficient to provide it reasonable compensation and return for the water service rendered customers affected by this application. Rate relief is required.

Under the rates proposed by the Applicant, additional gross revenues of $1,324,904 would have been realized based on test year operations as analyzed herein. On a proforma basis, which assumes necessary expense adjustments calculated in a manner consistent with the Commission's findings, this increase in gross revenues would have yielded an increase in net operating income of $682,251, resulting in income available for fixed charges of $1,806,709. Applying this dollar return to the jurisdictional rate base results in a 11.17 percent rate of return. Although it is apparent that the present rates are inadequate, the increase proposed by the Company results in a rate of return in excess of that proposed as reasonable by both witnesses sponsoring rate of return recommendations. Thus, the Commission must examine these recommendations in order to determine a fair rate of return for purposes of establishing just and reasonable rates.

RATE OF RETURN

Two witness presented testimony on the rate of return issue. Company witness Dr. George A. Christy recommends an 11.05 percent rate of return (Applicant's Ex. 7A, Revised Appendix 9). Staff witness Jerry L. Wissman recommends a rate of return in the range of 9.04 to 9.29 percent (Staff Ex. 6, Table 1, p. 2).

The major dispute in this rate of return area revolves around the determination of which capital structure should be employed. The Applicant proposes that the Commission utilize only the Applicant's capital structure and not that of its parent in determining the cost of capital. Dr. Christy testified that, although the Applicant is a solely owned subsidiary of the American Water Works Company, Inc., the rate of return should be set to reflect only the capital of the subsidiary since it is the assets of the subsidiary which the investors consider when making their investment decision. Dr. Christy maintains that since 60 percent of Ohio American capital consists of the debt and preferred stock which the Applicant floats itself, the Staff should not have used the consolidated capital structure. Furthermore, Dr. Christy stated that the utilization of the parent, American Water Works Company, Inc., does not operate as a market determined measure of the actual cost of common equity to the subsidiary Ohio-American.

The Staff proposes the use of a consolidated capital structure of the parent company, American Water Works Company, Inc., in determining a fair rate of return for the Applicant. The Consumers' Counsel concurred that this was a proper capital structure to be utilized. A primary reason for the Staff to use the parent's capital structure to determine a fair rate of return for the subsidiary-applicant is that the Applicant is a fully owned subsidiary of the parent. The Staff strongly feels that the parent's capital structure should be used and Staff witness Wissman stated as follows:

> "The capital structure of any subsidiary is to a large degree subject to the discretion of the parent. The parent owns the equity of its subsidiary. Dividend payments from each subsidiary flow directly to the parent. The level of dividends required is not at the sole discretion of the subsidiary, as it would be if its equity were publicly held.
>
> The use of consolidated capital structure is consistent with the Staff's use of market measures and the determination of the cost of capital. Economically efficient capital budgeting by the parent company requires that the parent devote resources to its various productive activities up to the point where the expected return on the marginal dollar invested in each activity is equal to the cost of capital of the consolidated entity. Again no distinction can be made between the parent and the subsidiary." (Staff Ex. 6, p. 5)

Further, on cross-examination of other Company witnesses, the interchangeability of the management of the various

subsidiaries, the parent corporation and the service corporation, which provides services to the Applicant, was established. It is quite apparent from reviewing the record that the Applicant is not an independent entity but is very dependent upon the parent for financing and management.

The Commission believes that the use of the consolidated capital structure is appropriate in this case. Although the applicant does issue its own debt, it receives its equity financing from the parent, American Water Works, Inc., and also receives additional managerial and financial aid from the parent and service corporation. The Applicant is not an independent corporation but a 100% owned subsidiary. Aside from the legal considerations, it is essentially a division of the parent. Similar situations were presented in Ohio Suburban Water Company, Case No. 77-1512-WS-AIR (March 8, 1979), Ohio Water Service Company, Case Nos. 77-686-WW-AIR and 78-957-WW-CMR (March 28, 1979) and Ohio Water Service Company, 78-712-WW-AIR (July 18, 1979). In those cases, the Commission concluded that it was reasonable to believe that the debt investor is not blind to the relationship between the parent and the subsidiary. There is nothing in this record which would lead us to a different conclusion. The Commission remains convinced that the consolidated capital structure of the parent (as proposed by the Staff) is the appropriate capital structure to use in arriving at a fair and reasonable rate of return for the Applicant.

