

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF TWIN LAKES)
UTILITIES, INC. FOR AUTHORITY TO)
DEFER COSTS ASSOCIATED WITH A) CAUSE NO. 44170
MANAGEMENT AUDIT TO BE)
PERFORMED PURSUANT TO THE)
COMMISSION'S ORDER IN CAUSE) APPROVED:
NO. 43957 AND FOR ASSOCIATED)
ACCOUNTING AUTHORITY.)

DEC 19 2012

ORDER OF THE COMMISSION

Presiding Officers:

Carolene Mays, Commissioner

Aaron A. Schmoll, Senior Administrative Law Judge

On March 20, 2012, Twin Lakes Utilities, Inc. ("Petitioner" or "Twin Lakes" or "Company") filed its Petition with the Indiana Utility Regulatory Commission ("Commission") for authority to defer costs associated with a management audit to be performed pursuant to the Commission's Order in Cause No. 43957 and for associated accounting authority. Petitioner also prefiled its testimony and exhibits constituting its case-in-chief on March 20, 2012. On April 27, 2012, Petitioner filed its Stipulation in Lieu of Prehearing Conference, which was granted by the Commission's May 16, 2012 Docket Entry.

The OUCC filed its responsive testimony and exhibits on June 15, 2012. On July 27, 2012, Petitioner filed its rebuttal testimony and exhibits. An evidentiary hearing was conducted in this Cause on August 15, 2012 in Room 222 of the PNC Center, 101 W. Washington St., Indianapolis, Indiana. At the hearing, the testimony and exhibits of the parties were admitted into the record without objection. No members of the public participated at the hearing.

Based upon the applicable law and the evidence of record, the Commission now finds:

1. **Notice and Jurisdiction.** Notice of this Commission's public evidentiary hearing was given as required by law. Twin Lakes is a public utility as defined by Ind. Code § 8-1-2-1 and is subject to the jurisdiction of the Commission in the manner and to the extent provided by law. Accordingly, we have jurisdiction over Twin Lakes and the subject matter of its Petition.

2. **Petitioner's Characteristics.** Petitioner owns, operates, manages and controls plant and equipment that are used and useful in the provision of water and sewer services in Lake and Porter Counties. Petitioner is currently serving approximately 3,200 water and sewer customers within a rural area straddling the Lake and Porter County line. Most of Twin Lakes' customers are residential and located within the Lakes of the Four Seasons development. Petitioner is a wholly-owned subsidiary of Utilities, Inc., which is a parent corporation to more than 90 systems providing utility service to approximately 280,000 customers in 15 states.

3. **Relief Requested.** Petitioner's existing water and wastewater rates and charges were approved in Cause No. 43957 on February 22, 2012 (the "43957 Order"). Among other things, the 43957 Order directed Petitioner to perform a management audit and submit the report within six months of the date of the 43957 Order. In its Petition, Twin Lakes requested authority to defer the full costs, including associated carrying costs, incurred in connection with the management audit. Petitioner proposed to record such costs in National Association of Regulatory Utility Commissioners ("NARUC") Account 186.2. Petitioner submitted that such accounting treatment should commence as of the date of the Petition, and continue until such costs are recovered by Petitioner in a subsequent case involving Petitioner's general rates and charges.

4. **Evidence Presented.**

(a) **Petitioner's Direct Evidence.** Dmitry Neyzelman, Senior Regulatory Accountant for Utilities, Inc. and its subsidiaries, including Twin Lakes, testified regarding Petitioner's requested accounting authority.

Mr. Neyzelman explained that the 43957 Order contained a number of requirements, including the requirement that Twin Lakes select and engage an independent third party to perform a management audit of Twin Lakes. As set forth in the 43957 Order, the scope of the audit "shall provide a comprehensive review of Petitioner's management structure and identify appropriate management policies and procedures that need to be in place to assure proper, timely and reasonable management of the utilities' operations."

Mr. Neyzelman testified that Twin Lakes seeks authority to defer, for future recovery, prudent costs, including carrying costs, associated with the management audit. He stated that Twin Lakes proposes to treat these costs as a regulatory asset using NARUC Account 186.2, until the inclusion of such costs in retail rates. He explained that for purposes of calculating carrying charges, Petitioner proposed to use its weighted cost of capital using the capital structure in place as of the date the expense is recorded and the 9.50% cost of equity utilized in Petitioner's most recent rate order, for a total weighted cost of capital of 8.047%.

