ORIGINAL

CAS

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF HAMILTON SOUTHEASTERN UTILITIES, INC. TO: 1) INCREASE ITS SEWER RATES AND CHARGES PURSUANT TO THE COMMISSION'S MINIMUM STANDARD FILING REQUIREMENTS; 2) ADOPT A NEW RATE SCHEDULE REFLECTING THE APPROVED RATES AND CHARGES; 3) INCREASE ITS SYSTEM DEVELOPMENT CHARGES; 4) IMPLEMENT A FATS, OILS AND GREASE CHARGE; AND 5) UPDATE ITS RULES AND REGULATIONS	)	CAUSE NO. 44683 APPROVED: NOV 09 2016

ORDER OF THE COMMISSION

Presiding Officers:
Angela Rapp Weber, Commissioner
Aaron A. Schmoll, Senior Administrative Law Judge

On September 24, 2015, Hamilton Southeastern Utilities, Inc. ("Petitioner" or "HSE") filed its Verified Petition and Notice of Intent to File in Accordance with Minimum Standard Filing Requirements ("Verified Petition") with the Indiana Utility Regulatory Commission ("Commission").

On December 9, 2015, a petition to intervene was filed by the Indiana Apartment Association ("Apartment Association"), which was granted.

The Commission conducted a hearing beginning on February 24, 2016, at 9:30 am in Room 222 of the PNC Center, Indianapolis, Indiana. During the hearing, evidence constituting HSE's case-in-chief and rebuttal was offered and admitted into the record and its witnesses were offered for cross-examination. In addition, evidence constituting the respective cases-in chief of the Indiana Office of Utility Consumer Counselor ("OUCC") and the Apartment Association was offered and admitted into the record and their witnesses were offered for cross-examination. The parties also stipulated on the record to a cost of equity of 9.60%.

Having considered the evidence presented and the applicable law, the Commission finds:

1. **Notice and Jurisdiction.** Due, legal, and timely notice of the Verified Petition filed in this Cause was given and published by Petitioner as required by law. Due, legal and timely notice of the Evidentiary Hearing in this Cause was given and published as required by law. Petitioner is a public utility as that term is defined in Ind. Code § 8-1-2-1(a), and the Commission has authority to approve rates and charges for utility service under Indiana Code § 8-1-2-42. Accordingly, the Commission has jurisdiction over Petitioner and the subject matter of this proceeding.

2. **Petitioner's Characteristics.** HSE is a corporation organized under the laws of the State of Indiana and is engaged in the provision of sewer utility service 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, 43581, and 43761. Petitioner owns, leases, operates, manages, and controls utility plant, property, equipment, and related facilities that are used and useful for the convenience of the public for the provision of sewer utility service.

3. **Existing Rates.** Petitioner's existing basic rates and charges for sewer utility service were established in the Commission's August 18, 2010 Order in Cause No. 43761.

4. **Relief Requested.** In its original pre-filed case-in-chief, Petitioner requested an across-the-board rate increase of 8.42%. Petitioner also requested that its System Development Charge ("SDC") be increased from $2,400 to $2,850 in all existing service areas, excluding the areas formerly served by Flatfork Creek, which HSE proposed to increase from $3,200 to $3,650. HSE also requested approval to implement a Fats, Oils, and Grease ("FOG") program. Additionally, HSE requested approval of revisions to its rules and regulations including FOG program rules, rules related to inflow and infiltration, and tree dripline rules. In its rebuttal testimony, HSE agreed to certain adjustments proposed by the OUCC resulting in a reduction to the requested across-the-board rate increase from 8.42% to 6.27%.

5. **Test Year.** Petitioner proposed that the test year be the 12 months ended December 31, 2014, with adjustments for changes that are fixed, known, and measurable and occurring by December 31, 2015.

6. **Overview of Petitioner's Case-in-Chief.** Mr. Kendall W. Cochran, President of HSE, testified on behalf of HSE. 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 discussed significant improvements made to HSE's system that were needed to address overflow issues on the system and the impact such improvements had on HSE's financial performance. Mr. Cochran also provided an overview of HSE's operations for which other witnesses testifying on behalf of HSE in this Cause explained in more depth. In addition, Mr. Cochran discussed justifications for proposed changes to HSE's SDCs and proposed changes to HSE's tariff and rules and regulations, including the addition of FOG management rules and a FOG charge. Mr. Cochran concluded that HSE's rates need to be increased by 8.42% across-the-board for each of HSE's CTAs. Mr. Cochran testified that the primary reason for the requested rate relief was HSE's inability to achieve the 9.8% rate of return approved by the Commission in 2010. The main contributors to HSE's lower than granted and negative rates of return, according to Mr. Cochran, are system maintenance expenses, repairs, operational cost increases and property tax and other expenses.

Mr. Cochran testified that HSE's system is requiring more maintenance and repairs due to the system's age. Operational issues with the system resulted in a Notice of Violation and Agreed Order with the Indiana Department of Environmental Management. As part of the Agreed Order, HSE agreed to a Compliance, Maintenance and Operation Plan ("M&O Plan"). Mr. Cochran testified that the cost to address system maintenance and to implement the M&O Plan has

impacted HSE's ability to earn a return as granted by the Commission in HSE's last rate case. Mr. Cochran also testified that these operational costs are not one-time costs but are costs that will be incurred on a regular basis to implement the M&O Plan.

Mr. Cochran also discussed an ongoing tax dispute with the Indiana Department of Revenue regarding the payment of Utility Receipts Tax ("URT") on SDCs imposed by HSE. As a result of the dispute, HSE sought to include in its rates the recovery of any additional URT assessments for SDCs. With regard to the URT issue, HSE accepted the OUCC's suggested remedy to defer URT tax liability on SDCs on its balance sheet for future cost recovery. Mr. Cochran also supported the conclusions of other HSE witnesses regarding HSE's tax treatment as a subchapter-S corporation ("S-Corporation") and HSE's cost of equity. Mr. Cochran testified that an S-corporation has many tax advantages that benefit both HSE's shareholders and ratepayers, including that the earnings of HSE are "flowed through" to the shareholder tax returns, which results in taxes that are paid by the shareholder at the lower individual rates rather than the higher corporate rates that would be paid by HSE. This makes the effective tax rate on HSE earnings less for both the customers of HSE and the shareholders. Mr. Cochran also testified that HSE submitted evidence that federal and state taxes have actually been paid on HSE's behalf by the shareholders. Mr. Cochran also agreed with the stipulation entered with the OUCC that the cost of equity should be 9.60%. Mr. Cochran concluded that he believes the rates identified in the case-in-chief have been sufficiently justified and are in the public interest. Mr. Cochran also concluded that HSE's rates continue to be competitive with surrounding communities and are below most investor-owned utilities' rates.

Mr. Krohn testified on behalf of HSE regarding rate base and operating revenue. Mr. Krohn assisted in the preparation of financial exhibits relative to the proposed revenue requirements and the rate base for this proceeding. Mr. Krohn testified that HSE's current rates consist of a $34.63 monthly flat rate per single family equivalent dwelling unit ("EDU"), and that additional charges include a $2,400 SDC ($3,200 for the Flatfork CTA until 1,750 EDUs are developed in the CTA area).

