**BEFORE**
**THE PUBLIC UTILITIES COMMISSION OF OHIO**

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| In the Matter of the Application of<br>Aqua Ohio, Inc. to Increase its Rates and<br>Charges for Its Waterworks Service. | )<br>)<br>) | Case No. 21-0595-WW-AIR |

# OBJECTIONS TO THE STAFF REPORT OF INVESTIGATION AND AUDIT OF THE APPLICATION TO INCREASE RATES BY AQUA OHIO, INC.

Pursuant to R.C. 4909.19, Ohio Adm. Code 4901-1-28, and the February 17, 2022 Entry, Applicant Aqua Ohio, Inc. ("Aqua") hereby respectfully submits its objections to the February 11, 2022 Staff Report of Investigation ("Staff Report"), which includes by reference the February 11, 2022 *Audit of the Application to Increase Rates of Aqua Ohio, Inc. for the Period January 1, 2021 through December 31, 2021, 2022* (the "Audit Report"). The Commission entered into a contract with auditor Larkin & Associates, PLLC ("Larkin") to complete portions of the rate case investigation, including attesting to Aqua's financial information, reviewing the depreciation study, investigating the cost of service study and proposed rates, and audit the functional areas of Aqua's management policies, practices, and organization.[1] Larkin's findings are included in the Audit Report[2], and the Staff Report contains numerous references to the Audit Report. As such, these Objections include reference to both the Staff Report and Audit Report, which are referred to collectively herein as "Reports."

Aqua reserves the right to supplement or modify these objections in the event that Staff makes additional findings, conclusions, or recommendations with respect to the Staff Report.

[1] Staff Report at 4.

[2] The Audit Report also contains findings by Larkin's subcontractor Acadian Consulting Group ("ACG").

Aqua also reserves the right to respond—either in support or opposition—to objections or other issues raised by other parties in this proceeding.

## OBJECTIONS TO THE REPORTS

R.C. 4909.15, 4909.18, 4909.19, and 4905.22 require the Commission to set rates that are just and reasonable. R.C. 4909.15(A)(2) and (E)(2)(a) also require the Commission to determine a fair and reasonable rate of return to the utility. In the Reports, Staff and Larkin make a number of recommendations that, if adopted, would result in unjust and unreasonable rates and would not allow Aqua the opportunity to earn a fair and reasonable rate of return. Aqua objects to these recommendations as stated below.

### I. OPERATING INCOME AND RATE BASE

**Objection No. 1:** Aqua objects to the Audit Report's claim that the Company's Revenue deficiency is $8,241,535 per Exhibit LA-1, Schedule A, Page 1, column A, line 7. A footnote on this page incorrectly indicates that this amount is from Aqua's Application. It is not. Aqua's Application shows the Revenue deficiency to be the same as its Revenue Increase Requested - $8,290,405. Aqua received no data requests or explanations related to this Revenue deficiency mischaracterization.

**Objection No. 2:** Aqua objects to the Audit Report's removal of the April 1, 2022 non-union wage increases. Ohio law authorizes a water-works company to "propose adjustments to the revenues and expenses . . . for any changes that are, during the test period or the twelve-month period immediately following the test period, reasonably expected to occur." R.C. 4909.15(D). Actual April 1, 2022 non-union wage increases have been approved and will be effective prior to the effective date of new base rates. All else equal, Aqua cannot earn its allowed rate of return when a known and measurable compensation cost component is not recovered in rates. Alternatively, the Company is incentivized to reduce its labor complement by an off-setting cost amount, which could lead to less reliable utility service of Aqua's customers.

**Objection No. 3:** Aqua objects to the Audit Report's failure to determine labor expense based on Aqua's projected staffing levels at the full complement. While the report reflects seven pro formed positions vacancies, there are only two vacancies at March 1, 2022. These remaining vacancies are planned to be and are being filled in the ordinary course of business, will be staffed during the years the corresponding rates are in effect, and are representative of normal utility operating expenses. All else equal, Aqua cannot earn its allowed rate of return when known and measurable compensation costs are not recovered in rates. Alternatively, the Company is incentivized to reduce its labor complement by an off-setting cost amount, which could lead to less reliable utility service for our customers. While the Company can and does experience vacancies from time to time, it also can and does incur costs of overlapping employees for some positions to ensure smooth transitions. To pro form any unknown and unmeasurable net vacancy credit is no more appropriate than to pro form other unknown and unmeasurable expense increases.