Mr. Neyzelman explained that based on the proposal provided by the independent third party, the costs will be approximately \$45,000. He stated that in order for Twin Lakes to defer the expenses and reflect the costs as a regulatory asset, it must be probable that such costs will be recovered through rates in future periods. In order to satisfy this probability standard, Mr. Neyzelman stated that the Commission's order in this proceeding should specifically approve the proposed accounting treatment and state the intent to allow the recovery of the costs in future rates.

Mr. Neyzelman testified that these expenses were not included in Petitioner's *pro forma* operating expenses found in Cause No. 43957 and so are not being recovered through Petitioner's current rates. He explained that these costs represent 3.7% of the total level of expense just approved by the Commission and this level of expense will, without the requested accounting treatment, erode Petitioner's earnings by approximately \$47,000. He added that this effect would decrease the return on equity to 8.81%, rather than the authorized return of 9.50%

found in the 43957 Order. Furthermore, Mr. Neyzelman stated that this level of earnings erosion is substantial and can only be avoided with the requested deferral authority.

Mr. Neyzelman concluded that the costs that Petitioner seeks to defer are reasonable and necessary expenditures to comply with the Commission's Order in Cause No. 43957. As the purpose of the audit is to identify opportunities to improve Twin Lakes' operations, ultimately benefitting Twin Lakes' customers, he believed it was appropriate that Twin Lakes be afforded the opportunity to recover these costs in a subsequent rate proceeding.

(b) OUCC's Evidence. Margaret Stull, Senior Utility Analyst for the OUCC, discussed the OUCC's recommendation to deny Petitioner's request. Ms. Stull testified that the Commission did not address any potential recovery of the management audit costs in its 43957 Order. She stated that in response to OUCC Data Request Q1-1 and 1-2, Petitioner stated that in addition to the consultant's costs, it intends to defer its legal costs as well as capitalized internal labor costs (Attachment MAS-1) and in total, Petitioner estimates that total costs will be \$92,000 before it records any carrying charges.

Ms. Stull testified she did not consider it appropriate for Petitioner to recover the costs of the Commission ordered management audit from its customers. She explained that in its 43957 Order, the Commission stated that "...a review of Petitioner's past cases raises questions about the effectiveness of Petitioner's management and the efficiency of its operations" and that the Commission continued by stating that the Lake of the Four Seasons Property Owners' Association ("LOFS") raised issues about the operations of the utility, including Petitioner's maintenance of the system in a safe manner, and stated that it had similar concerns. She explained that it is inappropriate to include the costs of this required management audit in rate base and require ratepayers to pay both a return "on" and return "of" these costs. She added that the management audit was ordered due to the Commission's concerns about numerous customer complaints, widespread quality issues and maintenance problems endemic to Petitioner's water and wastewater systems and that the Commission has attempted to deal with these issues several times over the past twenty years with no apparent progress towards solving these problems. Furthermore, she stated Petitioner should not be allowed to recover the costs of a management audit intended to provide solutions to the problems it has been unable to resolve.

Ms. Stull testified that in *South Haven Sewer Works, Inc.*, Cause No. 41903 (IURC 6/5/02), the Commission declined to permit the utility to pass on legal expenses incurred in response to a Commission ordered investigation into "...deficiencies in the management and operation of the utility" and in that Cause, the Commission stated that "the ratepayers should not be penalized for the mistakes of the utility's management", further stating "...if we were to allow Petitioner to recover the costs of the investigation, Petitioner's management would have less incentive to operate its utility in a responsible manner." (See Commission's Final Order in Cause No. 41903).

Ms. Stull recommended that the Commission deny Petitioner's request for deferral and subsequent recovery of costs related to the management audit required by the 43957 Order.

(c) Petitioner's Rebuttal Evidence. In rebuttal, Mr. Neyzelman responded to the issues raised by Ms. Stull. He also provided as an attachment a draft copy of the management

audit report. He testified that he disagreed with Ms. Stull's position regarding the Company's requested accounting treatment. He pointed out that the Commission in the 43957 Order noted that management at Twin Lakes had changed and that there is a sincere focus on improving customer service and eliminating operational issues. Mr. Neyzelman added that Ms. Stull's recommendation would only serve to further decrease revenue needed by the Company to address these issues in a timely fashion.