Mr. Krohn testified that the test year used in his financial analysis is the twelve months ended December 31, 2014. HSE's pro forma revenue requirement is based on the test year actual results after making adjustments for fixed, known, and measurable changes occurring within 12 months following the end of the test year. Mr. Krohn concluded that HSE needs an increase to its rates of 8.42% across-the board. Mr. Krohn also testified that HSE's test year rate base is $5,844,301, which includes a 45-day working capital allowance of $813,089. Additionally, Mr. Krohn testified regarding HSE's proposed increase to its SDC charges of $450 and HSE's proposed $30 FOG charge and $90 inspection fee for customers not in compliance with the FOG rules.

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. In his analysis, Dr. Boquist considered: 1) current economic conditions as they relate to the cost of capital; 2) adjustments needed to reflect the size and investment quality rating of the company and the marketability of the company's stock; and 3) specific adjustments for the unique aspects of the company's service territory relative to the firms studied in Dr. Boquist's sample of proxy water companies. Dr. Boquist testified that the minimum cost of equity should be a level that is sufficient to attract

capital to the business on reasonable terms; to maintain the financial integrity of the firm, thus permitting the company to render continuous and reliable service to its customers at reasonable cost; and to provide the firm with a return commensurate with that available on investments of corresponding risk. Dr. Boquist concluded that an 11.74% cost of equity for HSE is reasonable.

Mr. Mares testified concerning HSE's tax treatment and the implications of taxable income of HSE on the current rate case proceedings. Mr. Mares testified that he prepared HSE's tax returns for the test year ending December 31, 2014. He also testified that the shareholders of HSE have consented to have HSE's change in tax treatment. In lieu of HSE paying taxes, the shareholders of an S-Corporation are taxed on their proportionate share of the company's taxable income at each individual shareholder's respective tax rate, as provided by Section 1372 (a) of the Internal Revenue Code. Mr. Mares determined the tax rate to be used in HSE's cost of service calculation by using the individual HSE shareholder rates for each shareholder as if no other income is earned by the shareholder and applied these rates to HSE's pro forma earnings. Mr. Mares testified that the Commission in HSE's last rate case used and approved this methodology in computing HSE's federal and state income tax expense. Taking the actual federal and state tax rates for each individual shareholder and applying the rates to HSE's pro forma net income, Mr. Mares concluded that HSE's effective tax rate for the test year was 23.03% for federal taxes and 4.4% for state taxes, resulting in a combined tax rate of 27.43%.

7. **Overview of OUCC's Case-in-Chief.** Ms. Margaret A. Stull testified on behalf of the OUCC. The purpose of Ms. Stull's testimony was to present the OUCC's proposed revenue requirement for HSE. Ms. Stull recommended a decrease in pro forma operating revenues of $3,173 and a decrease in pro forma operating expenses of $2,162,049 from HSE's proposal. Ms. Stull also proposed findings on HSE's rate base, depreciation expense, and working capital. Ms. Stull accepted HSE's non-recurring fee proposals related to the $30 monthly FOG charge as well as the proposed $90 FOG inspection fee and HSE's proposed increase to its SDCs. Ms. Stull also testified that HSE should not be allowed to include state and federal income tax expense in its cost of service.

Ms. Stull proposed four adjustments related to rate base including three additions to utility plant in service for test year materials and supplies, engineering fees, and legal fees that Ms. Stull characterized as capital in nature. She also proposed a reduction to rate base to remove the 10% management fee added to the cost of utility plant purchased and installed by SAMCO during the test year. Ms. Stull proposed to exclude all affiliate expenses from the calculation of working capital, resulting in reducing HSE's working capital request from $813,089 to a working capital amount of $96,733. Ms. Stull discussed HSE's practice of relying on its affiliate SAMCO to provide operating services under its affiliate agreement on file with the Commission and proposed a reduction to operating expenses of $690,506. Overall, Ms. Stull recommended an across-the-board rate decrease of 14.01%.

Mr. James T. Parks testified on behalf of the OUCC concerning HSE's operations and its use of SAMCO to perform under its affiliate agreement on file with the Commission all operations and maintenance functions of the utility. Mr. Parks concluded that if HSE relied on its own staff to perform some of the functions performed by SAMCO, HSE's test year and projected operating costs would be significantly less. Mr. Parks also concluded that OUCC witness Margaret Stull's proposed adjustments related to SAMCO expenses are conservative and reasonable. Additionally,

Mr. Parks discussed a particular proposed change to HSE's rules and regulations regarding the responsibility to install and maintain HSE's service lines that he concluded would negatively affect customers.

Mr. Edward R. Kaufman testified on behalf of the OUCC regarding HSE's cost of equity. Mr. Kaufman accepted HSE witness Dr. Boquist's unadjusted range of cost of equity for the water industry of 8.00% to 8.81%. Mr. Kaufman focused his testimony on refuting Dr. Boquist's company-specific risk adjustments of 150 basis points under the DCF model and 374 basis points under the CAPM model. Mr. Kaufman testified that HSE has very low company-specific risk and concluded that Dr. Boquist's company-specific risk adjustments are unnecessary. Mr. Kaufman recommended a cost of equity for HSE of 8.40%.

8. Overview of Apartment Association's Case-in-Chief. Ms. Lynne Petersen testified on behalf of the Apartment Association to address the impact of HSE's rates on multi-family communities. In particular, Ms. Petersen questioned HSE's billing practices whereby HSE charges a flat rate of 0.7 EDUs per month per apartment unit regardless of occupancy or use. Ms. Petersen explained that HSE's billing practice allows HSE to collect 100% from the multi-family communities regardless of the occupancy of any of its units. Ms. Petersen recommended that HSE remedy its billing practices to avoid over-collection and unreasonable billing practices.

9. Overview of Petitioner's Rebuttal Testimony. Mr. Cochran responded to the testimony of OUCC witnesses Ms. Stull and Mr. Parks, and Apartment Association witness Ms. Petersen. Mr. Cochran disagreed with Ms. Stull and Mr. Parks's testimony regarding HSE's use of SAMCO as its primary engineering contractor. Mr. Cochran also disagreed with Ms. Stull's capitalization of certain HSE expenses and Ms. Stull's testimony regarding HSE's tax liability as an S-Corporation. Mr. Cochran also disagreed with Ms. Petersen's testimony regarding HSE's billing practices. Additionally, Mr. Cochran proposed a revision to HSE's rules and regulations in response to Mr. Parks's testimony.

Mr. Krohn responded to the testimony of Ms. Stull concerning her reclassification of operation and maintenance ("O&M") expenses as capital costs and reduction of SAMCO engineering expense. Mr. Krohn disagreed with Ms. Stull's recommendation to reduce HSE's working capital allowance. Mr. Krohn also disagreed with Ms. Stull regarding her testimony that HSE not be allowed to include income tax expense in its cost of service calculation. Mr. Krohn agreed to certain proposed adjustments made by Ms. Stull including an adjustment to Purchased Sewage Treatment costs. Mr. Krohn also agreed with Ms. Stull's treatment of the URT tax dispute with the Indiana Department of Revenue and made an adjustment that would keep track of the URT tax expense but defer that item until a final decision was made by the Tax Court. The net effect of the OUCC's adjustments with which Mr. Krohn agreed resulted in a change to HSE's rate increase from 8.42% to 6.27%.