Cost of Debt and Preferred Stock

Having adopted the consolidated capital structure as recommended by the Staff, we will adopt the cost assigned to the long-term debt and preferred stock by the Staff. As the Staff's capital structure was updated to June 30, 1980, consistency requires that the cost assigned to debt and preferred stock components of the capital structure reflect the impact on the embedded cost resulting from all security issues as of June 30, 1980. The Commission finds the proper embedded cost of debt for use in this proceeding to be 7.45 percent and the embedded cost of preferred stock to be 5.67 percent (Staff Ex. 6, Table 1, p. 2).

Cost of Common Equity

The third component in the cost of capital approach is the cost of equity. Unlike the cost of debt and preferred stock which can be readily computed, the cost assigned to the common equity component of the capital structure can only be estimated.

Dr. Christy offered a modified DCF analysis, based on Ohio-American Water's own capital structure. In doing this analysis, Dr. Christy chose six publicly traded operating water companies located in California, Indiana, and New Jersey. He found them to have the same average level of risk as the Ohio-American Company and then combined them with a number of averaging techniques of the various component measurements of DCF to reach his final DCF recommendation of 15.25 percent (Company Ex. 7A, p. 21).

Staff witness Wissman, utilizing the discounted cash flow (DCF) methodology, computed the cost of equity on American Water Works, Inc. Staff witness Wissman also verified the DCF methodology by use of the CAPM method and determined the cost of equity to be 13.95 percent.

The Commission has considered and rejected the modified DCF methodology employed by Dr. Christy. In the East Ohio Gas

Company, Case No. 79-535-GA-AIR (July 9, 1980), the Commission found that:

> "After chosing what he believed to be a comparable company, Mr. Rothey performed a DCF analysis using data from comparable companies. The Commission finds that this approach suffers from the same pitfalls as a comparable earnings analysis, but this approach also is a misapplication of the DCF formula, which uses market information to determine the cost of common equity of a unique and distinct company and not the average of many companies. The Commission must reject Mr. Rothey's analysis." at page 18

With the approach in the instant application being virtually the same as that of Mr. Rothey in the East Ohio Gas Company case, the Commission must reject Dr. Christy's methodology for the same reasons.

Staff witness Wissman has updated his base line cost of equity to June 30, 1980. The Staff's analysis, using the October, 1979 to September, 1980, average price of $12.15 and dividend of $.96 and a 6.05 expected growth rate, results in an estimated base line cost of common equity of 13.95 percent. To the base line cost of equity, the Staff made adjustments to protect against selling cost and dilution and to allow financial flexibility in order to respond to changing market conditions. This adjustment was made by multiplying the base cost of the equity (13.95 percent) by 1.32 and 1.1 to obtain a lower and upward bound of 14.40 and 15.35 percent, respectively (Staff Ex. 6, p. 13). These adjustment values were determined by the Staff several years ago and have been relied upon by the Commission in many cases.

Upon review of the evidence, the Commission believes the recommendation of witness Wissman to be best supported. As noted in prior cases and restated by the Staff in this proceeding, the use of the DCF methodology is a sound basis for determining the cost of equity because it is:

> "the only method consistent with the Staff's effort to promote economic efficiency in a regulated environment. The Staff concurs with the contention that regulatory authorities must function as a substitute for a competitive market forces and believe that achievement of economic efficiency is beneficial to both the utility and the consumers.
>
> The DCF approach is consistent with economic efficiency because it equates the 'required' return of the equity investor (or cost of capital to the Company) to what can be earned on new additional investment in the competitive market place." (Staff Ex. 6, p. 9).

It is for this reason that the Staff did not rely, as did the Applicant, on the modified DCF, which is actually a comparable earnings approach. Firms to be compared can be too easily affected by arbitrary decisions, depending upon the returns being sought (Staff Ex. 6, p. 11). For these reasons, the Commission believes that the method employed by Staff

witness Wissman produces the most reliable conclusion as to the return requirements of the equity investor presented on this record and, therefore, accepts his recommendation. The question then becomes which point within the range of his cost of equity recommendation should be selected. The witness's purpose in giving a range is to adjust for possible selling cost, market pressure and financial flexibility. In the recent Columbia Gas of Ohio, Inc., Case No. 79-610-GA-AIR, et. al., Mr. Wissman testified to the factors to which he considered justified in the use of the upward bounds of the adjustment. His views about the propriety of using these factors have not changed since testifying in that case (Tr. IV, pp. 166, 168). In making his recommendation of an adjustment he knew "of no plans for the American Water Works System to issue common equity" during the next year and one-half (Tr. IV, p. 168). In view of this testimony, the Commission concludes that the lower bound of witness Wissman's recommended range, or 14.40 percent, represents the appropriate cost of equity for use in the rate of return determination for purposes of this proceeding.

