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STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF HAMILTON SOUTHEASTERN )  
UTILITIES, INC. FOR APPROVAL OF A NEW ) CAUSE NO. 43761  
SCHEDULE OF RATES AND CHARGES FOR )  
SEWER SERVICE ) APPROVED: AUG 18 2010

**BY THE COMMISSION:**

**James D. Atterholt, Commissioner**  
**Aaron A. Schmoll, Senior Administrative Law Judge**

On August 11, 2009, Hamilton Southeastern Utilities, Inc. (“Petitioner” or “HSE”) filed a Verified Petition with the Indiana Utility Regulatory Commission (the “Commission”) requesting approval of a new schedule of rates and charges for sewer service under the Commission’s Minimum Standard Filing Requirements. *See* 170 IAC 1-5 *et seq.* On August 25, 2009, Petitioner filed its Notice of Submission of Minimum Standard Filing Requirements. Pursuant to notice as provided by law, proof of which was incorporated into the record, a Prehearing Conference in this Cause was held on September 10, 2009, at 10:00 a.m. in Room 224 of the National City Center, 101 West Washington Street, Indianapolis, Indiana. Petitioner and the Office of the Utility Consumer Counselor (“OUCC” or “Public”) appeared and participated at the Prehearing Conference. On September 16, 2009 the Commission entered its Prehearing Conference Order establishing the procedural schedule in this Cause. Because Petitioner filed its Petition in accordance with the Minimum Standard Filing Requirements, the Commission set a rate base cutoff date of April 3, 2010 for inclusion in rate base of Petitioner’s major project, the 106<sup>th</sup> St. Lift Station.

Pursuant to proper legal notice, proof of which was incorporated into the record of this Cause by reference, and placed in the Commission’s official files, a second public hearing in this Cause commenced at 9:30 a.m. on November 4, 2009 in Room 224 of the National City Center, 101 West Washington Street, Indianapolis, Indiana. At the hearing, the prefiled direct testimony and exhibits of Kendall W. Cochran, Otto W. Krohn, A. Brad Mares, and John A. Boquist, Ph.D. were offered and admitted into the evidentiary record without objection. The hearing was continued to April 13, 2010.

Pursuant to proper legal notice, proof of which was incorporated into the record of this Cause by reference, and placed in the Commission’s official files, a public hearing in this Cause commenced at 9:30 a.m. on April 13, 2010 in Room 224 of the National City Center, 101 West Washington Street, Indianapolis, Indiana, and continued through April 14, 2010. At the hearing, the prefiled direct testimony and exhibits of OUCC witnesses Margaret A. Stull, Harold L. Rees, and Edward R. Kaufman were offered and admitted into the evidentiary record without objection. The prefiled rebuttal testimony and exhibits of Kendall W. Cochran, Otto W. Krohn, A. Brad Mares, and John A. Boquist, Ph.D. were also offered and admitted into the evidentiary record without objection.

Based upon the applicable law and evidence herein, the Commission now finds as follows:

**1. Notice and Commission Jurisdiction.** HSE is a “public utility” within the meaning of the Public Service Commission Act of 1913, as amended. Proper notice of the public hearing in this Cause was given as required by law. The Commission has jurisdiction over the parties and the subject matter of this Cause pursuant to Ind. Code §§ 8-1-2-4, -6, -38 to -42, and -61, among others.

**2. Petitioners’ Characteristics.** Petitioner, Hamilton Southeastern Utilities, Inc., is a corporation organized under the laws of the State of Indiana, with its principal office located at 11901 Lakeside Drive, Fishers, Indiana 46038. HSE has the corporate power and authority to engage in the business of providing sanitary sewage disposal service in Indiana. HSE has been operating as a public sewage disposal utility as authorized by the Commission since 1989. HSE operates in its current service territory pursuant to certificates of territorial authority (“CTA”) and indeterminate permits issued by the Commission in Cause Nos. 38685, 38819, 38897, 39567, 40501, 41528, 41745, 41752, 41798, 43435, and 43581.

**3. Existing Rates and Test Year.** Petitioner’s existing basic rates and charges for sewer service were established as its initial rates pursuant to the Commission’s Order in Cause No. 39191, dated January 22, 1992. Petitioner’s initial system development charge (“SDC”) was approved in Cause No. 43435 dated February 11, 2009. As provided in the Prehearing Conference Order, the test year to be used for determining Petitioner’s actual and proforma operating revenues, expenses and operating income under present and proposed rates is the 12 months ended December 31, 2008, adjusted for changes that are fixed, known and measurable for rate making purposes and that will incur within twelve months following the test year. In accordance with the Minimum Filing Requirements, the Commission set a rate base cutoff date of April 3, 2010. The financial data for this test year, when adjusted for changes, is a proper basis for fixing new rates for Petitioner and testing the effect thereof.

**4. Relief Requested.** Petitioner has requested an across-the-board rate increase of 10.185%. Petitioner has also requested that its present system development charge of \$2,400 be confirmed and approved.

**5. Overview of Petitioner’s Case-in-Chief.** Mr. Kendall W. Cochran, President of HSE, testified on behalf of Petitioner. Mr. Cochran testified that the purpose of his testimony was to give a brief overview of HSE’s case-in-chief and to explain why the relief requested is necessary. Additionally, Mr. Cochran explained the 106<sup>th</sup> Street Lift Station project, why the construction of that lift station at this time is necessary and in the public interest, and the date that the project was to be completed and in service. Mr. Cochran concluded that after months of investigation and analysis, it was his reasoned opinion that HSE’s base rate should be increased by 11.116%. Mr. Cochran took the Commission’s Order in Cause No. 43435 (Order granting HSE a CTA for area in Wayne Township near Noblesville and approving system development charge) as a directive to conduct a thorough review of its rates. Mr. Cochran testified that he

believes that the financial plan developed and presented in the rate case will ensure HSE's long-term financial health, meet the requirements of the Commission, and conform with general utility practices.

Mr. Cochran also supported the conclusions regarding HSE's taxes as a subchapter-S corporation and HSE's cost of common equity. Mr. Cochran testified that HSE has been organized as a subchapter-S corporation since its inception in 1989. The status commonly referred to as an S corporation has many advantages that benefit both the shareholders and ratepayers. One of the main advantages of this type of corporation is the tax treatment afforded to the corporation and the shareholders of the corporation. As an S corporation, the earnings of HSE flow through to the shareholders' tax returns and resulting taxes are paid by the shareholders at lower individual rates. This makes the effective tax rate on HSE earnings less for both the customers of HSE and the shareholders benefit from not being taxed on dividends that would be taxed to them if they were a C corporation rather than an S corporation. Mr. Cochran also agreed with Dr. Boquist that HSE's cost of equity should be between 11% to 14%. Mr. Cochran testified that HSE has no long-term debt and given the current credit market does not believe it would be prudent to begin substantial borrowing at this time. Mr. Cochran concluded that he believes the rates identified in the case-in-chief have been sufficiently justified and are in the public interest. He also concluded that HSE's basic rates and system development charges are very competitive with other surrounding utilities.

Mr. Mares testified concerning HSE's tax treatment and the implications of taxable income of the utility on the current rate proceedings. Mr. Mares testified that he has prepared HSE's tax returns for the tax and test year of December 31, 2008. He added that in lieu of HSE paying taxes, the shareholders in this corporation are allocated a proportionate share of the company's taxable income. He concluded that HSE's effective tax rate, based upon the aggregate tax of the allocated shareholder income from HSE, for the test year was 31% for federal taxes and 4.4% for state taxes. He testified that HSE's actual tax expense paid to the IRS and Indiana Department of Revenue for 2008 was \$305,709.

Dr. Boquist testified to HSE's cost of capital. Dr. Boquist offered what he believes would be a fair rate of return on the fair value of HSE's property. Dr. Boquist considered (1) current economic conditions as they relate to the cost of capital; (2) the size and investment quality of the rating of the company and the marketability of the company stock; and (3) specific adjustments due to the unique aspect of the company's service territory relative to the firms studied and the sample of proxy water companies. Dr. Boquist testified that the minimum cost of common equity should be a level that is sufficient to return capital to the business on reasonable terms and to maintain the financial integrity of the firm, thus permitting the company to render continuous and reliable service to its customers at reasonable costs, and to provide the firm with a return commensurate with that available on investments of corresponding risk. Dr. Boquist concluded that an 11% cost of common equity capital for HSE is reasonable.