Dr. Boquist responded to the testimony of Mr. Kaufman. Dr. Boquist found Mr. Kaufman's recommendation of an 8.40% cost of equity to not be supported by proper consideration of the risks faced by HSE. Dr. Boquist recommended an upward adjustment to the cost of equity to reflect the company-specific risk inherent in HSE's operations. Dr. Boquist continued to recommend that the Commission find a cost of equity of 11.74%.

Mr. Mares responded to the testimony of Ms. Stull regarding her recommendations related to HSE's income tax liability and capitalization of certain HSE expenses. Mr. Mares testified that when HSE has positive net income, its shareholders pay income tax expense related to HSE's earnings. Mr. Mares also testified that the methodology he used to determine HSE's income tax expense was the methodology approved by the Commission in HSE's last rate case. Mr. Mares also disagreed with Ms. Stull's recommendation to capitalize certain maintenance and engineering expenses as being inconsistent with HSE's long-established capitalization policy.

10. Petitioner's Rate Base.

A. Reclassification of O&M Expense as Capital Costs.

1. Petitioner's Evidence. HSE calculated its Net Utility Plant in Service to be $7,237,722. After making adjustments to remove disallowed plant in service of $2,206,510, HSE's Net Utility Plant in Service was determined to be $5,031,212.

2. OUCC's Evidence. Ms. Stull made several adjustments to reclassify O&M expenses as capital costs. The OUCC proposed to add $715,747 to HSE's proposed Net Utility Plant in Service by capitalizing certain HSE O&M expenses, including 46% of engineering services provided by SAMCO, and by eliminating certain SAMCO charges. The OUCC argued that certain materials and supplies expense should be capitalized based on the NARUC Uniform System of Accounts guidelines' recommendation that costs over $750 be capitalized. The OUCC also argued that certain materials and supplies expense related to lift station O&M should be capitalized because it was a cost incurred by HSE before HSE could begin using its new odor control equipment at a lift station and therefore is more appropriately capitalized. The OUCC recommended certain engineering expenses that exceed $750 be capitalized based upon the NARUC Uniform System of Accounts guidelines. The OUCC concluded that 46% of the SAMCO engineering costs were incurred before HSE could accept property being conveyed by developers. After capitalizing the engineering expenses, the OUCC recommended a 20% reduction to the capitalized engineering expenses to reflect that HSE could, in the OUCC's opinion, supply these services in-house at a lesser cost. The OUCC also capitalized certain legal fees related to costs incurred to purchase or build an asset or bring the asset to the location and condition needed for it to operate in the manner intended by management. The OUCC also recommended an adjustment to remove the SAMCO 10% management fee included in the cost of assets purchased by SAMCO during the test year.

3. Petitioner's Rebuttal Evidence. Mr. Mares responded to Ms. Stull's recommendation to reclassify certain O&M expenses as capital costs. He disagreed with Ms. Stull and asserted that her recommendations are contrary to HSE's capitalization policy. He described HSE's capitalization policy as capitalizing items with a useful life of seven years or more and costing at least $1,000. Mr. Mares testified that Generally Accepted Accounting Principles ("GAAP") allows entities to establish their own capitalization policy and that HSE's amount of $1,000 is reasonable under GAAP. Mr. Mares also testified that his understanding of HSE's policy related to engineering expenses is that engineering expenses incurred related to daily operations and maintenance are expensed as incurred. In addition, he testified that it has been HSE's long-standing policy to expense engineering costs incurred related to construction plan review, document review, and survey review for assets not owned by HSE, and this includes engineering

costs incurred related to proposed development projects in HSE's CTA. These costs can be incurred at various stages of the proposed development—development phase, design phase, and construction phase. Mr. Mares added that HSE's policy related to engineering expenses has been subjected to audit consideration by the Internal Revenue Service during an audit of HSE's tax returns for 2012 and 2013, and Mr. Mares' own firm, Horizon CPA Services, has considered HSE capitalization policy during audit procedures for the test year. Mr. Mares also testified regarding Ms. Stull's proposed adjustment to capitalize 46% of SAMCO's engineering fees. He concluded that Ms. Stull's review of SAMCO invoices appears to disregard HSE's established capitalization policy and that there appears to have been no real analysis of the engineering expenses being incurred, only a 46% adjustment based on a review of some invoice samples using some capitalization policy different than HSE's long-established policy. According to Mr. Mares, HSE's capitalization policy is reasonable and has been consistently applied.

Mr. Krohn responded to Ms. Stull's recommendation that several HSE expenses should be capitalized. He disagreed that these expenses should be capitalized. Mr. Krohn testified that HSE has consistently applied GAAP to its audited financial statements. He testified that the OUCC's arbitrary assertion that 46% of HSE's contract management fees should have been capitalized is inconsistent with GAAP and would also violate GAAP's "consistency principle." Mr. Krohn also testified that the OUCC's proposed capitalization of lift station repair costs is inconsistent with GAAP and HSE's capitalization policy. Regarding the removal of SAMCO's 10% management fee from rate base, Mr. Krohn disagreed that the costs should have been capitalized in the first place and testified that SAMCO's fees are reasonable and that there should be no reduction related to the services provided by SAMCO. Mr. Krohn added that the adjustments proposed by the OUCC witnesses in capitalizing test year expenses and the reduction in SAMCO engineering charges are not "fixed, known and measurable." Mr. Krohn concluded that HSE has been consistently expensing the engineering charges based on GAAP, and that to change this policy without any rational basis would not be in accordance with GAAP.

Mr. Cochran responded to Ms. Stull's testimony regarding the SAMCO 10% management fee. He disagreed with Ms. Stull's conclusion that the management fee should be considered unnecessary and therefore an imprudent expense. According to Mr. Cochran, the 10% management fee only applies to material costs and subcontractor work pursuant to HSE's affiliate contract with SAMCO, which has been filed with the Commission. Mr. Cochran testified that only a small fraction of the SAMCO invoices contain a 10% mark-up on materials and subcontractor work. Mr. Cochran added that it is standard industry practice to mark-up material costs and subcontractor work, and such is shown in Petitioner's Attachment KWC-R-1. The mark-up, according to Mr. Cochran, reflects the costs that firms such as SAMCO incur in entering into contracts with subcontractors and in ordering, storing and handling materials, in managing the subcontractors' work, in billing and arranging for payment of the subcontractors, and in supervising and directing the subcontractors' work. Mr. Cochran also testified regarding HSE's capitalization practices. He testified that HSE has consistently utilized certain practices related to capitalization over its 25 year history and that HSE's management is in full support of these practices.