**Objection No. 4:** Aqua objects to the Audit Report's exclusion of 50% of incentive compensation from labor expense. The Audit Report states that goals such as ones tied to net income are shareholder-oriented and shareholders should pay for the incentive compensation associated with such goals. In fact, all incentive compensation is competitive and appropriate as a vital piece of the Company's overall compensation package. Incentive compensation related to the accomplishment of all goals is an important tool used by the Company to attract and retain highly qualified individuals, which ultimately benefits customers, with exceptional performance. The Incentive compensation program is geared toward cost containment, quality service, compliance initiatives and financial viability to ensure reasonable cost and high- quality service to customers. It is important to note, during the past four full calendar years since the last base rate increase, Aqua's simple average return on equity was more than 100 basis points lower than the implicit return last allowed by the Commission. Shareholders received less rather than more theoretically allowed despite goals tied to net income. At best it can be argued the goals minimized the earnings deficiency. Incentive compensation should therefore be permitted fully in Expense.

**Objection No. 5:** Aqua objects to the Audit Report's exclusion of stock-based compensation from labor expense. The Audit Report states that such compensation is a shareholder-oriented expense and thus should be supported entirely by shareholders. In fact, stock-based compensation is a vital piece of the Company's overall compensation package necessary to attract and retain highly qualified individuals, which ultimately benefits customers, with exceptional performance. This compensation is geared toward cost containment, quality service, compliance initiatives and financial viability to ensure reasonable cost and high- quality service to customers. Compensation has transitioned in part from non-goal-oriented defined benefit pension plans to performance- based rewards. Stock-based compensation should therefore be permitted fully in Expense.

**Objection No. 6:** Aqua objects to the Audit Report's exclusion of Supplemental Executive Retirement Plan (SERP) from expense. The Audit Report states ratepayers should not be "saddled" with costs of executive benefits that exceed the treatment allowed for all other employees. However, the plan is not a supplemental plan. Rather, it is a non-qualified pension plan. It is not a new retirement program offered to Company executives nor does it provide active employees with benefits that exceed those allowed for other pension-eligible employees. Prior to 2003, the Company provided pension benefits to its employees through its qualified pension plan and through a supplemental benefits plan for executives. The supplemental plan was provided because the Employee Retirement Income Security Act ("ERISA") limits the benefits that may be paid to certain salaried employees. Starting in 2015, in order to pass the non-discrimination test, certain highly compensated individuals were frozen in the base, qualified pension plan and moved to the non-qualified plan. In the non-qualified plan, they accrue service based on the same benefit calculations used in the qualified pension plan. Those benefits are not supplemental to or in excess of those in the qualified plan.

In 2003, the Company ended its retirement programs, moving all employees to 401K plans. However, those employees and executives who were hired prior to the 2003 termination of the pension plans retained their rights to retirement benefits under the plans. In order to fund those plans through retirement, the Company continues to accrue pension expense for the eligible employees. The fact that the SERP is no longer available to new employees does not disqualify the plan for rate recovery. The retirement benefits under SERP are provided pursuant to prior commitments made to attract qualified executives, and they should not be disallowed.

**Objection No. 7:** Aqua objects to the extent any of the Audit Report's adjustments described in these objections cause the understatement of employee insurance expense included in rates. Specifically, please refer to Objection No. 3 as it relates to a vacancy adjustment.

**Objection No. 8:** Aqua objects to the Audit Report's adjustment of rate case expense reflecting an amortization period of five rather than three years. Consistent with the three-year period reflected in the Company's application, Aqua anticipates its next base rate application will be filed in 2024. Additionally, the Audit Reports for water and wastewater reflect a total of $173,000 vs. the $200,000 that has previously estimated. Aqua objects to the combined $173,000 amount ($138,000 water, $35,000 wastewater) only to the extent Larkin will not commit to capping its charges to no more than said amount.

**Objection No. 9:** Aqua objects to the Audit Report's use of a two-year average of net charge off rates which has the effect of reducing uncollectible expense. This is inconsistent with Larkin's use of one year as filed by Aqua for wastewater. (A two-year average for wastewater would result in higher uncollectible expense). Aqua recommends uncollectible expense be treated consistently with Case No.16-0907-WW-AIR in which Staff used one year rather than a multiple year average.

**Objection No. 10:** Aqua objects to the extent any of the Audit Report's adjustments described in these objections cause the understatement of depreciation expense included in rates. Specifically, please refer to Objection No. 15 as it relates to utility plant in service adjustments. Additionally, the Commission Staff's practice of adjusting the depreciation expense to the recommended depreciable plant in service as of the date certain is not reflected in the Audit Report, thereby significantly understating depreciation expense further. Such normal ratemaking practice would have addressed the depreciation understatement inherent in the Company's rate application as reported to Larkin on December 16, 2021. No response or data requests related to the Company's December 16, 2021 submission have been received. Additionally, while the depreciation reserve was increased and rate base decreased due to the depreciation impact of a misclassified capitalized tank painting cost adjustment, it appears the associated increase in depreciation expense was missed in the Audit Report. The correct depreciation is synchronized to depreciable plant in service, resulting in $12,002,975 of pro forma expense vs. Larkin's $10,431,993.