Mr. Krohn testified on behalf of HSE regarding rate base and operating revenue and expenses. Mr. Krohn assisted with the preparation of financial exhibits relative to the proposed revenue requirements and the rate base for this proceeding. Mr. Krohn added that with the exception of two separate wholesale treatment cost tracking factors, HSE has operated with the

same basic rates and charges authorized by the Commission on January 22, 1992. HSE's current rates consist of a \$29 monthly flat fee for a single family equivalent dwelling unit ("EDU") along with a \$4.55 monthly tracking factor per EDU. Mr. Krohn testified that pursuant to the Commission's Order in Cause No. 43435, the test year for the rate case is the 12 months ended December 31, 2008. HSE's pro forma revenue requirement is based upon the test year actual results as adjusted for fixed, known and measurable changes occurring within 12 months of the test year. Rate base adjustments, by Order of the Commission, may be made through April 3, 2010. Mr. Krohn concluded that HSE needs an increase in rates of 11.116% across the board. Mr. Krohn testified that HSE's rate base as of December 31, 2008, is \$3,730,273. The \$3.7 million dollar subsequent investment along with a \$22,275 adjustment to working capital brings the rate base to \$7,512,549.

**6. Overview of the OUCC's Case-in-Chief.** Ms. Margaret A. Stull testified on behalf of the OUCC. The purpose of Ms. Stull's testimony was to address the proposed rate increase and the specific revenue requirements of Petitioner. Ms. Stull proposed pro forma adjustments to rate base and certain test year operating revenues and expenses. Ms. Stull eliminated \$3,170,728 from Petitioner's rate base. Ms. Stull also disagreed with HSE's working capital calculation and excluded a major portion of the 106<sup>th</sup> Street Lift Station costs and all of the costs associated with expansions of HSE Certificates of Territorial Authority. Overall, Ms. Stull recommended that the Petitioner decrease its rate by 17.96%.

Mr. Harold L. Rees testified on behalf of the OUCC concerning Petitioner's 106<sup>th</sup> Street Lift Station project and the need for the project. Additionally, Mr. Rees addressed the timing aspects relative to the provision of service and the impact on the rate base in this case. Mr. Rees testified that HSE's current system consists of about 184 miles of collection and force mains. Nearly all of these mains are constructed with PVC pipe of varying sizes. The system also has 21 lift stations equipped with pumps driven by electric motors. Several of the lift stations have odor control units, which is unusual for a sewer utility. Mr. Rees conducted a field audit of Petitioner's system and participated in a tour of the 106<sup>th</sup> Street Lift Station. Mr. Rees concluded that the utility's existing plant was in good condition and operations are high quality. HSE appears to maintain its plant and equipment in good working order. At the hearing in this matter Mr. Rees testified that as of ten days before the hearing the 106<sup>th</sup> Street Lift Station, the 36-inch force main and all other appurtenances were used and useful in the provision of utility service.

Mr. Edward R. Kaufman testified to Petitioner's cost of equity and overall cost of capital on behalf of the OUCC. Mr. Kaufman used both the DCF and CAPM analysis to estimate a cost of equity of 8.4%. Mr. Kaufman used a single-stage DCF model that produced a range of estimates from 8.85 to 8.9 percent and a 2-stage DCF model that produced an average cost of equity of 8.87%. Mr. Kaufman's analysis produced a range of estimates of 7.53% to 8.93%. Mr. Kaufman testified that because Petitioner has no long-term debt or other regulatory capital, a cost of common equity of 8.4% resulted in a weighted overall cost of capital of 8.4%. At the hearing on the OUCC's case-in-chief, Mr. Kaufman revised his overall cost of capital conclusion to 8.8% given recent market adjustments.

**7. Overview of Petitioner's Rebuttal Testimony.** Mr. Cochran responded to the testimony of Ms. Stull and Mr. Rees. Mr. Cochran disagreed with Ms. Stull's testimony

concerning HSE's tax obligation as an S corporation, the capitalization of HSE's CTA expansion costs, HSE's rent and purchased sewage treatment expense, and HSE's use of an affiliate company as its primary engineering contractor. Mr. Cochran also provided additional support for the inclusion of \$3.7 million in HSE's rate base and testified that there was no idle or unspent CIAC remaining in HSE's 2009 and 2010 CIAC accounts.

Mr. Krohn responded to the testimony of Ms. Stull concerning Petitioner's rate base and operating revenue and expenses. Mr. Krohn accepted some of the adjustments made by Ms. Stull, and rejected others. Mr. Krohn revised his rate increase from 11.116% to a 10.185% increase.

Mr. Mares responded specifically to the testimony of Ms. Stull regarding the actual income taxes paid by the shareholders on income generated by HSE. Mr. Mares included an analysis of the taxes paid on HSE's income for the taxable years 2004-2007. Mr. Mares concludes that HSE's effective tax rate for 2008 (HSE's test year) was less than the effective tax rates calculated for tax years 2004-2007; that the actual taxes paid in 2008 and the tax expense for the test year adjusted would be less as an S-Corporation than as a C-Corporation; and that the ratepayers and shareholders both benefit by being an S-Corporation rather than a C-Corporation.

In his rebuttal testimony, Dr. Boquist responded to the testimony of Mr. Kaufman. Specifically, Dr. Boquist disagreed with Mr. Kaufman's analysis of the risk premium that should be assigned to HSE. Dr. Boquist also took issue with portions of Mr. Kaufman's financial modeling.

## **8. Petitioner's Rate Base.**

### **A. CTA Expansion Costs.**

1. Petitioner's Evidence. HSE proposed to include \$1,749,065 of its actual costs to expand its CTA areas in rate base.

2. OUCC's Evidence. Ms. Stull excluded the \$1,749,065 of capital CTA costs in its proposed rate base. She testified that these costs do not represent a capital asset that is used and useful in the provision of utility service. She noted that Indiana Code § 8-1-2-6(b) excludes intangible assets from inclusion in ratebase. Because Ms. Stull removed these costs, she also eliminated \$466,010 of accumulated amortization related to those costs, as well as \$36,485 of annual amortization expense related to those costs.

3. Petitioner's Rebuttal Evidence. Mr. Cochran responded to Ms. Stull's assertion that HSE's organizational and CTA expansion costs should be excluded from rate base. He testified that earning a return on rate base is a good way to encourage utilities to invest in development. He added that to serve areas in Indiana, HSE must apply to the Commission, participate in lengthy legal proceedings, master plan the area, provide financial pro forma projections, and otherwise demonstrate that it has the financial, managerial, and technical ability to serve the areas. Mr. Cochran testified that no utility property can be constructed or placed into service until the Commission approves and grants the CTA. Because utility

construction projects cannot be placed into service without first obtaining a CTA, Mr. Cochran testified that such costs in obtaining the CTA should be included in the valuation of utility properties' rate base. He added that if HSE is unable to earn a return on its investment and CTA expansion, that it would discourage HSE's future investment in expanding its territory.

Mr. Krohn disagreed with Ms. Stull on the elimination of CTA expansion costs. Mr. Krohn testified that the value of HSE's CTAs are based upon HSE's actual costs and not an arbitrary assumption such as goodwill, going value, or natural resources. He testified that the CTAs are valued at cost and that they provide a tangible value to the utility. During the hearing, Mr. Krohn was asked about the Uniform System of Accounts for Class A Wastewater Utilities. Mr. Krohn testified that he believed Account 351 of the Uniform System of Accounts allowed HSE to capitalize its CTA expansion costs, and that Account No. 101 includes Account 351 in reflecting the original cost of utility plant used in computing a utility's rate base.

4. Commission Discussion and Findings. The OUCC proposed to eliminate \$1,749,065 of capitalized CTA costs for HSE's obtaining from the Commission its ten CTAs in which it operates. The OUCC argues that these costs represent intangible assets and that I.C. § 8-1-2-6(b) specifically excludes intangible assets from inclusion in rate base. The OUCC noted that HSE had not requested nor received permission from the Commission to treat these costs as regulatory assets, and approximately \$455,903 represent costs incurred to expand HSE's CTA in Noblesville and Boone County, areas just recently acquired by HSE, and that it is unreasonable to recover these costs from its customers in and around Fishers and Hamilton County.

Indiana Code § 8-1-2-6(b) specifically states that "public utility valuations shall be based upon tangible property." There is no dispute that the CTA costs are intangible, and therefore not includable. In fact, Petitioner cites to no other utility, and our research has not discovered any utility that includes CTA costs in rate base. We decline to do so here. However, utilities are permitted to seek recovery of such costs as an expense item based on test year expenses.

HSE noted that the Commission's Order in Cause No. 39191, dated January 22, 1992, approved a 2.2% composite depreciation rate to all plant accounts, including the organization/development account. While organization costs are addressed above, \$164,239 of the \$1.7 million "capitalized CTA costs" consist of master planning costs for the development of HSE's system, which the Commission finds appropriate to include in HSE's rate base. Accordingly, \$164,239 of Petitioner's proposed \$1,749,065 CTA cost shall be included in Petitioner's rate base. Associated with this reduction in rate base, HSE's accumulated amortization of its proposed CTA costs shall be reduced by \$335,463.