4. Commission's Discussion and Findings.

a. Capitalization Policy. As noted by HSE witnesses Mr. Mares, Mr. Krohn, and Mr. Cochran, HSE has a well-established, but unwritten, capitalization policy. That policy provides that certain expenses with a useful life of seven years or more and costing at least $1,000 be capitalized. The policy has been subject to review by the Internal Revenue Service and Horizon CPA Services, the firm that audits HSE's financial information, with no findings of any issues. HSE has applied this policy consistently and in accordance with GAAP principles. The OUCC has not presented sufficient evidence that this long-established policy, which has been consistently applied since HSE's inception, should be changed. Changing such a policy for a mature utility would require restating the capital and expense accounts for past periods in order for the change to be made in a consistent and fair manner. Therefore, we find that the materials and supplies expense and the legal fees expense should remain as O&M expenses as initially proposed by HSE.

Likewise, the evidence does not support the capitalization of 46% of the SAMCO fees identified by the OUCC. These engineering costs were incurred and expensed in accordance with HSE's capitalization policy. As explained by Mr. Mares, it has been HSE's long-standing policy to expense engineering costs incurred related to construction plan review, document review, and survey review for assets not owned by HSE. This includes engineering costs incurred related to proposed development projects that are in various stages of development. These development projects may never be completed, have not been completed, have not been conveyed to HSE, or may never be conveyed to HSE. As noted by Mr. Mares, HSE does not own the asset related to the development project for which these engineering costs have been incurred. HSE's policy related to engineering expenses has been reviewed by the Internal Revenue Service during audits in 2012 and 2013 and no adverse findings were made. We therefore conclude, for the same reasons stated above as to materials and supplies and legal expenses, that HSE's practice of expensing these SAMCO engineering fees is reasonable and consistent with HSE's long-standing capitalization policy.

In order to formalize HSE's capitalization policy, HSE shall file under this Cause, within 60 days of this Order, a written version of its capitalization policy.

b. Reduction to SAMCO Fees. Since we have found that HSE's capitalization policy warrants no change, there is no need to address the OUCC's request to reduce those capitalized expenses by a 20% reduction to SAMCO's charges. However, we address SAMCO expenses and the 10% management fee in our discussion on affiliate contract expenses below.

B. Accumulated Depreciation and Amortization.

1. Petitioner's Evidence. HSE had Accumulated Depreciation of $16,848,935 and Accumulated Amortization of $1,379,329 as of December 31, 2014. HSE removed Amortization of CTA Costs as of December 31, 2014, in the amount of $1,215,169. HSE removed all accumulated amortization from rate base except that portion related to master planning costs. HSE proposed Total Accumulated Depreciation and Amortization of $17,013,095. The average depreciation rate used by HSE since its last rate case amounts to 2.23%.

2. OUCC's Evidence. Ms. Stull calculated Accumulated Depreciation at December 31, 2014, to be $16,848,935. She calculated Accumulated Amortization to be $787,609 as of December 31, 2014. The Accumulated Amortization amount does not include the accumulated amortization of deferred rate costs of $591,720, which she reclassified to deferred debits where the deferred rate case costs are recorded. Ms. Stull only removed the accumulated amortization of CTA costs in the amount of $623,449 from rate base. Ms. Stull calculated Total Accumulated Depreciation and Amortization to be $17,013,095. Ms. Stull testified that the differences between the amounts proposed by HSE and those proposed by the OUCC have no net impact on rate base. Ms. Stull also testified about the accumulated depreciation rate used by HSE to calculate its accumulated depreciation. Ms. Stull testified that HSE applied various depreciation rates to its utility plant in service in determining its proposed accumulated depreciation instead of the 2.2% rate the Commission approved in Cause No. 43761.

3. Commission Discussion and Findings. The Commission concluded in Cause No. 43761 that HSE'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. The Commission found that HSE should use the 2.2% depreciation rate to its entire depreciable plant balance or provide a depreciation study to reflect revised depreciation rates. Although HSE used deprecation rates that on average are close to 2.2%, HSE did not apply this rate consistently to its entire depreciable plant balance. The Commission finds that HSE shall use the 2.2% depreciation rate on its entire depreciable plant balance going forward. The Commission accepts the OUCC's reclassification of amortization costs noting there is no impact on rate base.

C. Working Capital.

1. Petitioner's Evidence. Utilizing the 45-day FERC method, HSE proposed working capital allowance of $813,089. HSE's calculation excluded purchased sewage treatment costs of $3,592,116 and purchased power costs of $181,044 based on the Commission's order in Cause No. 43761.

2. OUCC's Evidence. Ms. Stull testified concerning HSE's working capital. Ms. Stull testified that it is not reasonable for HSE to use the FERC 45-day method to calculate its proposed working capital and instead suggested that HSE should use a lead-lag study. However, Ms. Stull agreed to use the 45-day method in this case with one modification: she proposed to exclude affiliate expenses from the calculation of working capital. According to Ms. Stull, the fees and cost reimbursements HSE pays to SAMCO are generally billed at the end of the month and paid during the subsequent month. Therefore, according to Ms. Stull, SAMCO charges are paid in arrears when HSE has begun receiving revenues from its customers for services rendered in the previous month. Ms. Stull further testified that there is no lag between when the expense is paid and when revenues are received. She concluded there is no need to include these costs in the calculation of working capital. The removal of the SAMCO charges results in a $3,797,634 reduction to HSE's proposed working capital allowance. Ms. Stull also proposed an adjustment to HSE's purchased sewage treatment cost due to an error in recording test year expense. Ms. Stull testified that HSE incorrectly recorded a transaction regarding SDCs due to the City of Fishers as purchased sewage treatment. The removal of the expense recorded in error

results in an additional reduction of $116,321. Ms. Stull also excluded HSE's proposed amortization of URT judgment of $89,332 for the tax liability dispute with the Indiana Department of Revenue. Ms. Stull's adjusted working capital allowance was $96,733.

3. Petitioner's Rebuttal Evidence. Mr. Krohn disagreed with Ms. Stull's analysis of the working capital allowance. He testified that HSE calculated working capital allowance using the exact same formula approved by the Commission in HSE's last rate case in Cause No. 43761. Mr. Krohn disagreed with Ms. Stull's conclusion that SAMCO's charges should be removed because the charges are paid in arrears. Mr. Krohn testified that HSE's revenues are also paid in arrears. According to Mr. Krohn, HSE bills its customers at the end of the month and collects the revenue the following month, which would also be paying in arrears. Mr. Krohn testified that the OUCC's proposed working capital amount of $96,733 is next to nothing for a $12 million per year operation with responsibility for a utility plant investment of nearly $100 million. Mr. Krohn testified that the FERC formula is a method adopted as a means to avoid an expensive lead-lag study, and therefore should not be altered or changed. Mr. Krohn also testified about Ms. Stull's adjustment regarding purchased sewage treatment. Mr. Krohn agreed that an adjustment to purchased sewage treatment was needed. Mr. Krohn also agreed to reduce the amount of O&M expenses eligible for working capital treatment by $89,332 to remove the potential URT tax liability. After making the adjustments related to purchased sewage treatment and the deferred URT tax liability, HSE's proposed working capital allowance was reduced from $813,089 to $795,979.