**Objection No. 11:** Aqua objects to the extent any of the Audit Report's adjustments described in these objections cause the understatement of property taxes included in rates. Specifically, please refer to Objection No. 15 as it relates to utility plant in service adjustments.

**Objection No. 12:** Aqua objects to the extent any of the Audit Report's adjustments described in these objections cause the understatement of the payroll taxes included in rates. Specifically, please refer to Objection Nos. 2 through 5 as they relate to the wage increase, vacancy, incentive compensation and stock-based compensation expense adjustments.

**Objection No. 13:** Aqua objects to the extent the Audit Report's adjustments described in these objections affect the calculation of federal income and excise tax included in rates.

**Objection No. 14:** Aqua objects to the extent the Audit Report's adjustments described in these objections affect the calculation of interest synchronization included in rates.

**Objection No. 15:** Aqua objects to the use of projected rate base amounts given actual December 31, 2021 amounts were available, but not requested, several weeks before the Audit Report was issued. Use of December 31, 2021 actual rate base complies with the Audit Report at page 3-4 in that "Larkin recommends that the Applicant update the official record as needed, to reflect plant additions through the date certain, December 31, 2021." Rather than requesting December 31, 2021 actual rate base detail, Larkin took a project-by-project piecemeal approach of projected additions and retirements. However, while plant in service was reduced for retirements, the depreciation reserve was not, significantly overstating the reserve and understating rate base. The Larkin team did an exhaustive review of all projects, finding them to be reasonable in terms of construction and costs. (SAP projects discussed in Objection No. 16). What the Audit Report lacks is actual costs given ample time existed to true up "11+1" information with actual. The actual rate base is $270,307,343 vs. Larkin's $260,431,993.

**Objection No. 16:** Aqua objects to the Audit Report's removal of the Service Center SIP Project, including the SAP investment, from the rate base, which results in reductions of $5.205 million to plant in service and $4.685 million to rate base. Larkin asserts that the SAP project cannot be considered "used and useful" pursuant to R.C. 4909.15(A) because it was purportedly not being used as of December 31, 2021. [*See*, Audit Report at 3-5.] Larkin asserts that:

> [T]he SAP system was 'ready to operate' by December 31, 2021, but was not being used for the benefit of customers until 2022, and thus fails to meet the Ohio 'used and useful' standards to be included in rate base by December 31, 2021, which is the date certain in the current Aqua rate case.

[*Id.* at 3-6; *see also, id.* (While the SAP system was "ready for use" by December 31, 2021, it was not actually being used to run Aqua Ohio's business and for processing of transactions until 2022); *id.* at 3-7 ("SAP was not being used by Aqua Ohio until 2022 to run its business for the benefit of customers").]

*A. The SAP System was Used.*

Larkin's conclusion flows from an incorrect assumption. Larkin stated that "since the legacy Lawson and Hyperion systems are being used for 2021 accounting, including closing the books for 2021 and consolidation reporting for 2021, SAP was not being used by Aqua Ohio until 2022 to run its business for the benefit of customers." [Audit Report at 3-7 (emphasis added).] Simply because the legacy systems were used to "close the books for 2021," that does not mean that SAP was not being used. SAP was used extensively in 2021 for data loads, testing, training, validation and review. It was essential for SAP to be loaded with and hold data prior to January 1, 2022 in ensure Aqua's continuing seamless operation for its customers. SAP needed to be and was "used" to house numerous categories of Aqua's master data, including, but not limited to:

- Vendor Master data: approved vendors and vendor information
- Material/Inventory Master Data, including valuation of said materials
- Enterprise structure and general ledger accounts/charts of accounts
- Utility plant assets tied to Aqua's GIS system for real-time tracking
- Employee Master Data, which identifies and manages all company employees and is used to track labor costs by project or task.

This master data requirement necessitated that Aqua use the system for storage and processing of data. Aqua also used the SAP system to review the data and validate it for completeness and accuracy. The process was intensive, and SAP was continually being used extensively during that process.

Other additional tasks were completed in SAP in 2021 including multiple rounds of in-person and virtual training, system loads (beginning in May 2021), and four rounds of testing including acceptance testing and full integration testing. (Each round lasting at least three (3) to four (4). All of this was done in Aqua's SAP environment.

Aqua also conducted and completed performance testing of SAP for several months, where Aqua simulated hundreds of users working on thousands of orders, doing POs, pulling materials from inventory and processing invoices. Testing scripts were developed and deployed for selected users to test all scenarios in which SAP was to be used. Each test was documented, and any deviations from expected results were delivered to our implementation team for further review and potential correction. All tests were required to pass without exception. All end users of SAP were required to attend numerous training sessions that were developed by our SAP team. The sessions were developed in an effort to capture each and every transaction in SAP that would be relevant to employees' daily/monthly tasks.