#### B. Working Capital.

1. Petitioner's Evidence. Utilizing the 45-day FERC method, HSE proposed a working capital allowance of \$1,044,270.

2. OUCC's Evidence. Ms. Stull testified concerning HSE's working capital. She testified that the 45-day formula, used to calculate the working capital needs of a

utility by taking 12.5% of the operations costs, has been accepted by this Commission and FERC. Nevertheless, she proposed an adjustment reducing HSE's working capital requirement because of various differences between HSE's and the OUCC's proposed operation and maintenance expenses. She also adjusted HSE's annual operating and maintenance expense for items paid in arrears. These included payroll taxes, property taxes, purchased power and purchased wastewater treatment expense. Her proposed working capital allowance was \$418,795.

3. Petitioner's Rebuttal Evidence. Mr. Krohn disagreed with Ms. Stull's analysis of the working capital allowance. He testified that all costs to some extent are paid in arrears, but on an annual basis these costs are incurred and paid throughout the year just as receivables are billed and collected throughout the year. He testified that the 45-day allowance for working capital should include all cash operating costs. Mr. Krohn added that the wastewater industry is capital intensive, especially compared to other utilities. He added that HSE has more than \$65,000,000 of gross plant investment and that the requested working capital allowance represents less than 2% of the current gross plant value. While plant valuation is not a typical factor in evaluating working capital, in this particular fact situation it illustrates the magnitude of this HSE's responsibility for operation, maintenance and replacement of its utility plant by relating the working capital requirement to the value of the utility's fixed assets.

4. Commission Discussion and Findings. Cash working capital represents the cash needed to be invested in the utility to give the utility the financial wherewithal to pay reasonable O&M expenses in the ordinary course of business prior to recovery in rates. There is normally a time lag between the point when a service is rendered and the related operating costs are incurred and the point when the revenues to recover such costs are received.

While both parties utilize the FERC 45-day test, HSE failed to remove certain expenses that are typically not included in the 45-day formula, such as taxes and purchased power, and in this case, purchased wastewater treatment. The rationale for not including such expenses is that the time period between the billing and payment of such expenses is long enough that additional capital is not necessary. Accordingly, the HSE's cash working capital allowance shall be \$509,987, as set forth below:

O&M Expenses	\$7,136,991
Less: Purchased Power	141,169
Purchased Sewage Treatment	2,915,923
Subtotal	4,079,899
Times: 45-Day Factor	0.125
Working Capital	\$509,987

C. Major Project – 106<sup>th</sup> St. Lift Station.

1. Petitioner's Evidence. Mr. Cochran testified that the 106th Street Lift Station is necessary for the orderly and efficient delivery of sewage disposal service to customers in HSE's existing CTA areas. HSE funded the 106<sup>th</sup> Street Lift Station upgrade, 106<sup>th</sup>

Street 36-inch force main, and 106<sup>th</sup> Street gravity sewer upgrade as capital projects using cash funds available for investments. He testified that the 106<sup>th</sup> Street Lift Station will be used to pump wastewater to the Town of Fishers at the wastewater treatment plant located on Eller Road. The Town of Fishers has required HSE to extend the point of discharge for the HSE 106<sup>th</sup> Street Lift Station to the Town of Fishers Eller Road wastewater treatment plant influent structure. The total length of the forced main to the treatment plant is approximately 22,500 lineal feet. Approximately one mile of the forced main is being constructed by HSE and the remainder by the Town of Fishers. He testified that HSE is using CIAC to fund the oversizing to the 36-in. forced main. HSE is also using CIAC to fund the oversizing of the lift station facilities. Mr. Cochran estimated that the 106<sup>th</sup> Street Lift Station project in total will cost \$5,000,000 of which \$3.7 million will be funded through cash held for investment by HSE.

2. OUCC's Evidence. In her direct testimony, Ms. Stull excluded \$1,262,197 of the \$3.7 million dollars to major project costs HSE had proposed to include in rate base. During cross-examination, Ms. Stull made a significant adjustment to her testimony based on Petitioner's rebuttal testimony. Rather than removing approximately \$1.2 million from rate base, Ms. Stull testified that she was only removing \$100,000 from the \$3.7 million dollars that HSE had invested in its utility plant during the test year. In essence, Ms. Stull accepted that HSE had paid \$3.6 million dollars of its own capital on the major project. Ms. Stull testified on cross examination that Petitioner should be forced to expend all of its unused CIAC before using its retained earnings. At the hearing, Ms. Stull testified that it was her belief that Petitioner could have approximately \$100,000 left in its CIAC funds, and that amount should be used before retained earnings. She testified to this because of a discrepancy between the Petitioner's April 2010 Investment Update and Petitioner's response to a data request served by the OUCC. In the Petitioner's April 2010 Investment Update, Petitioner reported that it was spending approximately \$2,071,749.49 of its CIAC on the 106<sup>th</sup> St. Lift Station. In a data request response, Petitioner indicated that it was spending \$2,162,167.59 of its CIAC on the lift station. Because of this discrepancy, Ms. Stull removed \$100,000 from Petitioner's rate base.

3. Petitioner's Rebuttal Evidence. Mr. Cochran testified that the OUCC's position in regards to the 106<sup>th</sup> Street Lift Station is inconsistent with its position in Cause No. 43435. In that case, Mr. Kaufman stated that, "I believe Petitioner relies too heavily on contributed plant and contributed capital to fund its utility plant in service." Additionally, Mr. Kaufman testified that, "Petitioner should be making moves to increase the amount of plant funded through equity to avoid the possibility of negative rate base and negative equity." Finally, Mr. Kaufman testified that, "potential rate reduction from the use of CIAC is not true savings to the ratepayers." Mr. Cochran testified that given this testimony and the Commission's reliance on this testimony in Cause No. 43435, HSE thought it prudent to invest a significant amount of equity into its system to demonstrate to the Commission and the OUCC that HSE was serious about answering Mr. Kaufman's assertions.

Mr. Krohn also disagrees with the Public's assertion that it can only invest its equity funds after expending all CIAC funds. Mr. Krohn noted that this treatment would be the opposite of the treatment recommended by the OUCC in Cause No. 43435. Regardless of that position taken by the OUCC Mr. Krohn testified that HSE has spent all of its 2009 CIAC funds as of the filing of Petitioner's rebuttal testimony. Additionally, Mr. Krohn testified that HSE has

expended all 2010 CIAC funds collected that would not have had to be expended until the end of 2012 under IRS regulations. Mr. Krohn also responded to Ms. Stull’s testimony on the stand that she would revise her major project cost, but still exclude \$100,000 of major project costs from her rate base calculation. Mr. Krohn presented an exhibit on the stand before his cross-examination that showed a misclassification of an expenditure in an exhibit provided to the OUCC and upon which Ms. Stull relied in making her estimate. In responding to a data request from the OUCC, Mr. Krohn misclassified a \$198,140 expenditure. Mr. Krohn testified that this item was placed in the 106<sup>th</sup> St. Lift Station Upgrade Account, and should have been placed in the Thorpe Creek Lift Station Upgrade Account. This adjustment lessened the computed amount of CIAC spent by HSE on the 106<sup>th</sup> St. Lift Station by \$198,140 in error. Mr. Krohn concluded that HSE had in fact spent \$3.7 million in equity on the 106<sup>th</sup> St. Lift Station.

4. Commission Discussion and Findings. Based on the additional testimony and exhibit provided by Mr. Krohn, the parties in their proposed orders agree that the \$3.7 million was expended by HSE for construction of the 106<sup>th</sup> Street Lift Station project as of the cutoff date. According, HSE’s rate base shall include \$3.7 million to recognize the 106<sup>th</sup> Street Lift Station.

With regard to the OUCC’s assertion of possible reimbursement to HSE’s capital accounts from CIAC funds collected in the future to reimburse all or part of the \$3.7 million, Mr. Cochran testified that HSE will not seek to reimburse itself through CIAC for any funds invested by the utility that are included in its rate base calculation. We find that limitation appropriate. To the extent the final cost of the 106<sup>th</sup> Street Project exceeds \$3.7 million invested by HSE, however, HSE may reimburse itself for the overage using CIAC funds.