Rate of Return

Applying a cost of equity of 14.40 percent to the equity component of the capital structure approved herein, produces when combined with the findings related to long term debt and preferred stock, a weighted cost of 9.04 percent. The Commission concludes that a rate of return of 9.04 percent is sufficient to provide the Company reasonable compensation for the water service it renders customers affected by this application.

Authorized Increase

A rate of return of 9.04 percent applied to the rate base of $16,181,178 heretofore determined results in an allowable return of $1,462,778. Certain expenses must be adjusted if the gross revenues authorized are to produce this dollar return. These adjustments, which have been calculated in a manner consistent with findings herein, result in an increase of $318,685. The net effect of these adjustments is to increase the allowable expenses to $5,306,415. Adding the authorized dollar return to these allowable expenses results in a finding that Applicant is entitled to place rates into effect which will generate $6,769,193 in gross annual operating revenues. This represents an increase of $657,005 over the revenues which would be realized under Applicant's present rate schedule.

RATES AND TARIFFS

A few issues remain for the Commission's determination. These are the deletion of a late-penalty payment, the reasonableness of the proposed reconnection charge, and a stipulation in regard to the charge for public fire protection. These issues will be discussed below.

Charge for Public Fire Protection

The Company initially proposed that an annual charge of $160 per hydrant for all hydrants be imposed (Company Ex. 9, Schedule E-1, p. 4), and the Staff recommended that the charge be adopted. OCC and the Cities of Marion and Tiffin objected to this proposal.

As a result of negotiations which occurred before the hearing, the parties to this case reached agreement on this issue and entered into a stipulation and recommendation (Joint Ex. 1). The stipulation would have the effect of providing for the recovery of the cost of making available public fire protection on an uniform basis throughout the Company's service

area. After reviewing the stipulation and the record, the Commission finds the stipulation to be reasonable, and hereby adopts the stipulation in regard to the charge for public fire protection.

Late-Payment Penalty

Applicant proposes in this case to delete, in its uniform tariff, the provision which in certain of its districts provided for a discount for prompt payment of customers' bills (Company Ex. 9, Schedule E-4; Company Ex. 6). OCC supports the Applicant's proposal to delete the provision for a discount for prompt payment. The Staff, in its Staff Report, has recommended that the Applicant retain the discount (Staff Ex. 1, p. 24). Staff witness Carl Green testified that by retaining the discount, Applicant may recover some of the costs that are not included in the reconnection fee and further by having a discount would be an incentive for people not to permit themselves to have their water disconnected and find themselves paying an additional charge to be reconnected. Staff witness Green stated that the complete cost for all of this would probably be significantly more than the $12.28 specified by Applicant (Staff Ex. 2, pp. 3 and 4).

The OCC points out that it should be noted that the Staff did not propose in its testimony a discount provision a specified percentage of the customers bill. OCC argues further that this places the Applicant in a somewhat difficult position, in as much as only two of the previous four tariffs contained such clauses. Moreover there were in those tariffs two different percentages specified--5 percent and 10 penalties in the Marion and Lawrence County Districts, respectively.

In view of the record on this topic, the Commission finds that the Company's proposed tariffs are reasonable and that it would be only fair to delete the charges in the two remaining communities of the four that have this provision in their tariff. Furthermore, the Company put on witness Johnstone who testified as to the reasonableness and accuracy of its disconnection and reconnection charges (Tr. III, p. 17). Therefore, the record is such on this topic that the Commission finds that it should adopt the tariff provisions as proposed by the Applicant.

Effective Date

It has been the practice of the Commission to provide in its rate orders that tariffs filed pursuant to such orders shall be applicable to service rendered thirty days following the issuance of the entry accepting those tariffs for filing. The purpose of delaying the effective date of the tariffs has been to give notice of the authorized increase to the affected customers through mailings by the company prior to the time those rates go into effect. The Commission continues to believe that this is a reasonable practice, but finds that there are circumstances presented by this case which compel a departure from this policy.