To say that SAP was not "used," is not only incorrect, but ignores the facts.

*B. The SAP System was Useful.*

In the Audit Report, Larkin cites to the decision of the Ohio Supreme Court in *In re Application of Suburban Natural Gas Co.*, 2021-Ohio-3224, which interpreted whether a project is "useful" under Ohio law. Although Larkin does not conclude that the SAP project was not "useful," because Larkin references the *Suburban Natural Gas*, Aqua will also address why the SAP project is "useful."

The Court held that in order to be "useful" under Ohio law, "the property must be beneficial in rendering service for the convenience of the public as of the date certain." *In re Application of Suburban Nat. Gas Co.*, --- N.E.3d ---, 2021-Ohio-3224, ¶ 25. The issue in *Suburban* was a 4.9 mile natural gas pipeline extension and whether the entire extension was needed for service of Suburban's customers or whether it was built to service *future* customers. The argument was that only 2 miles of the pipeline was currently needed, but the additional miles were for a growth horizon. *Id.* at ¶¶ 12-14.

That is not the issue with the SAP system. The SAP system was beneficial in rendering service for the convenience of Aqua's customers as of the date certain: December 31, 2021. The use of complete enterprise software is not done by simply "flipping a switch" and is not analogous to the capping of a natural gas pipeline. The software is used by ramping up the information in the system and the customers benefit from that use. Efficient and accurate operation as a result of software has been recognized as benefits to utility customers for purposes of "used and useful" determination. *See*, *Great Northern Utilities, Inc., et al.*, Proc. No. 11-0059, 11-0141, 11-0152, 2011 WL 5115035 (Ill. Comm. Comm'n Sept. 14, 2011). Moreover, when switching from one software system to another, the "nonlive" software is still "used and useful" when housing data that can assist in the more rapid implementation of the new system. *See*, *In re SourceGas Distrib., LLC*, Proc. No. 30022-148-GR-10, 2011 WL 941272 (Wyo. P.S.C. Feb. 10, 2011).

For example, if a hydrant was hit or a pipe burst from extreme cold on January 1, 2022, Aqua would need to immediately respond by starting a work order, dispatching crews, picking materials or procure additional materials and resources, all of which would be done through SAP. If SAP was not fully tested, loaded, and ready for use on December 31, 2021, then such a call would spell disaster. As a utility, Aqua's highest responsibility is to serve its customers and keep them safe. Aqua's customers would not be able to be provided safe and reliable service without the usefulness of having SAP tested, fully vetted, and ready by December 31, 2021. Such process with SAP is directly beneficial to rendering quality and reliable service to Aqua's customers. In fact, it would be completely inappropriate, *if not impossible*, to suggest that Aqua's plan for implementation of SAP was just to 'start up' SAP on a certain date.

The SAP system costs required are both used and useful and should be included in rate base for the test period identified.

## II. RATE OF RETURN

**Objection No. 17:** Aqua objects to Staff's application of the Discounted Cash Flow (DCF) model as it understates the cost of common equity for Aqua in the following respects: (1) Staff incorrectly uses the sum of the last four quarterly dividends for the calculation of its dividend yield, and not the most current dividend multiplied by four;[3] (2) Staff gives undue weight to *Value Line* projected earnings per share (EPS) growth rates in their DCF analysis without any justification.[4] If all projected EPS growth rates were considered equally, the group average growth estimate would increase from 7.12% to 7.53%; and most significantly (3) Staff performs a multi-stage DCF (MSDCF) analysis, which is not applicable for utilities. The MSDCF is inapplicable to utilities because the model reflects the company/industry life cycle, which is typically described in three stages: (1) the growth stage, which is characterized by rapidly expanding sales, profits, and earnings. In the growth stage, dividend payout ratios are low in order to grow the firm; (2) the transition stage, which is characterized by slower growth in sales, profits, and earnings. In the transition stage, dividend payout ratios increase, as their need for exponential growth diminishes; and (3) the maturity (steady-state) stage, which is characterized by limited, slightly attractive investment opportunities, and steady earnings growth, dividend payout ratios, and returns on equity. Because utilities are in a steady-state, the application of a non-constant DCF model is not applicable. The notion that

[3] The use of historical dividends runs counter to the prospective nature of the cost of equity and ignores existing expectations for each proxy company's dividend payments.

[4] Staff assigns 50% weight to *Value Line* projected EPS growth rates, while equally weighting projected EPS growth rates from Seeking Alpha, CNBC, and Yahoo Finance for the remaining 50%.

the utility industry is in the steady-state stage in the industry lifecycle is supported in several finance texts.[5] Correcting for the above errors results in an indicated DCF cost rate of 9.46%.