E. Quantification of Original Cost Rate Base.

As described above, we find that Petitioner has a pro forma rate base of \$5,728,902 as set out below:

UPIS	\$	61,508,388
Add: Net 106th St Project (3/17/10 Update)		3,700,000
Less: CTA costs		1,584,826
Sub-Total	\$	63,623,562
Less: Accum Depreciation		6,831,272
Accum Amortization		466,010
CIAC - net of CWIP		57,805,816
Add: Working Capital		509,987
Accum Amort. CTA Costs		335,463
Amort. Of CIAC		6,362,988
<i>Total Original Cost Rate Base</i>	\$	<u>5,728,902</u>

9. Cost of Capital and Rate of Return.

A. Petitioner's Evidence. Dr. Boquist used five sample companies as proxy companies to represent the business and economic situation of HSE. Dr. Boquist made an adjustment for the fact that HSE is a small company, has less geographic diversification in its service territory, and, carries a higher risk profile than the sampled companies. Dr. Boquist used two models to complete his analysis: (1) the discounted cash flow model ("DCF"); and (2) the capital asset pricing model ("CAPM"). Based on these two methods, Dr. Boquist testified that the results for HSE ranged from 11% to 14%. Dr. Boquist concluded that an 11% cost of common equity capital is reasonable and conservative for HSE and a higher request could be supported. Dr. Boquist added that the unadjusted average cost of common equity capital on a market value basis for the proxy sample was 9.47% according to the two-stage quarterly dividend DCF model. Dr. Boquist then added an adjustment of 1.5% or 150 basis points to the unadjusted two-stage DCF model to reflect the greater inherent riskiness of HSE relative to the sample utilities. Under the CAPM analysis Dr. Boquist determined that the size-adjusted required return of common equity capital would be 14.04%

B. OUCC's Evidence. Mr. Kaufman testified that he would not adjust his analysis for business or financial risks because he believes that Petitioner has especially low business and financial risk. Mr. Kaufman testified that he believes that HSE has little or no competition or substitutes for its service, resulting in relatively stable revenues when compared to other industries. Petitioner charges all customers a flat fee per EDU. Because revenue does not change based on usage, Kaufman argues that Petitioner's revenues are quite stable. Also, Petitioner has no long-term debt. Because Petitioner has no long-term debt, Mr. Kaufman believes it has less risk than other similarly situated companies that have long-term debt. Mr. Kaufman testified that utilities typically have at least 50% debt in their capital structure and by using a suitable amount of debt can reduce their cost of capital.

Mr. Kaufman's prefiled testimony supported an 8.4% cost of equity. However, at the April 13, 2010 hearing, he adjusted his recommendation upwards to an 8.8% cost of equity based upon a change he made to his CAPM analysis. The risk premium for 2008 was 4.75%. Updated 2009 information moved it to 5.2%. Mr. Kaufman testified that 8.8% is a reasonable cost of equity in this market. He stated that lower inflation rates generally translate into lower capital costs. He testified that because his DCF analysis ranges between 8.78% and 8.9% and his CAPM analysis ranges from 7.53% to 8.39% that the mid point of those numbers is 8.22%. Mr. Kaufman gives more weight to his single-stage DCF analysis and CAPM analysis based on historical risk premiums. This narrows his overall range to 7.91% to 8.9%. The midpoint of this range is 8.4%. Mr. Kaufman also disagrees with Dr. Boquist's company-specific risk adjustment of 150 basis points. Because HSE has no debt and has a fixed rate for all customers, Mr. Kaufman alleges that Petitioner tends to be less risky than other companies in the proxy group selected by Dr. Boquist.

C. Petitioner's Rebuttal Evidence. Dr. Boquist responded to Mr. Kaufman's estimate of 8.4% cost of common equity capital. Dr. Boquist determined that Mr. Kaufman's estimate is not supported by a proper application of the DCF or the CAPM models. Such a low cost of equity capital, if adopted by the Commission, would jeopardize the financial integrity of HSE, particularly if it is subsequently applied to the book value of HSE's property. Use of such a low cost in common equity capital to determine HSE's authorized return results in a level of

net operating income that would not constitute a fair rate of return. Mr. Kaufman's recommendation is additionally well below his recommendation of 9.25% cost of equity capital in the recent *Indiana American* rate case and also below the 9.5% he recommended for *Utility Center* and the 9.75% he recommended in the most recent *South Haven* case.

Dr. Boquist disagreed with Mr. Kaufman's assertion that HSE had especially low business risks. Dr. Boquist added that the company faces regulatory risks as evidenced by this proceeding. Additionally, HSE has more business risks than it did previously because it now has new CTAs to serve both Noblesville and Zionsville. Additionally, given the recent downturn in the real estate market, Dr. Boquist testified that there is no guarantee of the number of housing units that will be hooking up to the system. Furthermore, Dr. Boquist testified that the wastewater treatment contracts with Fishers and Noblesville are subject to renewal placing the company at greater long-term risk than if they owned their own systems and controlled their own wastewater treatment options. Dr. Boquist added that in recognition of the substantial risk of contract termination, the company maintains land holdings and explores potential plant sites to provide them with a credible threat during contract negotiations. For all of these reasons, HSE has substantial business risks. Therefore, Dr. Boquist disagrees with Mr. Kaufman's analysis of HSE's financial risk. Because HSE has such a small and regionally concentrated customer base, Dr. Boquist believes that HSE has a substantial amount of risk that must be reflected in its cost of capital.

D. Commission Discussion and Findings. HSE's witness, Dr. John Boquist, finds that based upon his analysis an 11% cost of common equity capital for HSE is reasonable. Dr. Boquist used the dividend growth model or Discounted Cash Flow (DCF) model and the Capital Asset Pricing model (CAPM). Dr. Boquist took into account the limited marketability of HSE's common equity, along with the business and financial risk associated with the utility in arriving at this 11% cost. The OUCC's witness, Mr. Kaufman, disagreed with Dr. Boquist on his assessment of the utility's risk and concluded that HSE had an especially low business and financial risk, and recommended an 8.8% cost of equity.

We recognize the cost of common equity cannot be precisely calculated and estimating it requires the use of judgment. Due to this lack of precision, the use of multiple methods is desirable because no single method will produce the most reasonable result under all conditions and circumstances.

Further, we must consider the effect tracking mechanisms have in reducing risk in order to ensure that these reduced risks are properly reflected in HSE's cost of equity. See *Petition of PSI Energy*, Cause 42359 at 53 (May 18, 2004). HSE's most significant expense, purchased wastewater treatment, is a tracked expense that can be adjusted upon approval of a revised tariff under the Commission's 30 day filing process.

Based on the entirety of the evidence at issue, and giving such weight to the evidence as we deem appropriate, we find that HSE's cost of common equity capital shall be 9.8%.

## **10. Operating Income Under Present Rates.**

### **A. Revenue Adjustments.**

1. Petitioner's Evidence. Petitioner projected a pro forma operating revenue increase of \$121,787. Mr. Krohn testified that this adjustment is based on the addition of 605 customers during the test year. The operating revenues were normalized for a full year of revenues for the customers that were added during 2008.

2. OUCC's Evidence. Ms. Stull did not accept HSE's revenue adjustments. She agreed that revenue normalization is appropriate but disagreed with HSE's methodology. Ms. Stull annualized the number of bills that would accrue for any increase or decrease in the number of customers. She then calculated an average test year bill by dividing the test year revenues by the total number of test year customer bills. Finally she multiplied the total additional bills by the calculated average bill to yield an increase in test year revenues. She testified that this adjustment normalizes the growth of HSE's customer base on a per bill basis. Her proposed pro forma rate revenue increase was \$125,629. Ms. Stull also included income generated by SAMCO's rental of office space from HSE. This rental income yields an increase of \$31,937 for the test year operating revenues. She testified that total pro forma present rate revenues for HSE should be \$8,846,054.

3. Petitioner's Rebuttal Evidence. Mr. Krohn disagreed with Ms. Stull's recommendation concerning pro forma operating revenues of Petitioner. He added that Ms. Stull's adjustment attempts to normalize revenues by taking monthly customer billing data that includes changes in a number of customers' bills that are not necessarily related to growth. Customers can leave HSE's certified territories for a number of reasons, including move-in and move-outs, foreclosures and reasons other than actual customer growth. He testified that Petitioner's method of normalizing revenues for actual growth is reasonable and appropriate for this proceeding.

Mr. Krohn also took issue with the revenue differential relating to the OUCC's assumption that rental income will increase by \$31,937. Mr. Krohn testified that HSE offsets its rental expense for the test year with income generated during the test year from rentals. HSE acknowledged that rental income in 2009 increased by \$8,653, but disagrees with the Public's proposed adjustment. Mr. Krohn testified that pro forma net rent expense should amount to \$28,300.

4. Commission Discussion and Findings. HSE's adjustment to test year revenues utilized the change in total number of customers during the test year. It assumed a linear rate of growth by adding to revenues one-half of the annualized operating revenues for the test year for the new customers added during the twelve-month period following the test year. The Public normalized revenues using customer billing data. We prefer the OUCC's methodology, and find the OUCC's adjustment of \$125,629 to be appropriate. However, with regard to rental income, HSE's adjustment of additional revenues of \$8,653 due to increased rent is appropriate.