Mr. Neyzelman explained that the *South Haven* case is distinguishable from the present situation. In that case, South Haven sought recovery of \$490,665 in costs related to an investigation initiated by the Commission in Cause No. 41410. In addition, the investigation addressed a number of issues related to the operation of that utility, including falsified documents, failure to file twelve separate affiliate contracts, persistent use of the utility's personnel to perform non-utility functions, misallocation of expenses and the lack of an appropriate rate structure for non-residential customers and also further suggested that the utility was not cooperative with the Commission's investigation and failed to take steps within its own control to improve its credibility. He said the Commission concluded that "ratepayers should not be penalized for the mistakes of the utility's management." Order at 20.

Mr. Neyzelman explained that unlike the *South Haven* case, the costs for which Twin Lakes is seeking deferral authority relate to an audit required by the Commission in light of ongoing operational issues at Twin Lakes, not for reasons of falsifying documents, violating Commission rules and regulations or otherwise mismanaging the utility. Mr. Neyzelman stated that the draft audit report generally confirms that Twin Lakes and its parent company, Utilities, Inc. have adequate management policies and procedures in place to assure proper, timely and reasonable management of the utility's operations. He added that Twin Lakes has been fully cooperative throughout this process and has worked diligently to identify the third party auditor and perform the management audit within the six-month period set forth by the Commission. He explained that while he fully acknowledges the need to address the operational issues facing Twin Lakes, he does not believe the cost deferral authority sought in this proceeding amounted to a "penalty" for ratepayers. Furthermore, as indicated in the draft audit report (on page 2), the audit "was performed for ultimate benefit of the ratepayers of Twin Lakes in Indiana" and that the customers will benefit in the long term from the insight and recommendations that arise from the management audit, and it is appropriate that the costs associated with the management audit be considered for inclusion in the cost of providing utility service.

Mr. Neyzelman briefly discussed some of the findings of the draft audit report. He stated that with respect to Twin Lakes' water and wastewater operations, the audit made the following findings:

- Utilities, Inc. and the Midwest Region has developed a fairly extensive key performance indicator (KPI) reporting and monitoring process;
- The organization and management for field activities is reasonable;
- Twin Lakes has developed a system plan in the last five years and is expected to grow over the next several years;

- All capital projects are reviewed and approved by a Capital Project Review Team;
- Operations and maintenance activities are reasonable, but could be enhanced;
- Utilities, Inc. has developed a robust safety program, although further improvement is necessary; and
- The use of technology has improved significantly over the last five years.

He said these findings suggest that Twin Lakes and Utilities, Inc. generally have solid management practices in place, although certain operational issues need to be addressed. He maintained that the Petitioner will take steps to both remediate existing issues and proactively reduce future operational issues and that the reporting and other requirements of the final order in Cause No. 43957 will further support the Company's efforts in this respect.

Mr. Neyzelman testified that the Commission made a number of findings in the 43957 Order to recognize the Company's operational issues, including setting Twin Lakes' cost of equity at 9.50%, rather than the 10.2% agreed to by the parties, and by declining to allow recovery of additional rate case expense incurred by the Company. He explained that he mentioned these findings to highlight the fact that the Commission has already sent a clear message to Twin Lakes regarding the need to improve its customer service and operational issues. He said that disallowing the Company's request to defer the substantial costs that will be incurred to comply with the Commission's directive in Cause No. 43957 would only serve to cause greater earnings erosion.

Mr. Neyzelman stated the Company is expending significant time and resources responding to and assisting the consultant in the performance of the management audit and that these resources ultimately benefit the Company's customers, and it is therefore appropriate that such costs be considered for future recovery in rates. He reiterated that the Company is not seeking guaranteed recovery of these costs, but rather is merely requesting deferral authority for these costs so they may be considered in the Company's next rate case. At that time, the total costs and the results of the management audit will be available to the parties and the Commission, and the Commission will be better positioned to determine the reasonableness of including these costs in the Company's revenue requirement.

He testified that while Twin Lakes acknowledges that there is a need to improve customer service and its utility operations, the Company is taking steps to remedy those situations. He explained that one step in that process will be to conduct the Commission-ordered management audit. He added that denying the Company an opportunity to defer the costs associated with the management audit for consideration in a future rate case would only serve to further reduce the Company's financial ability to take action based upon the results of the audit. Furthermore, he believes that the Commission should consider the reasonableness of cost recovery for the management audit in the context of a base rate case, when the Commission and other parties will have had an opportunity to review the results of the management audit and the Company's progress in remediating the service issues identified by the Commission in Cause No. 43957.