**Table A: Corrected Staff DCF Analysis**

| | AWK | AWR | CWT | MSEX | SJW | WTRG |
|---|---|---|---|---|---|---|
| Average Price | $158.01 | $79.64 | $55.57 | $82.15 | $65.00 | $45.74 |
| Annualized Div[6] | $2.41 | $1.46 | $0.92 | $1.09 | $1.36 | $1.07 |
| Dividend Yield | 1.53% | 1.83% | 1.66% | 1.33% | 2.09% | 2.35% |
| Growth Rates | | | | | | |
| Seeking Alpha | 8.22% | 6.00% | 4.00% | NA | 8.00% | 6.58% |
| CNBC | 8.70% | 5.50% | 21.00% | 13.50% | NA | 3.90% |
| Yahoo! Finance | 8.60% | 6.30% | 11.70% | 2.70% | 7.00% | 6.40% |
| *Value Line* | 6.48% | 5.49% | 4.72% | 3.99% | 10.50% | 6.32% |
| Average Growth | 8.00% | 5.82% | 10.36% | 6.73% | 8.50% | 5.80% |
| Dividend Yield | 1.53% | 1.83% | 1.66% | 1.33% | 2.09% | 2.35% |
| DCF Cost Rates[7] | 9.65% | 7.76% | 12.18% | 8.14% | 10.77% | 8.28% |
| Average DCF | | | | 9.46% | | |

**Objection No. 18:** Aqua objects to Staff's application of the Capital Asset Pricing Model (CAPM), as it is inconsistent with its application of the model in Aqua's last rate case (Case No. 16-0907-WW-AIR). The differences in Staff's report from Case No. 16-0907-WW-AIR are as follows: (1) the Staff now uses betas provided by Standard & Poor's Capital IQ in addition to *Value Line* betas; (2) in their calculation of the market risk premium (MRP), Staff subtracts the 1972-2020 average three-month Treasury bill from the 1972-2020 average return on large stocks in this proceeding, but subtracted the 1926-2015 average total return on long-

[5] *See, for example,* Bodie, Kane, and Marcus, Investments, 7th Edition, McGraw-Hill Irwin, 2008, at 616-617.

[6] Most recent dividend * 4. Source, Staff Workpapers.

[7] DCF Cost Rate = Dividend Yield * (1 + Average Growth) + Average Growth/

term Treasury bonds from the 1926-2015 average return on large stocks in the Company's prior case; and (3) for the measurement of the risk-free rate, Staff uses a six-month average yield of 20- and 30-year Treasury bonds in this proceeding, but used the 1926-2015 average total return on long-term Treasury bonds in Case No. 16-0907-WW-AIR. The Staff does not explain its departure from past practice in its Report. If Staff applied the CAPM consistently with its application of the CAPM in Case No. 16-0907-WW-AIR, the indicated result would be 10.93%.[8]

**Objection No. 19:** Notwithstanding the inconsistency issues addressed in Objection No. 18, above, Aqua objects to Staff's application of the CAPM, as it also serves to understate the Company's cost of common equity due to inputs not consistent with economic theory. These inputs are: (1) the use of 20-year Treasury bonds; (2) the use of three-month Treasury bills; (3) the use of current interest rates; (4) the use of a subset of data for calculating the MRP; and (5) the consideration of only one MRP. In addition to the above, Staff also failed to consider an empirical CAPM (ECAPM) in their analysis.

**Objection No. 20:** Aqua objects to Staff's use of a six-month average 20-year U.S. Treasury Bond yield and three-month Treasury bills as input to their CAPM model. The use of these bonds are unsuitable as the tenor of the risk-free rate used in the CAPM should match the life (or duration) of the underlying investment. As noted by Morningstar: "The traditional thinking regarding the time horizon of the chosen Treasury security is that it should match the time horizon of whatever is being valued. Note that the horizon is a function of the

[8] 10.93% = 6.1% * (0.79 * (12.2% - 6.1%)). Source, 2021 SBBI® Yearbook Stocks, Bonds, Bills, and Inflation ®, at 6-17, Staff Workpapers.

investment, not the investor. Morin also confirms this when he states: "[b]ecause common stock is a long-term investment and because the cash flows to investors in the form of dividends last indefinitely, the yield on very long-term government bonds, namely, the yield on 30-year Treasury bonds, is the best measure of the risk-free rate for use in the CAPM(footnote omitted)… The expected common stock return is based on long-term cash flows, regardless of an individual's holding time period."[9] Pratt and Grabowski recommend a similar approach to selecting the risk-free rate: "In theory, when determining the risk-free rate and the matching equity risk premium (ERP) you should be matching the risk-free security and the ERP with the period in which the investment cash flows are expected."[10] As a practical matter, equity securities represent a perpetual claim on cash flows; 30-year Treasury bonds are the longest-maturity securities available to match that perpetual claim. Staff's use of 20-year Treasury bonds and three-month Treasury bills do not match the life of the assets being valued and should be disregarded.