B. Depreciation Expense.

HSE proposed a \$74,000 increase in depreciation expense. In response, Ms. Stull eliminated \$1.262 million from rate base, and used a 2.2% depreciation rate rather than a 2.0 % depreciation rate. This resulted in a decrease in Petitioner’s adjustment to \$53,362.

The differences between the OUCC and Petitioner’s proposed depreciation expense are associated with the parties’ proposed equity investment in the 106<sup>th</sup> Street Lift Station and the composite depreciation rate used. Petitioner multiplied a 2.0% composite rate to a \$3.7 million equity investment in the 106<sup>th</sup> Street Lift Station to yield a \$74,000 adjustment. The OUCC multiplied a 2.2% composite rate based on a \$2,437,803 equity investment (\$3,700,000 - \$1,262,197 proposed CIAC balance) to yield a *pro forma* depreciation expense increase of \$53,632.

Petitioner’s *pro forma* depreciation expense adjustment should be based on the Commission approved composite depreciation rate of 2.2% for wastewater systems without a wastewater treatment plant. Petitioner’s depreciation adjustment should also be based on the total cost of the 106<sup>th</sup> Street project, which would be offset by the amortization of CIAC for any CIAC funds used toward the project. However, because HSE may reimburse itself with future CIAC funds to the extent the 106<sup>th</sup> Street project exceeds \$3.7 million, Petitioner’s depreciation proposal is based only on the \$3.7 million equity investment it has made. Therefore, the Commission finds that HSE’s depreciation expense shall be adjusted upwards by \$81,400, as set forth below:

106th Street Project	\$ 3,700,000
Times: Composite Rate	2.2%
Depreciation Expense for 106th St.	\$ 81,400

Finally, we note that for future cases, Petitioner shall either apply the Commission’s composite depreciation rate of 2.2% (for wastewater systems without a treatment facility) to its entire depreciable plant balance or provide a depreciation study to reflect revised depreciation rates.

C. Operating Expenses

1. Operation and Maintenance.

a. Petitioner’s Evidence. Mr. Krohn testified that the adjusted operation and maintenance expense, including depreciation and taxes, amounts to \$8,881,588. Mr. Krohn made several adjustments to Petitioner’s operating and maintenance expense.

Mr. Krohn included an adjustment for an increase in payroll related to employee benefits that was implemented in 2009 by HSE management.

Mr. Krohn also added an adjustment that reflects the increase in sewage treatment costs attributable to the growth and customer rates that occurred during the test year. This adjustment totaled \$40,307.

Mr. Krohn made an adjustment that reflects the anticipated increase in operating costs related to sewer cleaning (\$125,533 increase) and video inspections (\$106,934 increase) related to the sewer system. This adjustment also provides for an overall increase of 5.2% for the operations contract with HSE's contract affiliate (\$68,499) and other contract services (\$30,365 increase).

Mr. Krohn's next adjustment was for anticipated changes in purchase power costs related to three new lift station pumps and controls including the 106<sup>th</sup> Street Lift Station. This adjustment totals \$34,440 in the test year.

Mr. Krohn's fifth adjustment reflects the increase in the annual liability insurance premium (\$2,770 increase).

Adjustment six of Mr. Krohn's testimony, related to property tax expense, reflects an expected 13.23% increase in HSE's depreciable fixed assets, based upon the conveyed sewers through July 31, 2009. The property tax increase based on additional assets is \$186,700.

Adjustment seven reflects the anticipated increase in Indiana utility receipts tax for the additional sales from the revenue normalization adjustment.

Mr. Krohn's adjustment nine<sup>1</sup> eliminates certain costs that for ratemaking purposes are being excluded and reduces the test year rental expenses related to the Noblesville contract by the test year rental income from office space.

Finally, Mr. Krohn's adjustment ten increases test year expenses by \$40,000 for rate case expense, which is \$120,000 amortized over three years.

b. OUCC's Evidence. Ms. Stull disagreed with Petitioner's O&M expense and with the adjustments made by Mr. Krohn. She proposed modifications to HSE's salary expense, employee benefits, expense normalization, non-allowed expenses, rate case expense amortization, depreciation expense, payroll tax expense, property tax expense, and utility receipts tax. She excluded HSE's proposed adjustments for purchased power, contractual services for HSE's affiliate, and income tax expense. She proposed additional adjustments for purchased treatment expense, affiliated rent expense, and amortization expense. Her proposed adjustments resulted in an overall decrease of \$833,367 to test year operating expenses yielding pro forma operating expenses of \$6,929,648.

Ms. Stull made an adjustment for salary and wage expense and employee benefits expense based on the fact that HSE had only six employees as of December 2009, rather than a test year employee count of seven employees. This decreased the pro forma salary expense by \$28,723. The OUCC determined the pro forma employee benefit expense should be \$124,369, an increase of \$5,334 to test year employee benefit expense.

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<sup>1</sup> Adjustment 8 related to depreciation expense, which we addressed *supra*.

Ms. Stull also proposed an adjustment to purchased sewage treatment expense. She testified that an analysis of HSE's purchase sewage treatment costs for 2008 and 2009 revealed decreasing volumes and costs despite an increase in customer base. She testified that her adjustment yields a pro forma decrease of \$349,977 to test year purchased treatment costs.

Ms. Stull also disagreed with HSE's proposed power expense adjustment. She testified that these costs are not fixed, known and measurable and any increase in costs will occur outside the 12 month adjustment period. She testified that because the 106<sup>th</sup> Street Lift Station did not go into service until March 2010, no additional energy usage would be appropriate in HSE's revenue requirement. For these reasons Ms. Stull excluded the \$34,440 test year purchase power expense increase.

Ms. Stull also made an adjustment for HSE's purchased sewage treatment expense. She calculated the sewage treatment costs as 29.296% of operating revenues during the test year. She then applied this percentage to her proposed revenue normalization adjustment which yields an increase of \$36,804 to test year purchase sewage treatment expense.

Ms. Stull also excluded rent expense paid on land for a future sewage treatment plant. She testified that the land is not currently used and useful and the expense provides no material benefit to HSE's current customers. This yields a decrease to rent expense of \$56,625.

Ms. Stull also included an adjustment to exclude nonrecurring or non-allowed expenses. These included expenses for a holiday party and nonrecurring legal expenses. Her adjustment yields a pro forma decrease of \$47,525 in test year operating expenses.

Ms. Stull also proposed to eliminate \$5,000 for HSE's tax consultant and amortize HSE's remaining rate case expenses over a seven year period rather than a three year period. This yields a pro forma rate case amortization expense of \$16,429.

Ms. Stull also made an adjustment for a decrease in payroll tax expense of \$2,202. This is a result of Ms. Stull's adjustment to payroll because HSE is employing six rather than seven employees as of December 31, 2009.

Ms. Stull also eliminated HSE's proposed increase of \$186,700 to property tax expense. She testified that this is a result of the improvements to the 106<sup>th</sup> St. Lift Station. She believed that because these will not be paid until 2011, they are not fixed, known and measurable.

Finally, Ms. Stull disagreed with Petitioner's calculation of the utility receipts tax. Because Ms. Stull uses a different revenue number than Mr. Krohn, this yields an increase in Petitioner's utility receipts tax of \$3,950.

c. Petitioner's Rebuttal Evidence. Mr. Krohn testified that the OUCC's proposed operation and maintenance expense adjustments suggest that costs for HSE will decline by 11% in the future. Mr. Krohn testified that test year actual expenses as presented by Petitioner and the Public amounted to \$7,765,015. Mr. Krohn testified that the OUCC has made a series of adjustments that would suggest that these costs will decline by \$864,448. Mr.

Krohn testified that the most significant adjustment differences relate to the OUCC's proposed reduction in pro forma wholesale wastewater treatment charges from Fishers and the OUCC's deduction of 20% of the actual test year engineering and contract operating expenses.

Mr. Krohn testified that the reduction in wholesale treatment charges recommended by the OUCC should be denied. Mr. Krohn noted that during 2009, power costs associated with the lift station pumping actually increased by \$64,519. He testified that the increased pumping costs support the notion that wastewater flows actually increased and did not decrease as suggested by the OUCC. The OUCC's proposed 2009 adjustment to test year wholesale treatment charges is not fixed, known and measurable because it only relies on ten months' worth of data and is based on an inaccurate flow meter, as explained more fully below.

Mr. Krohn also disagreed with Ms. Stull's elimination of the adjustment for purchased power expense. Mr. Krohn testified that the actual 2009 power cost for HSE amounted to \$171,248. The test year power costs were \$106,729. The 2009 actual costs for purchase power actually exceed the amount proposed in HSE's pro forma adjustments. Therefore, there is no basis to reduce or eliminate Petitioner's proposed power cost adjustment. Total pro forma power costs will undoubtedly exceed the 2009 actual expense level as the 106<sup>th</sup> Street Lift Station pumps were not even placed into service in 2009.