5. Commission Discussion and Findings. In its February 22, 2012 Order in Cause No. 43957, the Commission directed Petitioner to select an independent third party and conduct a management audit within six months. The Commission ordered this audit as a result of performance issues ongoing since the early 1990s associated with Petitioner's water and wastewater operations. We briefly noted this history in our Order under Cause No. 43128, as follows:

On April 17, 1991, the Commission, in Cause No. 39050, approved 23.14% and 64.84% increases to Twin Lake's water and sewer rates, respectively. The Commission also noted that while there was little dispute as to the rate increases, "there was extensive evidence concerning service problems allegedly incurred by Petitioner's customers." *Twin Lakes Utilities, Inc.*, Cause No. 39050, 1991 PUC Lexis 128, at *34 (IURC Apr. 17, 1991). Accordingly, the Commission required Twin Lakes to conduct an engineering study of its sewer system and establish a preventative maintenance program to periodically check the sewer system for damage and infiltration. The Commission also found that Petitioner's cleaning program whereby Petitioner would clean ten percent of its sewer system annually was "not adequate," and that the sewer system deficiencies noted in the 1990 Pitometer smoke testing report should be "immediately corrected." *Id.* at *57.

Most recently,¹ in Cause No. 42488 (Mar. 31, 2004) ("2004 Order"), the Commission approved a Settlement Agreement between the parties that are involved in the present case. In that case, the Commission approved a settlement that provided a 9.07% and 40.89% increases to Petitioner's water and sewer rates, respectively. In addition, Petitioner committed to spend \$500,000 on an inflow and infiltration remediation program through 2007, "to further diagnose and remediate residual instances of inflow and infiltration (I&I) into its sewer system, as warranted." 2004 Order at 4. In its Order, the Commission noted that customers complained of sewer discharges that had been ongoing since its prior rate case.

Twin Lakes, Cause No. 43128 (IURC Jan. 16, 2008).

As evidenced in Cause No. 43128 and Cause No. 43957, and despite several Commission-approved rate increases, issues continued to plague Petitioner's wastewater system, and additional problems were brought to the Commission's attention with respect to its water system.

In this Cause, Petitioner proposed to defer the audit costs (and associated legal and personnel costs) to Petitioner's next rate case by treating those costs as a regulatory asset under NARUC Account 186.2. The OUCC, in response, argues that the costs of the management audit should not be deferred, but should be expensed. The OUCC cites to our Order in *South Haven Utilities*, Cause No. 41903, as a comparison to the present case. In Cause No. 41903, the Commission denied the utility's request to recover costs associated with a Commission

¹ Twin Lakes also sought a rate increase in 1992, which was limited to its water rates. See *In re Petition of Twin Lakes Utilities, Inc.*, Cause No. 39573, 1993 PUC Lexis 106 (Mar. 10, 1993).

investigation into deficient utility practices. *South Haven*, Cause No. 41903, at 20 (IURC June 5, 2002).

Petitioner disputes the comparison of Twin Lakes to South Haven given the criminal nature of several of the issues addressed in Cause No. 41903. We agree that there is no basis for comparing the criminal issues discussed in Cause No. 41903 to those facing Twin Lakes, and that any comparison on that basis is inappropriate. However, with respect to the discussion in Cause No. 41903 related to the disallowed costs related to the Commission investigation, the basis of the Commission's denial was linked to deficient management practices, not the criminal nature. *See id* at 19-20. Accordingly, *South Haven* does provide guidance with respect to disallowance of costs associated with investigation into deficient utility management.

Ultimately, as Mr. Neyzelman noted in his direct testimony, in order to create a regulatory asset for deferral, "it must be probable that such costs will be recovered through rates in future periods." *Supra*, at 2. Given the history noted above, we believe, as previously stated in *South Haven*, that "ratepayers should not be penalized for the mistakes of the utility's management." *South Haven*, at 20. The Twin Lakes management audit was ordered to be undertaken precisely because past utility management failed to remedy the outstanding issues. Thus, we agree with the OUCC that Petitioner's request to defer the costs, including carrying costs, associated with the management audit ordered by the Commission in Cause No. 43957, be denied.

The dissent offers two criticisms of our decision: first, that the Commission should have addressed the cost deferral issue in its Order in Cause No. 43957; and second, that the Commission's denial of deferred accounting treatment would prevent Twin Lakes from earning its authorized return.