**Objection No. 21:** Aqua objects to Staff's use of current Treasury yields in its CAPM analysis, as it is inappropriate for cost of capital and ratemaking purposes. The use of current interest rates is inappropriate because both cost of capital and ratemaking are prospective in nature. The cost of capital, including the cost rate of common equity, is expectational in that it reflects investors' expectations of capital markets in the future, including expectations of interest rates and risks. As Morningstar observes: "It is important to note that the expected equity risk premium, as it is used in discount rates and cost of capital analysis, is a forward-

[9] Roger A. Morin, New Regulatory Finance (Public Utility Reports, Inc., 2006), at 151.

[10] Shannon Pratt and Roger Grabowski, Cost of Capital: Applications and Examples, 3rd Ed. (Hoboken, NJ: John Wiley & Sons, Inc., 2008), at 92 [Clarification added].

looking concept. That is, the equity risk premium that is used in the discount rate should be reflective of what investors think the risk premium will be going forward."[11] Ratemaking is also prospective in that the rates set in this proceeding will be in effect for a period in the future. In view of the above, Staff should use the projected risk-free rate available at the time of preparation of their Report.[12]

**Objection No. 22:** Aqua objects to Staff's use of the time period of 1972-2020 for its calculation of its MRP for the CAPM. The provider of Staff's MRP Data, Duff & Phelps makes it clear that the arbitrary selection of short historical periods is highly suspect and unlikely to be representative of long-term trends in market data. For example, SBBI - 2021 states:

> The estimate of the equity risk premium depends on the length of the data series studied. A proper estimate of the equity risk premium requires a data series long enough to give a reliable average without being unduly influenced by very good and very poor short-term returns. When calculated using a long data series, the historical equity risk premium is relatively stable. Furthermore, because an average of the realized equity risk premium, is quite volatile when calculated using a short history, using a long series makes it less likely that the analyst can justify any number he or she wants.[13]

In view of the above, Staff should have relied on the entire period of 1926-2020 to calculate their MRP, consistent with their calculation in Case No. 16-0907-WW-AIR.

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[11] Morningstar, Inc., 2013 Ibbotson Stocks, Bonds, Bills and Inflation Valuation Yearbook, at 53.

[12] The appropriate projected risk-free rates is the average of the consensus forecasts of approximately 50 economists from *Blue Chip Financial Forecast* for 30-year Treasury bonds for the six quarter ending with the fourth quarter, 2022 from the September 1, 2021 edition, and the long-range consensus forecasts from the June 1, 2021 edition for 2023-2027 and 2028-2032, or 2.70%.

[13] SBBI – 2021 at 10-23.

**Objection No. 23:** Aqua objects to Staff's use of only one measure of the MRP in its CPAM analysis. Relying on a single ERP measure is inconsistent with other facets of Staff's cost of common equity analysis, in which they rely on multiple models, growth rate estimates, and betas. As discussed on page 5 of the Direct Testimony of Dylan W. D'Ascendis, the use of multiple models adds reliability and accuracy. Given Staff's reliance on *Value Line* in selecting its proxy group, for growth rates in its DCF model, and betas in its CAPM, Staff should have also looked to additional data from *Value Line* in estimating additional MRPs. Using the same approaches discussed on pages 30-32 of the Direct Testimony of Dylan W. D'Ascendis, and applying the projected risk-free rate of 2.70% as discussed above, Staff would have derived *Value Line* MRP estimates of 5.85%[14] and 12.35%.[15] When averaged with Staff's corrected historical MRP estimate of 6.10%, results in an indicated MRP estimate of 8.10%.[16]

**Objection No. 24:** Aqua objects to Staff's not considering the ECAPM in its CAPM analysis, despite the fact that numerous tests of the CAPM have confirmed the ECAPM's validity as discussed on pages 27 through 29 of the Direct Testimony of Dylan W. D'Ascendis. Incorporating the ECAPM model, a more robust ERP estimate of 8.10%, and the projected risk-free rate of 2.70% results in an average CAPM/ECAPM result of 9.47%.[17]

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[14] Six-month average 3-5 year projected capital appreciation of 30% from *Value Line Summary & Index* (March 5, 2021 – August 20, 2021) equals an estimated annual appreciation of 6.78% ($(1+30\%)^{1/4} - 1 = 6.78\%$). Adding the average estimated median dividend yield of 1.77% to the 6.78% median annual appreciation results in a projected market return of 8.55%. Subtracting the projected risk-free rate of 2.70% from the projected market return of 8.55% results in an MRP of 5.85%.