Mr. Krohn disagreed with the OUCC's reduction in property tax expense. He testified that it is inconceivable that property tax expense will actually decline in light of the substantial amount of utility plant additions that have occurred since the end of the test year. In total Mr. Krohn testified that over \$15,000,000 of utility plant in service has been added to HSE's plant value since the end of the test year. Therefore, he concluded that Petitioner's proposed pro forma property tax expense of \$907,964 is over supported by these facts. He testified that the increased plant value is fixed, known and measurable. Finally, he testified that net tax rates billed have actually increased for businesses over the past several years.

Mr. Krohn testified that actual rate case expenses already exceeded the amounts reflected in Petitioner's pro forma adjustment and proposed a three-year amortization schedule. Mr. Krohn testified that a three-year amortization period is reasonable, appropriate and has been a standard rule of thumb for many utility rate proceedings before the Commission. Because HSE has depleted its cash reserves and because growth and new development in its CTA areas have declined significantly, it is unreasonable to assume that HSE would not seek future rate adjustments for seven years. The proposed \$40,000 annual requirement is reasonable in light of the actual costs of this particular rate case versus the nominal allowance utilized for ratemaking purposes in the Petitioner's pro forma adjustment.

Mr. Cochran testified to the expense associated with the proposed wastewater treatment plant in Noblesville. Mr. Cochran testified that the site is the only site available within the drainage basin of HSE's service area which meets the size requirement and IDEM's separation requirements from surrounding homes. Mr. Cochran testified that this wastewater treatment plant site is necessary in the event Noblesville cancels its wholesale contract with HSE per the terms of Wholesale Sewer and Facilities Agreement executed on August 25, 2009, with Noblesville.

Mr. Cochran also disagrees with Ms. Stull's reduction of \$349,977 in purchased sewage treatment costs. He testified that HSE identified early in 2009 a discrepancy with the flow meter data for the Shoemaker Ditch monitoring site and tested a new meter type during the second quarter of 2009. From June 2009 through January 10, 2010, HSE's engineer met with Fishers to discuss the need for the change in flow meter type due to the hydraulic jump which is occurring in existing flow meter due to high velocity in the 18-inch gravity interceptor. The Town of Fishers stated they understood the reason for the proposed change, investigated the proposed meter, and notified HSE that the proposed new meter was acceptable. Recently, the Town of Fishers approved the meter change and HSE is pursuing the implementation of a new meter. Mr. Cochran believed that Mr. Krohn's adjustment to treatment expense during the 2008 test year more accurately represents the real increase in treatment expenses since there are pending discrepancies in the flow meter data.

Mr. Krohn testified that HSE does acknowledge that there is one less employee for HSE and that HSE has no current plan to replace that particular staff person. Therefore, HSE is willing to accept the OUCC's proposed adjustments for payroll, employee benefits and payroll taxes. HSE is also willing to accept the Public's proposed adjustments for non-recurring and non-allowed operating costs. Mr. Krohn concluded that the resulting across the board rate increase is 10.185% when these adjustments are taken into account, with a monthly rate per EDU in the amount of \$36.97.

d. Commission Discussion and Findings.

i. Wholesale Treatment Expenses. HSE adjusted wholesale wastewater treatment charges from the Town of Fishers by increasing the test year expenses for the increase in the number of customers added during the 12-month period subsequent to the test year, resulting in a \$40,307 increase in wholesale treatment costs. The OUCC noted decreasing volumes and costs for purchase of treatment from the Town of Fishers for the first ten months of 2009. The OUCC annualized the reduction in volumes during the first ten months and decreased purchased sewage treatment expense on a pro forma basis by \$349,977. The Petitioner noted that the first ten months of 2009 data used by the OUCC was erroneous because of a known metering problem at the Shoemaker Ditch flow meter, which was identified by HSE and the Town of Fishers in early 2009. Petitioner provided evidence that HSE and the Town of Fishers are in the process of replacing that flow meter given that recent tests performed by HSE demonstrate that the existing meter has been giving false readings. The documented increase in the number of customers (905 in 2008 and 958 in 2009) and the increase in 2009 power costs related to pumping expense support HSE's position that a meter malfunction occurred. Accordingly, we find that wholesale treatment expense adjustment of \$40,307 is appropriate.

ii. Purchased Power Costs. With regard to purchased power costs, HSE proposed an increase to test year purchase power expense of \$34,440 to reflect what it indicated was increased costs related to increased pumping capacity at three lift stations. The Public proposed no increase in pro forma power cost expense on the basis that such costs are not fixed, known and measurable and will occur outside of the 12-month adjustment period

because the 106<sup>th</sup> Street Lift Station pumps were not placed into service until 2010. The Petitioner's evidence establishes that there was an actual increase in 2009 power costs of \$64,519 over the 2008 test year as opposed to the \$34,440 pro forma proposed power cost expense adjustment requested by HSE in this proceeding. In other words, Petitioner underestimated its power costs but does not seek recovery of the actual increase based on 2009 data. Accordingly, the Commission finds that HSE's purchase power cost expense adjustment of \$34,440 is appropriate.

iii. Property Tax Expense. With regard to HSE's proposed increase in property tax expense, it asserted that it has constructed \$3,848,590 of new plant with its own invested capital, an additional \$3,108,079 of new plant constructed with cash CIAC and has received an additional \$8,793,408 of conveyances of local sewer mains contributed by developers, totaling \$15,750,017 of new property subject to property taxes. The pro forma adjustment proposed by the Petitioner was \$186,700. The OUCC's position is that the proposed increase sought by HSE in property tax expense was a result of its improvements to its 106<sup>th</sup> Street Lift Station and such is outside of the twelve-month adjustment period for fixed, known and measurable expenses. The OUCC therefore excluded the entire proposed adjustment on that basis.

The value of HSE's used and useful property subject to taxation is not disputed by either party, and with exception of the 106<sup>th</sup> Street Project, was known within 12 months of the test year. However, even for major projects added to ratebase beyond the 12 months, pursuant to the Commission's minimum standard filing requirements, the Commission has allowed utilities to recover property tax expense for those projects. Further, Petitioner demonstrated that actual property taxes will exceed the Petitioner's pro forma adjustment. The Commission therefore finds that HSE's adjustment of a \$186,700 increase in property tax expense to be appropriate.

iv. Rate Case Expense. With regard to rate case expense, Petitioner supported its cost of \$120,000 and proposed a three year amortization, while the OUCC excluded \$5,000 for Mr. Mares and proposed a seven year amortization. HSE's testimony was that, due to the state of the economy with regard to lack of new home construction, lack of new growth and development coming to a standstill in its CTA areas, it will need financing and rates to continue to make improvements to its system and serve its new CTA's in Noblesville and Zionsville. HSE represents that it has now invested most of its unrestricted cash into capital improvements related to the 106<sup>th</sup> Street project and, therefore, it would be unreasonable to believe that HSE could wait for seven years before seeking future rate adjustments.

The Commission finds that Mr. Mares' expenses are reasonable and shall be included, and that rate case expense shall be amortized over four years, which results in a \$30,000 rate case expense amortization.

v. Employee Expense/Non-Recurring Expense. The Petitioner and OUCC have agreed on payroll expense and the Public's proposed adjustments for payroll, employee benefits and taxes. Petitioner has also agreed to accept the Public's proposed adjustments for non-recurring and non-allowable operating costs.

vi. Rent Expense. HSE currently rents land it intends to potentially use for a future wastewater treatment plant, and paid \$56,625 in rent. The OUCC eliminated this expense because the land is not used and useful. We find that rent for property that is currently not serving customers cannot be included in present rates, and the elimination of the \$56,625 of rent expense is appropriate.