4. Commission Discussion and Findings. Cash working capital represents the funds 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. This time lag results in a risk to the utility because the utility may not have recovered its costs by the date its expenses are due.

HSE used the FERC 45-day method to calculate its working capital allowance. HSE used the same process to calculate its working capital allowance as it did in its last rate case in Cause No. 43761. By its very nature, the FERC 45-day method includes O&M expenses regardless of when those charges are collected, with the exception of purchased utility services. The OUCC has essentially done a partial lead-lag study, focusing only on the SAMCO charges but ignoring all other expenses and customer revenue. A partial lead-lag study is not an appropriate method for calculating working capital allowance. The appropriate methodologies for calculating working capital are either a full lead-lag study that considers the payment of all expenses and the collection of all revenues or the FERC 45-day method. We do not consider a full lead-lag study to be necessary at this time, and find that the 45-day method is adequate.

The reason that purchased utility expenses have been removed in accordance with the 45-day method is that such services are payable after utility customers make payment for the utility service that utilized the expense. For affiliate expenses such as those at issue here, we see little reason to require ratepayers to provide a return to the shareholders when the shareholders are on both sides of the transaction, especially in light of our concerns over the cost of the SAMCO services, which we address below. There is no reason that SAMCO could not adjust billing cycles

so that SAMCO bills would be payable after customer payments were received by HSE. Ultimately, we agree with the OUCC that SAMCO expenses should be removed from HSE's working capital calculation.

In its Brief in Support of the Proposed Order, HSE revised its working capital allowance to reflect $47,500 of rate case expense that had inadvertently been removed from HSE's working capital calculation submitted with its rebuttal testimony and a reduction of $9,770 to remove certain non-allowable and non-recurring expenses. When those revisions are made, in addition to removing the SAMCO expenses, we find that HSE's revised working capital allowance is $111,779.

D. Quantification of Petitioner's Original Cost Rate Base. As described above, the Commission rejects the adjustments made by the OUCC to Petitioner's rate base, with the exception of the adjustment related reclassification of amortization costs (as noted above). Petitioner has supported its capitalization practices and we therefore reject the capitalization of the O&M expenses discussed above. Petitioner has not supported the costs charged by SAMCO and the reasonableness of using SAMCO to operate the utility, as discussed more fully below. Petitioner has also not supported its revised working capital allowance. Therefore, based upon the evidence presented, we find that Petitioner has a pro forma rate base of $5,142,9991, as set out below:

Utility Plant in Service	$92,671,846
Less: Disallowed CTA Costs Per Cause No. 43761	(2,042,350)
Sub-Total	$90,629,496
Less: Accum. Depreciation	(16,848,935)
Accum. Amortization	(787,609)
Add: Amortization of CTA Costs	623,449
Contributions-in-aid of Construction	(86,243,029)
Future CIAC	1,935,482
Accum. Amortization of CIAC	15,722,358
Net Utility Plant in Service	$ 5,031,212
Add: Working Capital	111,779
Total Original Cost Rate Base	$ 5,142,991

11. Cost of Capital and Rate of Return.

A. Petitioner's Evidence. Dr. Boquist used ten 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) this 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's cost of equity ranged from 8.00% to 11.74%. Under the two-stage DCF model, Dr. Boquist estimated an 8.81% cost of equity based on the sample companies. He then made a 150 point basis point adjustment to reflect the greater inherent riskiness of HSE compared to the sample companies. Under the CAPM analysis, Dr. Boquist estimated an 8.00% cost of equity based on the sample companies. He then added 374 basis points to account for HSE's size. Dr.

Boquist concluded that an 11.74% cost of equity is a reasonable and conservative estimate for HSE.

B. OUCC's Evidence. Mr. Kaufman accepted Dr. Boquist's unadjusted range of cost of equity for the water industry of 8.00% to 8.81%. Mr. Kaufman disagreed with Dr. Boquist's company-specific risk adjustments. Mr. Kaufman concluded that HSE has very low company-specific risk and testified that Dr. Boquist's company-specific risk adjustments were unnecessary. Based on his conclusion that no company-specific risk adjustments were needed, Mr. Kaufman recommended a cost of equity of 8.40%. Mr. Kaufman also noted that because HSE had no debt, Petitioner's cost of capital is also 8.40%.

C. Petitioner's Rebuttal Evidence. Dr. Boquist disagreed with Mr. Kaufman's 8.40% cost of equity recommendation. Dr. Boquist testified that Mr. Kaufman's 8.40% cost of common equity capital for HSE was not supported by proper consideration of the risks faced by the company. According to Dr. Boquist, if such a low cost of equity was adopted by the Commission, it would jeopardize the financial integrity of HSE, particularly if it is subsequently applied to the book value of HSE's property. Dr. Boquist concluded that the Commission should find HSE's cost of equity to be 11.74%.

D. Stipulation as to Cost of Equity. At the hearing, HSE and the OUCC stipulated on the record to a 9.60% cost of equity, which they agreed was supported by the testimonies of Dr. Boquist and Mr. Kaufman.

E. Commission Discussion and Findings. Based on the stipulation, the Commission finds 9.60% to be a reasonable cost of equity and within the range proposed by the parties. Therefore, the cost of equity shall be 9.60%. Because HSE's capital structure is 100% equity, HSE's cost of capital is also 9.60%

12. Operating Income Under Present Rates.

A. Revenue Adjustments.

1. Petitioner's Evidence. Petitioner proposed three adjustments to test year revenues: 1) an increase of $645,630 to normalize customer growth through May 15, 2015; 2) an increase of $293,285 to estimate customer growth from May 15, 2015 through December 31, 2015; and 3) an increase of $57,600 to estimate revenues from its proposed FOG program. HSE proposed total adjustments of $996,515 to test year operating revenues of $11,008,500, resulting in pro forma operating revenue of $12,005,015.

2. OUCC's Evidence. Ms. Stull accepted HSE's revenue adjustments of $938,915 for customer growth through December 31, 2015. Ms. Stull agreed that an adjustment related to FOG revenue was appropriate, but she disagreed with the amount proposed by HSE. Ms. Stull proposed FOG revenues of $75,627, an increase of $18,027 over HSE's proposed amount. Ms. Stull testified that the FOG revenue should at least cover the program costs. Ms. Stull estimated the program costs to be $75,627, which was based on HSE's costs to inspect restaurant grease traps. Ms. Stull proposed an additional revenue adjustment of $21,200 to reflect the elimination of test year unbilled revenues. Ms. Stull testified that based on HSE's methodology for

calculating customer growth, unbilled revenues are unnecessary and duplicative. Ms. Stull proposed an overall increase of $993,342 to operating revenues to yield pro forma operating revenues of $12,001,842.

3. Petitioner's Rebuttal Evidence. HSE did not accept the proposed increase in FOG revenue. However, HSE agreed with Ms. Stull's adjustment related to unbilled revenues, resulting in a decrease to operating revenues of $21,200. Petitioner added a $4,837 adjustment (increase) in Forfeited Discounts. This adjustment is at the same rate Forfeited Discounts were relative to the flat rate revenues in the test year (.53%).