[15] Using data from *Value Line* for the S&P 500 Index, an expected return of 15.05% was derived based on expected dividend yields and long-term growth estimates as a proxy for market appreciation. Subtracting the expected risk-free rate of 2.70%, as calculated above, results in an MRP of 12.35%.

[16] 8.10% = (6.10% + 5.85% + 12.35%) / 3.

[17] CAPM Result: 9.28% = 2.70% * (0.81 * 8.10%); ECAPM Result: 9.66% = 2.70% + (0.25 * (8.10%)) + (0.75 * (0.81 * 8.10%)); Average Result: 9.47% = (9.28% + 9.66%) / 2.

**Objection No. 25:** Aqua objects to Staff not including a size adjustment to reflect the unique risks facing Aqua as compared to the proxy group. Regarding a size adjustment, as noted in the Direct Testimony of Dylan W. D'Ascendis, Aqua's smaller size relative to the proxy group indicates greater relative business risk for the Company. Smaller companies are less able to cope with significant events, such as those affecting revenues or expenses, and the adverse impacts of those events. As discussed at length in Aqua's Rate of Return Testimony, size has been shown to be material to risk and Staff should have incorporated an adjustment of 0.25% to reflect this risk in its ROE estimate.[18] This increased risk of the Company is exacerbated in the Staff Report due to their exclusion of small capitalization stocks in their proxy group analysis.

## III. RATES AND TARIFFS

**Objection No. 26:** Aqua objects to the Audit Report's assertion that since Aqua's water systems are not interconnected, that assuming a unified cost system, and attempting to apply uniform rates, is incorrect. A unified cost of service study, and by extension, unified rates have been the policy of PUCO since Aqua acquired the systems. Evidence supports a unified system. For example, there are many similarities in the way the several areas are operated. All the systems pump their treated water through transmission lines to distribution areas that include mains, booster pump stations and storage facilities. All the areas provide water to individual customers through a service line and meter. All the areas rely on a centralized work force for billing, accounting, engineering, administration, and regulatory matters. All the areas rely on a common source of funds for financing working capital and

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[18] Direct Testimony of Dylan W. D'Ascendis, at 41.

plant construction. Inasmuch as the costs of operation are related to functions in which the operating characteristics are the same, the use of equal rates is supported.

**Objection No. 27:** Aqua objects to the Audit Report's recommendation to use the commodity-demand methodology to allocate revenue requirement to the various classes rather than the base-extra capacity method of allocation, as proposed by Aqua as "the use of a set of plant allocators that are heavily and unnecessarily weighted toward incorrect measures of system demand" [Audit Report at 5-7.] The base-extra capacity method has been approved by PUCO in Aqua's prior proceedings and, before Aqua's purchase of the systems, in Ohio American Water's proceedings. In addition, Gannett Fleming Valuation and Rate Consultants LLC has used the base-extra capacity method before public utility commissions in Pennsylvania, New Jersey, New York, Delaware, Virginia, West Virginia, Kentucky, Tennessee, Missouri, Indiana, Illinois, Iowa, and Arkansas. In each of these jurisdictions, the base-extra capacity method is the accepted method of allocation. In addition, ACG did not perform a full commodity-demand study as part of its report, only showing an "annotated" version of one allocation factor. It is not clear from their report that the results of an allocation using the commodity-demand method would be any different that the results of the base-extra capacity allocation. Therefore, their rejection of this methodology is not substantiated.

**Objection No. 28:** Aqua objects to the Audit Report's recommendation that in Aqua's next rate filing, that it be required to provide two cost of service studies, one using the base-extra capacity method and one using the commodity-demand cost allocation method. As stated in Objection No. 27, the commodity-demand method of cost allocation is not the standard method of allocation in Ohio, nor in many other jurisdictions. Creating two cost of service studies would be redundant and unnecessary as well as costly to Aqua's customers.

**Objection No. 29:** Aqua objects to the Audit Report's assertion that the cost of service study uses "undocumented peak demand allocation factors" [Audit Report at 5-11.] The factors used are the same factors used in prior Aqua rate cases before PUCO and are based on field studies of actual customer demands in other jurisdictions. In addition, the system maximum daily sendout used in the allocation factors is based on Company data. Aqua, correctly, used the largest maximum day to average day ratio of 1.5 (rounded up from a ratio of 1.48) which occurred in 2016. An average of these ratios, as recommended by the Audit Report, would not be used as the water system is designed to supply water based on <u>peak day</u> needs, not on <u>average peak day</u> needs.

**Objection No. 30:** Aqua objects to the Larkin's Report's recommendation that Aqua supply in its next rate filing, a "peak demand study using s sampling of its Ohio customer to determine maximum daily and hourly throughput send-outs by customer class." [Audit Report at 5-14.] This type of study is not only not necessary (see Objection No. 29) is expensive and time consuming, and the cost of which would be borne by the rate payers.