2. Affiliate Contract Expense

a. Petitioner's Evidence. Petitioner proposed a 5.2% increase in its contract operations with its contract affiliate ("SAMCO") and with regard to its other contract services with other contract providers. The increase reflects the current hourly billing rates pursuant to the contract between SAMCO and HSE. The annual contract engineering services are anticipated to increase by \$68,499 with its affiliate and \$30,365 per year with other contract providers.

b. OUCC's Evidence. Ms. Stull made an adjustment for HSE's transactions with its affiliated company. She testified that HSE should use the guidelines for cost allocations and affiliate transactions outlined by NARUC. She testified that NARUC recommended the price for services, products and the use of assets provided by a non-regulated entity should be at the lower of fully allocated costs or prevailing market prices. She testified that HSE had submitted to the OUCC that its affiliate charges market rates for its services. Ms. Stull presented no evidence that refuted HSE's position on that point. She testified that the OUCC was concerned, however, that there is significant profit included in the affiliate's charges to HSE. She testified that total test year operating expenses related to SAMCO are \$3,048,523. She testified that she disagrees with HSE's proposed rate increases for services provided by SAMCO. Ms. Stull accepted HSE's proposed increases for line cleaning and video inspections to test year SAMCO charges to yield total affiliate transaction charges of \$3,280,990. Ms. Stull did not accept Petitioner's proposed adjustments to the increases in either affiliated contract engineering services (\$68,499) or nonaffiliated contract engineering services (\$30,365). Furthermore, Ms. Stull did not accept the increase due to Lift Station maintenance with SAMCO (\$27,707). She testified that HSE's affiliate contract with SAMCO allowed SAMCO to charge a 10% mark-up on purchases, including the hiring of third party vendors to provide services. To this 10% mark-up Ms. Stull added another 10% estimated additional margin to yield a total estimated profit margin of 20% overall. This resulted in a decrease to HSE's proposed SAMCO expense of \$656,198.

c. Petitioner's Rebuttal Evidence. Mr. Cochran disagreed with Ms. Stull's 20% decrease in the cost paid to SAMCO. Mr. Cochran testified that SAMCO only marks up invoices to HSE that are related to material costs and subcontractor work per the Utility Services Agreement that is on file with the Commission. Markups on SAMCO invoices to HSE for material costs and subcontractors during the test year amounted to \$55,305, which is only 2% of the total amount paid to SAMCO rather than 10% as Ms. Stull asserts. This markup reflects the costs incurred by firms such as SAMCO in entering into contracts with subcontractors, managing and supervising the subcontractors' work, and billing and arranging for payment of the subcontractors. Mr. Cochran provided examples of rate schedules for other

municipalities and engineering firms which indicate an average of 10-12% markup on subcontractor and material costs. Mr. Cochran also testified that the rates between SAMCO and HSE are annually negotiated between representatives of both entities at arms length. Mr. Cochran testified that in all recent instances where SAMCO has requested a billing rate increase HSE has negotiated the requested increase down and in two instances negotiated with SAMCO to maintain its rates without an increase.

Mr. Cochran also testified that HSE conducted a rate study in 2009 to determine whether SAMCO charges rates that are competitive with the regional market. The rate study exhibit indicates that SAMCO charges rates that are at or below the regional market. Mr. Cochran also said that he disagrees with the conclusions reached by Ms. Stull with regard to the affiliate guidelines cited by Ms. Stull. Mr. Cochran testified that the guidelines themselves suggested they may not be appropriate for every situation. For instance, the guidelines cited by Ms. Stull state that, "they are not intended to be rules and regulations prescribing how cost allocations and affiliate transactions are being handled." Rather, the guidelines are intended to provide a framework for regulated entities and regulatory authorities in the development of their own policies and procedures for cost allocations and affiliated transactions. Mr. Cochran concluded that HSE has been able to monitor the local market to ensure that rates HSE pays SAMCO are competitive with local market rates. He testified that SAMCO has 178 clients and that such a broad customer base indicates that SAMCO's rates are extremely competitive in the region. He added that HSE does not subsidize SAMCO's operations, that HSE employees operate independently from employees of SAMCO, that HSE does not grant preference to or discriminate in favor of SAMCO, and that HSE and SAMCO do not participate in any joint advertising.

d. Commission Discussion and Findings. HSE increased its maintenance costs by 5.2% and its sewer cleaning by \$125,533 and video inspections by \$106,934. The OUCC calculated a pro forma contract maintenance and operations expense by adding HSE's proposed increases in line cleanings (\$125,533) and video inspections (\$106,934) to test year operations expenses of \$3,048,523 to yield a total contract charge of \$3,280,990. The OUCC then alleged that HSE's contract with its affiliate charged a 10% markup on purchases. The OUCC also assumed a 10% estimated additional profit margin that it alleged yielded a 20% overall margin on affiliate contract charges. The OUCC took the position that HSE could reduce costs by performing the work in-house as opposed to using HSE's affiliate. The OUCC recognized that HSE's affiliate did own vehicles and heavy equipment that HSE would need to purchase if it did the work in-house, but made no offsetting adjustment. The OUCC reduced the total contract operational charge of \$3,280,990 by 20% which yielded a downward adjustment of \$656,198 to HSE's operations expenses. The Public based its adjustment on a NARUC guideline regarding subsidization of affiliated companies.

HSE's position, as set out in its evidence, is that (i) the Public's elimination of 20% of test year expense, or \$656,198 was arbitrary and not fixed, known and measurable and was based upon incorrect assumptions with the regard to the 10% mark-up on purchases; (ii) HSE's contract rates are based on an affiliate contract that has been filed with the Commission, is based on rates that are below market rates for similar services, are annually negotiated, are below the contract rates the affiliate charges its other contract clients, and are the results of market studies

based upon competitive pricing; (iii) HSE's contract affiliate has expertise and equipment that the utility will have to duplicate worth hundreds of thousands of dollars, which would sit idle if purchased by HSE and used only in-house because HSE's system is not large enough to require full-time use; and, (iv) HSE's maintenance and operations cost is the only evidence on the record that is fixed, known and measurable and which is based on actual contracts as opposed to the OUCC's estimation of the costs which is based on incorrect assumptions and insufficient data.

Presently, HSE negotiates these charges annually and does so based upon market surveys of engineering firms that provide similar services. We are satisfied that HSE has demonstrated the reasonableness of its SAMCO contract and finds that the expenses related to SAMCO and the line cleaning and monitoring expenses are reasonable.

### 3. Tax Expense.

a. Petitioner's Evidence. Mr. Mares attached an exhibit that included a summary of the federal and state tax returns from each of the shareholders of HSE for HSE's test year, 2008. The exhibit summarized HSE's taxable income and concluded that HSE had a taxable income of \$835,130 for 2008. The shareholders paid actual total federal taxes of \$258,923 on the \$835,130 of taxable income of HSE. With regard to Indiana taxes, HSE had a taxable income of \$1,066,346 and for 2008 of which the shareholders paid actual state taxes of \$46,786. To conduct his analysis each shareholder of HSE provided Mr. Mares copies of the applicable parts of their federal and state tax returns for the calendar year 2008. HSE included the applicable pages of each shareholder's federal and state tax returns with its case-in-chief.

Mr. Mares reviewed the decision by the Indiana Court of Appeals in *S. Haven Waterworks v. Office of Util. Consumer Counselor et al.*, 621 N.E.2d 653 (Ind. Ct. App. 1993). Although Mr. Mares is not an attorney, he testified that he routinely reviews court decisions and provides tax advice based on those decisions. Mr. Mares concluded that the Court in that case found that evidence needed to be submitted by a subchapter-S utility that its shareholders actually paid income taxes attributable to the income from South Haven during the tax year. Mr. Mares concluded that the shareholders of HSE actually paid during the tax year federal and state income taxes attributable to the income from HSE. These amounts represent taxes that were actually paid to the federal and state taxing authorities which are attributable to the income of HSE during the tax year. Mr. Mares testified that these are not speculative, arbitrary or hypothetical numbers, but actual tax dollars paid to the federal and state authorities for the earnings and income generated by HSE. Mr. Mares concluded that the tax rate to be used should be 31% for federal tax purposes, and 4.4% for state income tax purposes. Mr. Mares also concluded that if HSE were a subchapter-C corporation, its federal tax rate would be 34% and its state tax rate would be 8.5% for a combined rate of 42.5%. This demonstrates a tax advantage to both the shareholders and the rate payers of HSE.

b. OUCC's Evidence. Ms. Stull conclude that HSE should not be allowed to recover its tax liability because it is an S corporation. On cross-examination Ms. Stull admitted that she was not a tax expert. She admitted that she had prepared some S corporation tax returns in the past, but had never prepared them specifically for utilities or analyzed the impact of the tax effect on S corporations rather than C corporations. Ms. Stull was

also unclear as to whether the corporation or the shareholders would be liable to the federal government for failure to pay taxes.

c. Petitioner's Rebuttal Evidence. Mr. Mares testified in response to Ms. Stull's testimony concerning income tax generated by HSE. Mr. Mares testified that to his knowledge, public utilities in Indiana are not required to choose a specific entity type. Additionally, Mr. Mares computed the effective tax rate for HSE for the four previous tax years before 2008 (2004-2007). Mr. Mares included as an exhibit his analysis and all of the shareholder tax returns for those years. Mr. Mares testified that this exhibit supported the conclusion that over the five-year period the effective tax rate for 2004-2007 was actually above the effective tax rate for 2008. Mr. Mares testified that adequate tax information has been provided to the OUCC and their staff to prepare a similar analysis and reach their own conclusion as to the taxable effects on the shareholders. Mr. Mares testified that all information he used to conduct his analysis was provided to the OUCC. Mr. Mares testified that interest income related to other corporate entities, rental income, capital gains, and alternative minimum tax calculations are not necessary to determine the taxable effect on the shareholders. Mr. Mares' analysis of the *South Haven* case led him to conclude that the prior holdings of the Commission and the Court of Appeals on this matter were made due to insufficient evidence that the taxes were actually paid. Mr. Mares concluded that he believes his exhibits are quite clear and provide more than adequate support that the tax on the HSE income was actually paid by the shareholders.