Section 4909.42 of the Revised Code provides that if the Commission has not acted upon a rate application filed pursuant to Section 4909.18 of the Revised Code within 275 days of the date of filing, the applicant utility, upon the filing of an undertaking in an amount determined by the Commission, may place the proposed rates into effect, subject to the condition that amounts charged and collected in excess of those finally determined to be reasonable by the Commission shall be refunded. Ohio-American Water Company has not attempted to place its

proposed rates into effect by filing an undertaking, even though the 275 day time period has expired in this case. The Commission believes that basic principles of fairness dictate that the Company should not be penalized for its forebearance, and that the appropriate course in this case is to establish the effective date of the tariffs filed pursuant to this order as the date they are approved by Commission entry. The customary notification requirement will, of course, be retained, the notice to be mailed to customers upon approval of its form by the Commission.

FINDINGS OF FACT:

From the evidence of record in this proceeding, the Commission now makes the following findings:

1) The value of all of the Applicant's property used and useful for the rendition of water service to customers affected by this application, determined in accordance with Sections 4909.05 and 4905.15, Revised Code, as of the date certain of June 30, 1979, is not less than $16,181,178.

2) For the twelve-month period ended December 30, 1979, the test period in this proceeding, the revenues, expenses and income available for fixed charges realized by the Applicant under the rates now in effect were $6,112,188, $4,987,730, $1,124,458.

3) This net annual compensation of $1,124,458 represents a 6.95 percent rate of return on the rate base of $16,181,178.

4) A 6.95 percent rate of return is insufficient to provide applicant reasonable compensation for the gas service rendered customers affected by this proceeding.

5) A rate of return of 9.04 percent is fair and reasonable and is sufficient to provide applicant just compensation and return on its property used and useful in furnishing this service.

6) A rate of return of 9.04 percent applied to the rate base of $16,181,178 results in an allowable annual dollar return in the amount of $1,462,778 based on test year operations.

7) The allowable annual expenses of Applicant for purposes of this proceeding are $5,306,415.

8) The allowable gross annual revenue to which Applicant is entitled for purposes of this proceeding is the sum of the amounts set forth in Findings 6 and 7, or $6,769,193.

9) Applicant's present tariffs should be withdrawn and applicant should submit new tariffs consistent in all respects with the discussion and findings set forth above.

CONCLUSIONS OF LAW:

1) The applications were filed pursuant to, and this Commission has jurisdiction thereof under, the provisions of Sections 4909.17 and 4909.19, Revised Code; further, the Applicant has complied with the requirements in those sections.

2) A Staff investigation has been conducted and a report filed and mailed and a public hearing has been held herein, the written notice thereof having complied with the requirements of Section 4909.19, Revised Code, and the directives of the Commission.

3) The existing rates and charges for natural gas service currently in effect are insufficient to provide Applicant adequate net annual compensation and return on its property used and useful in furnishing service in this area covered by these applications.

4) A rate of return of 9.04 percent is fair and reasonable under the circumstances presented by this case and is sufficient to provide Applicant just compensation and return on its property used and useful in furnishing service to its customers.

5) Applicant should be authorized to cancel and withdraw the tariffs now governing the service and to file new tariffs consistent with the discussion and findings set forth above.

ORDER:

It is, therefore,

ORDERED, That the application of Ohio-American Water Company for authority to increase its rates and charges for water service be granted to the extent provided in this Opinion and Order. It is, further,

ORDERED, That the Applicant withdraw its present tariffs and submit new tariffs consistent with the discussion and findings set forth above for approval by the Commission. Upon receipt of three (3) complete copies of said tariffs conforming to this Opinion and Order, the Commission will review and approve same by entry. It is, further,

ORDERED, That the effective date of such new tariffs shall be the date said tariffs are accepted for filing. The new rates included therein shall be applicable to all service rendered on or after the effective date. It is, further,

ORDERED, That Applicant shall immediately commence notification of its customers of the increase in rates authorized herein by insert or attachment to its billings, by special mailing, or by a combination of those methods. Applicant shall submit a proposed form of notice to the Commission when it files its tariffs for approval. The Commission will review same and, if proper, approve it by entry. It is, further,

ORDERED, That all objections and motions not specifically discussed within this Opinion and Order or rendered moot, be overruled and denied. It is, further,

ORDERED, That a copy of this Opinion and Order be served upon all parties of record.

THE PUBLIC UTILITIES COMMISSION OF OHIO

Chairman

Commissioners

Entered in the Journal

JAN 14 1981

A True Copy

David M. Polk
Secretary

WFB/lsb