**Objection No. 31:** Aqua objects to the Larkin's Report's recommendation to "adopt a revenue allocation method that increases rates from each rate group from their currently allowed level on an equal proportional basis" [Audit Report at 5-13.] Revenues under the proposed rates recommended by Aqua move revenues by class toward the revenue requirements by class per the cost of service. The revenue allocation proposed by the Audit

Report would move revenues under proposed rates away from revenue requirements by class as recommended by the cost of service study.

**Objection No. 32:** Aqua objects to the relative increases in the usage rates proposed by ACG in the Auditor's Report. [Audit Report at 5-31 through 5-35.] Aqua's proposed rates are designed to lessen the differences between rate groups, while some of ACG's proposed rates increase the differences. The use of the same rates in a utility with noncontiguous service areas is supported by the equivalent service rendered in each area. Although there would be considerable debate with respect to the equivalency of the service rendered to different customer classifications, there is no question that the service rendered to a residence in one area is the same as the service rendered to a residence in another area. Residential customers are relatively consistent in their uses of water: cooking, bathing, cleaning and other sanitary purposes, and lawn sprinkling. If customers use water for the same purposes, the service offering is the same and should be priced accordingly. Thus, from this perspective, there is no basis for charging different prices to customers in different areas.

In Table B below, note that, at present rates, Rate Group 2 rates for Blocks 1 and 2 are 1.31 and 1.32 times higher than those rates for Rate Group 1, while Rate Group 3 rates for those blocks are 1.67 and 1.53 times higher than those for Rate Group 1. Aqua's proposed rates would lessen those RG2/RG1 ratios slightly to 1.30 and lessen the RG3/RG1 ratios substantially to 1.54 and 1.43. But ACG's proposed rates design exacerbates the differences between rate groups by increasing the RG3/RG1 ratios as shown. Aqua requests that the Commission approve the long-term strategy of lessening the rate spread between rate groups in this and future cases.

**Table B: Comparison of Present Rates and Ratios**

| | Present Rates | | | Ratios | |
|---|---|---|---|---|---|
| | RG1 | RG2 | RG3 | RG2/RG1 | RG3/RG1 |
| Block 1 | $ 0.67 | $ 0.88 | $ 1.12 | 1.31 | 1.67 |
| Block 2[19] | $ 0.57 | $ 0.75 | $ 0.87 | 1.32 | 1.53 |

| | Aqua Proposed | | | Ratios | |
|---|---|---|---|---|---|
| | RG1 | RG2 | RG3 | RG2/RG1 | RG3/RG1 |
| Block 1 | $ 0.83 | $ 1.08 | $ 1.28 | 1.30 | 1.54 |
| Block 2 | $ 0.70 | $ 0.91 | $ 1.00 | 1.30 | 1.43 |

| | ACG Proposed | | | Ratios | |
|---|---|---|---|---|---|
| | RG1 | RG2 | RG3 | RG2/RG1 | RG3/RG1 |
| Block 1 | $ 0.71 | $ 0.93 | $ 1.20 | 1.31 | 1.69 |
| Block 2 | $ 0.60 | $ 0.86 | $ 0.96 | 1.43 | 1.60 |

**Objection No. 33:** Aqua objects to the Audit Report's private fire rate proposals. Aqua's proposals are in line with gradualism. Although ACG might not agree with the various increase amounts proposed by Aqua, its proposal to apply a single increase factor across all services in all rate groups does not achieve a more coherent rate structure. For example, the 2" connection sprinkler service is currently $8.50 per month in Rate Group 1, $29.60 in Rate Group 2, and $10.90 is Rate Group 3. Applying ACG's recommended single increase factor to those will not reduce the differences.

## IV. SUMMARY OF MAJOR ISSUES

**Major Issue No. 1: Return on Equity**

[19] Block 3 is not shown as it is not germane to most residential and commercial customers.

Aqua contends that Staff's recommended Return on Equity, ranging from 8.99% to 10.00%, is too low to permit the Company to earn a reasonable return under the circumstances, and therefore is unjust and unreasonable.

**Major Issue No. 2: Rate Base**

Aqua contends that the Staff Report's rate-base adjustments unreasonably exclude assets and capital expenses that are just and reasonable, used and useful and beneficial in providing service, and therefore properly recoverable in rates.

**Major Issue No. 3: Operating Income**

Aqua contends that the Audit Report unreasonably excludes test-year expenses that are just and reasonable, as well as known and quantified post-test year expenses, which are also just and reasonable.

**Major Issue No. 4: Cost of Service and Rate Design**

Aqua contends that the Audit Report includes recommended changes regarding the Cost of Service Study and Rate Design which are not just and reasonable and which do not achieve coherent rate structure.

[Attorney signature on following page]

Respectfully submitted,

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## CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was served by electronic mail upon the following parties this 14th day of March, 2022:

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