With respect to the first issue, the Commission's Order in Cause No. 43957 comprehensively addressed Twin Lakes' poor service in several aspects: the Commission lowered its return on equity; the Commission denied recovery of a portion of Twin Lakes' rate case expense; and the Commission ordered Twin Lakes to undergo a management audit. These three items collectively sent a clear message to Twin Lakes that its utility performance must improve. That clear message would become muddled if we granted Twin Lakes' deferral request. Twin Lakes is not seeking to merely "kick the can down the road" and have the Commission consider the deferred costs in its next rate case; Twin Lakes instead is seeking the Commission to state its "intent to allow the recovery of the costs in future rates." *Supra* at 2. As noted above, we conclude, as we did in *South Haven*, that ratepayers should not have to compensate the utility to figure out how to solve long-standing management deficiencies.

Further, the Commission would be hard-pressed to anticipate, at the time the rate order is issued, a future request for deferred accounting treatment so as to be able to address it in the rate order. However, given that the audit was part of the collective message that the Commission was sending, the clear intent of the order was to shift to the utility the responsibility for paying for the audit. If the utility was concerned about that message, it could have sought rehearing to express its concerns, but it did not do so.

Finally, with respect to the second issue of the potential earnings erosion in denying cost deferral, we note that *any* expense not accounted for in the test year contributes to a utility not earning its authorized return. Those expenses may be offset by reductions in other expenses, or by increases in utility revenues. While Mr. Neyzelman calculated a 70 basis point reduction by including the audit expense as a decrease in the authorized earnings approved in Cause No. 43957, Twin Lakes offered no testimony that either its overall expenses have not decreased or that its revenues have not increased from its test year. Without having the complete picture, as we would have in a rate case, Twin Lakes has failed to show any actual earnings erosion.

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

1. Petitioner's request to utilize deferred accounting treatment associated with the management audit performed pursuant to the Commission's Order in Cause No. 43957 is hereby denied.

2. This Order shall be effective on and after the date of its approval.

ATTERHOLT, LANDIS, MAYS AND ZIEGNER CONCUR; BENNETT DISSENTING WITH OPINION:

APPROVED: **DEC 19 2012**

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



Brenda A. Howe
Secretary to the Commission

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DISSENTING OPINION OF COMMISSIONER KARI A.E. BENNETT

In my view, the appropriate manner in which to view the isolated issue pending before the Commission is within the greater context of the rate case, especially the Commission's findings and conclusions regarding Twin Lakes' long history of poor service and its impact on the return on equity authorized. In the rate case, we took the unusual action of lowering Twin Lakes' return on equity 70 basis points below the level agreed to by the Utility and the OUCC, and expressly tied that action to our grave concerns about the Company's longstanding record of substandard service. In doing so, we recognized that the authorized return was at the lower end of the appropriate range presented as evidence by the parties. The Commission also required the management audit as part of the remedial measures to correct service deficiencies, but we did not expressly address whether Twin Lakes could seek rate recovery for the expenses associated with this or any other mandated remedial measure.

In this present case, Twin Lakes has requested deferred accounting treatment to preserve the opportunity to pursue rate recovery of this mandated expenditure during its next rate case. In support of its request, Twin Lakes presented information to illustrate how the anticipated cost of the Commission directed management audit could potentially affect the Company's earnings without deferred accounting treatment – during the year in which the management audit expense is incurred, Twin Lakes' overall ability to earn would drop an additional 70 basis points below the return authorized in the rate case. These cumulative Commission directed circumstances could result in a situation in which Twin Lakes would be authorized by this Commission to employ rates that are not designed to allow it an opportunity to earn a return on equity within the range we found to be appropriate.

In approving the rate case, I share my fellow Commissioners' significant concerns regarding Twin Lakes' inadequate service record. However, I wish now that we had directly addressed the issue of responsibility for payment of the management audit and other remedial measures within the broader context of our considerations and findings in the rate case. As I cannot now change that circumstance, I find it appropriate to grant Twin Lakes' request for deferred accounting treatment so as not to unnecessarily hamper its remediation efforts. Any decision on the actual inclusion of the deferred amount would rightfully be determined during the Company's next rate case, when a full accounting of the value of the audit can be more fully

vetted. Factors such as the extent of Twin Lakes' implementation of the audit's recommendations, the benefits of such actions that will reasonably accrue to customers, and the time period of the recovery would likely be determinative of the value assessed to the management audit at that time.