4. Commission Discussion and Findings. The Commission finds that HSE's proposed adjustments related to normalization for customer growth are appropriate. The Commission also finds that in the absence of known data, FOG revenue should equal FOG costs. We also find that a reduction of $21,200 related to unbilled revenues is appropriate and accept Petitioner's increase in Forfeited Discounts. Therefore, we find an adjustment to HSE's operating revenues of $998,179 to be reasonable, resulting in pro forma operating revenues of $12,006,679.

B. Operating Expenses.

1. Operation and Maintenance.

a. Petitioner's Evidence. Mr. Krohn proposed several adjustments to HSE's test year operating expenses resulting in an overall increase of $588,858. Mr. Krohn made the following adjustments:

- He included an adjustment of $284,763 for purchased wastewater treatment normalized for projected increases in revenue due to customer growth.
- He made an adjustment to wages and benefits of $31,387 to adjust for a 3% increase to employee salaries and wages, and to adjust for a 5% increase in employee insurance and benefits expenses resulting in adjustments of $5,662 and $3,766.
- He added an adjustment for engineering and contract services that reflects a 3% increase in SAMCO's rates and charges resulting in adjustments of $54,728 and $60,770.
- He removed lease expense for building and real property as required by Cause No. 43761 resulting in a decrease $66,539.
- He added an adjustment for property tax expense of $971.
- He included an adjustment related to payroll taxes based upon increases in wages and salaries resulting in an adjustment of $2,338.
- He included an adjustment of $8,294 for insurance expense based upon 2015 actual premiums.
- He added an adjustment for URT expense of $20,902 to normalize URT tax expense based upon normalized operating revenues.
- He added an adjustment for rate case expense amortized over three years of $87,500 based upon an estimated cost of the current rate case.

- He made an adjustment regarding the Indiana Department of Revenue judgment against HSE for URT on system development charges resulting in an adjustment of $89,332.
- Finally, Mr. Krohn made an adjustment of $2,491 related to IURC fees on normalized operating revenue.

b. OUCC's Evidence. Ms. Stull accepted HSE's adjustments related to salaries and wages, employee benefits, rents, and bad debt expense. She proposed modifications to HSE's adjustments for employee retirement, purchased sewage treatment, insurance, rate case expense, and the IURC Fee. Ms. Stull excluded HSE's proposed adjustment to contractual services for SAMCO's rate increase. Ms. Stull's proposed adjustments are as follows:

Ms. Stull proposed an overall reduction to employee retirement expense of $1,825. The adjustment consists of two components: 1) an increase of $3,971 to reflect 12% of pro forma salaries and wages and 2) a decrease of $5,796 to reflect reimbursement of 20% of retirement costs for the President and Controller. Ms. Stull testified that SAMCO reimburses 20% of costs for work done by HSE's President and Controller on behalf of SAMCO, including salaries and wages, bonuses, employee insurance benefits, and payroll taxes. However, according to Ms. Stull, SAMCO has not historically reimbursed the costs of retirement expenses. Ms. Stull testified that it is unclear why these have not been included in the amount reimbursed to HSE because they are necessary costs incurred for these positions. Ms. Stull also testified that she does not agree with the estimate of the time spent by HSE's President and Controller on SAMCO responsibilities. She testified that the 20% amount seems low and recommended the Commission require HSE to formally track the time worked for SAMCO.

Ms. Stull disagreed with HSE's adjustment to purchased sewage treatment. She proposed an overall increase to purchased sewage treatment of $168,442, which is composed of two elements: 1) a decrease of $107,100 to eliminate expense recorded in error; and 2) an increase of $275,542 to reflect an increase of 8.61% in purchased sewage treatment expense due to estimated customer growth through December 31, 2015. Ms. Stull testified that a transaction to record the SDCs due to the City of Fishers for the month of July was incorrectly recorded as purchased sewage treatment. Ms. Stull's adjustment to purchased sewage treatment is $116,321 less than the adjustment proposed by HSE.

Ms. Stull recommended an adjustment related to legal fees. She proposed two adjustments to legal fees: 1) a decrease of $121,061 to reclassify fees related to capital projects and the conveyance of contributed plant; and 2) a decrease of $1,500 to remove fees related to this rate case. Ms. Stull testified that the fees she proposes to capitalize include costs to negotiate contracts with developers and convey the property to HSE. She added that these costs are incurred by HSE before it accepts property from developers and these costs should be capitalized and included in the cost of the asset(s) conveyed. Ms. Stull testified that she included the legal fees removed from operating expenses in her calculation of HSE's rate base, as discussed above. She also testified that she removed legal fees related to this rate case because these fees are included in the estimate of rate case costs being amortized in this case.

Ms. Stull proposed a decrease to insurance expense of $934. According to Ms. Stull, the adjustment removes the 10% management fee charged by SAMCO for acquiring pollution

insurance, which it then bills to HSE. The $934 reduction results in an adjustment to insurance expense of $7,360 and pro forma insurance expense of $47,877.

Ms. Stull also made an adjustment to reflect a reduction in test year operating expenses related to expenses she deemed non-allowed and non-recoverable, resulting in a reduction of $9,770. She removed expenses for Indians tickets and charitable contributions to the Boy Scouts and HSE Schools Foundation, which she determined provide no material benefit to HSE's current customers and are not properly includable in pro forma operating expenses in this case.

Ms. Stull disagreed with HSE's adjustment related to rate case expense. She disagreed with the amortization period used by HSE. Ms. Stull proposed to amortize the rate case expense of $262,500 over a six-year period instead of three years due to the fact that it had been six years since HSE last filed a rate case. Ms. Stull proposed a pro forma rate case expense of $43,750.

Ms. Stull also disagreed with HSE's adjustment for IURC Fee expense. According to Ms. Stull, the current IURC Fee rate is 0.1077802% and not the 0.25% used by HSE. Applying the 0.1077802% rate to pro forma operating revenues yields pro forma IURC fee expense of $12,706, which is a $51 decrease from HSE's test year IURC fee expense of $12,757.

Ms. Stull accepted HSE's proposed adjustments to payroll taxes and property taxes. She proposed modifications to HSE's calculation of present rate URT expense. She also excluded HSE's proposed adjustment to recover URT assessments from the Indiana Department of Revenue related to SDCs and connection fees. Ms. Stull proposed an increase of $15,225 to test year URT expense. Ms. Stull excluded URT expense for SDCs and connection fees because she concluded that HSE is not currently paying URT on these fees and has not paid any URT on SDCs and connection fees since its inception. Ms. Stull testified that HSE has appealed Indiana Department of Revenue's URT tax judgment, and the Tax Court overturned this judgment. IDR is appealing the Tax Court's ruling, and it may be several years before any final adjudication is reached on this issue. Ms. Stull therefore concluded that it is not necessary to include the URT expense in HSE's revenue requirement when HSE currently has no obligation to pay the expense and may never have an obligation to pay it. Ms. Stull recommended tax expense adjustments for an overall increase of $18,534 resulting in pro forma tax expenses of $1,477,408. Ms. Stull also concluded that it is reasonable for HSE to defer the costs related to URT expense on SDCs and connection fees on its balance sheet for future recovery if and when the obligation becomes due.