Mr. Cochran also responded to Ms. Stull's assertion that HSE should not be allowed to recover its tax liability. He asserted that Indiana utilities organized under subchapter-C are, without question, allowed to recover their tax liability in the state. He testified that it appears that if HSE were to convert to a subchapter-C status, the OUCC would not contest the inclusion of HSE's tax liability. On the business aspect of converting to a subchapter-C corporation, Mr. Cochran testified that it is undisputed that HSE's tax liability will increase. This will hurt not only HSE, but the ratepayers as well. Mr. Cochran testified that if HSE is not able to recover its tax expense in this proceeding, HSE will inevitably convert to a subchapter-C corporation.

d. Commission Discussion and Findings. From its inception, HSE organized its business as provided by Section 1372(a) of the Internal Revenue Code (S corporation) and its shareholders have paid taxes on HSE income according to their individual tax rates. HSE's witness, Brad Mares, used the test year ending December 31, 2008, and computed the federal and state tax liability on HSE's earnings that were filed by HSE with the IRS and State of Indiana. This taxable income was allocated on the Schedule K-1 forms HSE filed with the IRS proportionately to each of HSE's shareholders. Mr. Mares' analysis and accompanying exhibits prove that the utility's shareholders do in fact pay tax on income related to the utility, as shown through the shareholders' state and federal tax returns.

In the Commission's Order in *South Haven Waterworks*, Cause No. 39225, the Commission determined that income taxes could not be recovered as an expense when "no evidence has been provided demonstrating that Petitioner's owner pays taxes, or in what amount. [In this case the] only evidence offered regarding the taxes Petitioner owner pays are testimonial allusions to an effective 31% individual tax rate." *In re South Haven Waterworks, Inc.*, Cause

No. 39225, at 4 (July 22, 1992). The Indiana Court of Appeals affirmed the Commission’s decision, noting, “[t]he adjustment for income tax expenses of a corporation is available only when the corporation can demonstrate that taxes were actually paid.” *S. Haven Waterworks v. Office of Util. Consumer Counselor et al.*, 621 N.E.2d 653, 655 (Ind. Ct. App. 1993). The Court also noted that the assignment of a tax liability as an operating expense cannot be “speculative, arbitrary, hypothetical and unsupported by the record.” *Id.*

Here, the shareholders’ tax returns show taxes were actually paid on HSE’s income. To the extent that our decision in *South Haven Waterworks* was critical of recovery of the tax liability based on S corporation income, we note that our statements in that case could only be taken as dicta given the failure of the utility to present the necessary evidence. Upon further reflection, the S corporation structure tends to benefit both shareholders and ratepayers, under the current tax laws, by avoiding higher C corporation tax rates.<sup>2</sup>

The Commission finds that HSE’s state effective income tax rate of 4.4% based on adjustments is correct and HSE shall be allowed to recover its actual taxes based on that rate. However, the Commission disagrees with HSE’s method of calculating actual federal tax liability. The Commission finds the tax on HSE’s earnings should be considered in isolation from other income earned by each shareholder. Therefore, the Commission finds the appropriate method to determine actual federal income taxes is based on the individual shareholder’s rates used by the IRS during the test year as if no other income is earned by the shareholder. Based on HSE’s net operating income as calculated by the Commission, HSE shall recover in rates \$218,845 in total state and federal income taxes.

D. Total Revenue Requirement.

Based upon the evidence and the determinations made above, we find that Petitioner’s adjusted operating results under its present rates are as follows:

**NOI After Pro Forma Adjustments**

Operating Revenues	\$8,842,442
Less: Operating Expenses	8,192,454
Less: Depreciation and Amortization Expense	147,586
Net Utility Operating Income Before Taxes	502,402
Allowance for Income Taxes	140,909
Net Utility Operating Income After Tax	<u>\$361,493</u>

In summary, we find that with appropriate adjustments for rate making purposes, HSE’s net operating income under its present rates for sewer service would be \$361,493. We have previously found HSE’s rate base is \$5,728,902. A return of \$361,493 represents a rate of return

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<sup>2</sup> We note that if recovery of taxes paid on S corporation income were disallowed, the opportunity to receive a return on S corporation shareholder investment may need to increase. *Contra In re South Haven Waterworks, Inc.*, Cause No. 39225, at 13. However, because we approve an allowance for income tax, we need not further address this issue.

of 6.3% on the rate base. We find that this is insufficient to represent a reasonable return, and therefore Petitioner’s present rates are unreasonable and confiscatory.

**11. Authorized Rate Increase.** On the basis of the evidence presented in these proceedings, we order that Petitioner shall be authorized to increase its rates and charges to produce additional operating revenue of \$283,083 or a 3.22% increase in its revenues, resulting in total annual operating revenue of \$9,125,525. This represents a 9.8% return on a rate base of \$5,728,902. This revenue is reasonably estimated to allow Petitioner the opportunity to earn net operating income of \$561,432 as follows:

Original Cost Rate Base	\$5,728,902
Times: Weighted Cost of Capital	9.80%
Required Net Operating Income (NOI)	<u>561,432</u>
Less: Adjusted NOI at Current Rates	361,493
Increase in NOI Required	<u>199,939</u>
Times: Gross Revenue Conversion Factor <sup>3</sup>	1.416
Recommended Revenue Increase	<u><u>\$283,083</u></u>
Percentage Increase	3.22%

This increase results in a customer’s monthly charge of \$34.63.

**12. System Development Charge and Bad Check Charge.** In this Commission’s Order in Cause No. 43435, the Commission approved HSE’s system development charge (“SDC”), subject to review in this rate case. HSE described its SDCs in its various CTA areas including Fishers, Flat Fork Creek, and Noblesville. Those financial exhibits also contained a comparison of SDCs with other communities surrounding HSE as a means of comparing its SDC with other utilities. The OUCC’s initial objection to HSE’s SDC program has been remedied by HSE demonstrating it does not have idle and unused cash CIAC contributions and that it expends CIAC on a timely basis so that it does not accumulate reserve CIAC funds. Furthermore, HSE takes the position that it will continue to not have idle or unused CIAC funds resulting from its being required to meet tax code regulations that require these funds be expended in two years so that CIAC is not taxed to the utility as income. The OUCC’s additional objection is also remedied by HSE’s agreement that it will not use future SDC proceeds to reimburse itself for any utility property that is included in rate base. Petitioner agreed that the authority granted to it in Cause No. 43435 to use future CIAC to reimburse itself for cost of the 106<sup>th</sup> Street project would only apply to amounts expended by HSE over the \$3.7 million included in rate base for that project. Given the facts presented by HSE and its representation with regard to not using CIAC to reimburse itself for property included in rate base, the Commission hereby approves the SDC set out in HSE’s existing tariffs.

<sup>3</sup> Since the Gross Revenue Conversion Factor is tied to the effective personal tax rates that change with each change in the overall revenue requirement, the Commission used an iterative process to develop the Gross Revenue Conversion Factor.

HSE also requested a bad check charge of \$20, which was supported by the evidence provided by Mr. Krohn, without objection from the OUCC. Accordingly, we find that HSE is authorized to increase its bad check charge to \$20.

**IT IS THEREFORE ORDERED BY THE INDIANA UTILITY REGULATORY COMMISSION that:**

1. Petitioner is hereby authorized to increase its rates and charges for sewer utility service by 3.22%, or \$283,083, in accordance with the findings herein, which rates and charges shall be designed to result in annual net operating income of \$561,432.
2. Petitioner's system development charge authorized in Cause No. 43435 is hereby confirmed and approved with the further condition that Petitioner shall not use any cash system development charges to reimburse itself for capital improvements related to the 106th Street project that have been included in Petitioner's rate base in this proceeding;
3. Petitioner's proposed Bad Check charge is hereby approved.
4. Petitioner shall file new schedules of rates and charges with the Water/Sewer Division of the Commission on the basis set forth in the findings herein, and in accordance with the Commission's rules. Such new schedules of rates and charges shall be effective upon filing and approval by the Water/Sewer Division and shall apply to sewer usage from and after the date of approval and shall cancel all previously approved rates and charges;
5. This Order shall be effective on and after the date of its approval.

**HARDY, ATTERHOLT, MAYS, AND ZIEGNER CONCUR; LANDIS ABSENT:**

**APPROVED: AUG 18 2010**

**I hereby certify that the above is a true and correct copy of the Order as approved.**

  
**Brenda A. Howe**  
**Secretary to the Commission**