c. Petitioner's Rebuttal Evidence. Mr. Krohn responded to Ms. Stull's testimony regarding proposed adjustments to HSE's operation and maintenance expenses. Mr. Krohn agreed with Ms. Stull's recommendation to reduce the adjustment to purchased sewage treatment and made an adjustment of $168,370, resulting in pro forma purchased sewage treatment expense of $3,475,723. Mr. Krohn also agreed with Ms. Stull's proposed adjustment to the IURC fee expense. The reduction of $51 related to the IURC fee expense results in pro forma Miscellaneous Expenses of $74,211. Mr. Krohn disagreed with Ms. Stull's adjustment related to employee retirement expense. Mr. Krohn also disagreed with Ms. Stull's adjustment to legal fees. Mr. Krohn testified that Ms. Stull's capitalization of HSE's legal fee expenses would not be consistent with HSE's capitalization policy and is inconsistent with GAAP. Mr. Krohn proposed a rate case expense adjustment of $40,000 in Petitioner's Attachment OWK-R-1, Schedule 5. Mr. Krohn agreed with Ms. Stull's recommendation to defer the costs of HSE's potential URT tax

liability with Indiana Department of Revenue subject to a true-up if HSE has any tax liability. HSE's revised adjustments of $328,709 results in pro forma operating expenses of $11,500,534.

d. Commission Discussion and Findings.

i. Reimbursement of Employee Retirement Benefits. Ms. Stull recommended a reduction to employee retirement expense of $1,825. This recommendation is based on SAMCO's $5,796 reimbursement to HSE for 20% of labor related costs for work performed by HSE's President and Controller on behalf of SAMCO, and a $3,971 increase to reflect 12% of pro forma salaries and wages. Accordingly, Ms. Stull proposed that employee retirement benefits should also be included in the reimbursement total. Historically, according to Ms. Stull, SAMCO has not reimbursed HSE for employee retirement benefits. HSE has estimated that HSE's President and Controller spend 20% of their time on SAMCO matters. We find it reasonable that HSE pay for the proportionate costs of employee retirement benefits. Therefore, a $1,825 reduction to employee retirement benefits is reasonable.

ii. Time Allocated to SAMCO Matters. Ms. Stull testified that she does not agree with HSE's 20% estimate of time spent on SAMCO matters by HSE's President and Controller and that the estimate appears to be low. She recommended that HSE formally track the time spent on SAMCO matters and base its time allocation on this information in its next rate case. Further, she recommended that HSE make this information available to the OUCC upon request in HSE's next rate case. We find that while we accept the 20% estimate as reasonable in this proceeding, HSE shall provide additional evidence in its next rate case to support its proposed allocation. Such evidence may include, but is not limited to, daily activity records, calendars, timesheets, or other information which supports the resource allocation.

iii. Purchased Sewage Treatment. Ms. Stull proposed an overall increase to purchased sewage treatment of $168,442. Her adjustment was primarily related to a transaction recorded in error during the test year related to SDCs due to the City of Fishers. Mr. Krohn agreed to make a reduction to purchased sewage treatment, resulting in a pro forma purchased sewage treatment expense of $3,475,795. We find the revised pro forma amount of $3,475,795 to be reasonable and supported by the evidence.

iv. Capitalization of Legal Fees. Ms. Stull proposed two adjustments to legal fees expense: 1) a decrease of $121,061 to reclassify fees related to capital projects and the conveyance of contributed plant and 2) a decrease of $1,500 to remove fees related to this rate case. Ms. Stull testified that these are costs incurred by HSE before it accepts property from developers and these costs should be capitalized and included in the cost of the asset(s) conveyed. We have already addressed the capitalization issue above, and decline to accept Ms. Stull's proposed adjustment. Regarding the removal of $1,500 related to legal fees, Ms. Stull included the invoice titled "2015 Rate Case." It appears that this amount should be included in HSE's rate case expense, and thus, a $1,500 O&M expense reduction is appropriate.

v. Insurance Expense. Both parties agree that insurance expense has a fixed, known, and measurable increase of $8,294. Ms. Stull recommended a decrease to test year insurance expense of $934 for the cost of pollution insurance acquired by

SAMCO and billed to HSE. The reduction of $934 removes the SAMCO management fee. Ms. Stull testified that the additional cost of SAMCO acquiring the insurance and then billing HSE is unnecessary and imprudent. Ms. Stull proposed a pro forma insurance expense of $47,877. HSE disagreed with Ms. Stull's adjustment and recommended an adjustment to test year insurance expense of $8,294, yielding pro forma insurance expense of $48,811. We find HSE's adjustment of $8,294 to be appropriate. As discussed below, we decline to include SAMCO's 10% management fee. Therefore, the $934 reduction to HSE's insurance expense adjustment is supported by the evidence. We find that pro forma insurance expense is $47,877 ($40,517+$7,360).

vi. Non-Allowed and Non-Recurring Expenses. Ms. Stull recommended a reduction to test year Miscellaneous Expenses of $9,770 to remove expenses that she concluded were non-allowed or non-recurring. The expenses include contributions made to charitable organizations and payment for Indians tickets. Ms. Stull testified that the expenses provide no material benefit to HSE's ratepayers. In its Brief in Support of the Proposed Order, HSE agreed to the OUCC's recommended reduction of $9,770. We therefore find a reduction of $9,770 to operating expenses to be appropriate and supported by the evidence.

vii. Rate Case Expense. Mr. Krohn estimated total rate case expenses of $262,500 and proposed a three-year amortization period, resulting in pro forma annual rate case expense of $87,500.[1] Ms. Stull disagreed with the three-year amortization period and recommended a six-year period. Ms. Stull testified that the amortization period should reflect the expected life of the rates being set in this case. She concluded that the time since HSE's last rate case is the most representative basis upon which to base the selection of an amortization period.

We find HSE's total rate case expense of $262,500 to be reasonable, but agree with the OUCC that a six-year amortization reflects the historic frequency of rate case filings. Accordingly, HSE's amortized rate case expense shall be $43,750.

viii. IURC Fee. Mr. Krohn made an adjustment of $2,491 to Miscellaneous Expenses related to IURC fees on normalized operating revenue, which was calculated by using an IURC Fee rate of 0.25%. Ms. Stull disagreed with the calculation of the adjustment and testified that as of July 2015, the IURC Fee rate is 0.1077802%. Using an IURC Fee rate of 0.1077802%, Ms. Stull proposed a reduction of $51 to test year IURC fee expense, yielding a pro forma IURC Fee expense of $12,706. Mr. Krohn agreed with Ms. Stull's proposed reduction of $51 using the July 2015 IURC Fee rate of 0.1077802%. The Commission agrees with Ms. Stull's reduction of $51 based upon an IURC Fee rate of 0.1077802%. Therefore, HSE's pro forma IURC Fee expense shall be $12,706.

ix. Tax Expense. HSE proposed adjustments to payroll taxes, property taxes, and URT. Total tax expense adjustments proposed by HSE resulted in an increase of $113,542 to test year tax expense of $1,458,874, yielding a pro forma other tax

[1] HSE revised its proposed rate case expense adjustment to $40,000 in its rebuttal evidence. However, HSE in its Brief in Support of the Proposed Order indicated that this was an inadvertent revision and that it does not recommend any adjustments to its initial proposal of total rate case expense of $262,500 amortized over three years.

expense of $1,572,416. Ms. Stull accepted the tax adjustments related to property taxes and payroll taxes. Ms. Stull excluded the adjustments related to URT. Ms. Stull proposed an adjustment to tax expense of $18,534, resulting in pro forma tax expense of $1,477,408. Mr. Krohn agreed with Ms. Stull's tax expense adjustments related to URT. He revised his URT tax expense adjustment to $14,019, resulting in pro forma URT tax expense of $166,365. Mr. Krohn also agreed with Ms. Stull's recommendation to defer the costs of HSE's potential tax liability to the IDR related to URT assessed on SDCs and connection fees. This results in a reduction to tax expense of $89,332. Overall, HSE agreed to reduce its tax expense by $96,215. The Commission finds the adjustments to URT tax expense to be appropriate. The Commission also finds the OUCC's recommendation that HSE defer URT tax liability on on its balance sheet for future cost recovery to be reasonable. Therefore, HSE shall defer these URT costs on its balance sheet, and in the event HSE actually pays URT on its SDCs and connection fees, HSE may collect these costs in a future rate proceeding or other proceeding initiated by HSE. The Commission also finds HSE's proposed adjustments to payroll tax expense and property tax expense to be appropriate.

Therefore, the Commission finds the following tax expense amounts to be reasonable:

	Test Year	Adjustment	Pro Forma
Property Tax	$ 1,276,746	$ 971	$ 1,277,717
Payroll Taxes	$ 29,782	$ 2,338	$ 32,120
Utility Receipts Tax	$ 152,346	$ 15,296	$ 167,642
URT Judgment	**Deferred Expense**		
Total Tax Expense	$ 1,458,874	$ 18,605	$ 1,477,479

2. Affiliate Contract Expense.

a. Petitioner's Evidence. Petitioner proposed a 3% increase in its contract operations with its contract affiliate SAMCO. The increase reflects current hourly billing rates pursuant to the contract between HSE and SAMCO. The 3% increase resulted in two adjustments to HSE's test year operating expenses: 1) an increase to Contractual Services-Engineering of $54,728, resulting in a pro forma amount of $1,878,980; and 2) an increase to Contractual Services-Other of $60,770, resulting in a pro forma amount of $2,086,444.

b. OUCC's Evidence. Ms. Stull made several adjustments for HSE's transactions with its affiliate company SAMCO. Ms. Stull 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 cost (fully allocated) or prevailing market prices, whichever is lower. Ms. Stull added that in Cause No. 43761, HSE said SAMCO charges HSE "market" rates for its services. According to Ms. Stull, SAMCO's charges appear to be at a rate that is higher than SAMCO's cost of providing the services. Therefore, HSE's operating costs, which it seeks to recover through rates, are inappropriately high. Ms. Stull also testified that HSE's customers are unnecessarily paying higher rates than they would otherwise if HSE operated and maintained its

utility with in-house personnel. Ms. Stull disagreed with HSE's proposed pro forma SAMCO charges. Ms. Stull recommended four adjustments related to SAMCO charges:

Ms. Stull decreased test year engineering fees by $726,198 to remove costs that she considers to be capital in nature (of which she added $580,958 to rate base, which is discussed above). She concluded that a considerable portion of the engineering fees billed by SAMCO (approximately 46%) related to work performed on capital projects.

She made two additional adjustments to remove costs that she concluded were capital in nature: 1) a decrease of $37,474 to lift station operating expenses that had been recorded as material and supplies expense and 2) a decrease of $25,527 to engineering fees to remove SCADA (industrial computer systems that monitor and control machines) and generator costs.

She decreased test year SAMCO charges by $62,330 to eliminate management fees included in pass through billings of certain operating costs. Ms. Stull testified that the 10% management fee is an additional mark-up cost tacked on by SAMCO pursuant to its contract with HSE. Ms. Stull added that the management fee should be considered an unnecessary and therefore imprudent expense.

Finally, she decreased test year SAMCO charges by $690,506 to represent SAMCO's fully allocated cost to provide these services and to better reflect HSE's cost to operate its utility with its own employees. Ms. Stull testified that she considers SAMCO's charges to include profit or additional mark-up and represent more than SAMCO's fully allocated costs to perform the services. Her proposed adjustment estimated a mark-up of 20% included in SAMCO's charges. Ms. Stull testified that she relied on the NARUC guidelines to make the adjustment. Ms. Stull applied the 20% reduction in costs to the following operating expense categories: lift station expenses, engineering fees, line cleaning and maintenance expense, manhole maintenance expense, and video inspection expense.

Mr. Parks testified regarding HSE's use of SAMCO to perform all operations and maintenance functions of the utility. Mr. Parks testified that, based on the size of HSE's operations, HSE could secure the same work provided by SAMCO at a much lower cost by performing the tasks with its own staff. Mr. Parks provided an analysis of the costs of HSE hiring an engineer compared to the hourly rate of a SAMCO engineer. Mr. Parks testified that a SAMCO Project Engineer has a billable rate of $126 per hour. He also testified that a typical median entry salary for a Civil Engineer with 0 to 5 years of experience is $55,000 to $60,000 per year. He added that if HSE had relied on its own staff to perform some of the functions performed by SAMCO, HSE's test year and projected operating costs would be significantly less. According to Mr. Parks, HSE's practice of relying on its affiliate to perform these tasks at a higher "market rate" unnecessarily increases operating costs. Mr. Parks concluded that Ms. Stull's proposed adjustments to get closer "at cost" operating costs are conservative and reasonable.

c. Petitioner's Rebuttal Evidence. Mr. Cochran responded to the recommendations made by Ms. Stull and Mr. Parks. Mr. Cochran disagreed with Ms. Stull's recommendation to exclude SAMCO's 10% management fee from HSE's operating expenses. Mr. Cochran testified that SAMCO only marks-up invoices to HSE that relate to material costs and subcontractor work per the Utility Services Agreement between HSE and SAMCO. This

agreement has been filed with the Commission and is the same agreement that was in effect during HSE's last rate case. According to Mr. Cochran, only a small fraction of the total invoices issued by SAMCO to HSE include the 10% management fee. All charges on SAMCO's invoices are at the rates agreed to by HSE and SAMCO, which are at or below the rates SAMCO charges to other customers. Mr. Cochran testified that it is standard industry practice to mark-up material costs and subcontractor work. Mr. Cochran provided examples of rate schedules between municipalities and engineering firms in Petitioner's Attachment KWC-R-1, which indicate a 10% to 15% mark-up for sub-contractor work and material costs. Mr. Cochran also testified that the rates between HSE and SAMCO are reviewed annually. According to Mr. Cochran, SAMCO requested rate increases each year from 2010 through 2014, but HSE was able to keep SAMCO's existing rates in place. He added that the rates in effect during 2010 through 2014 were the rates agreed to by HSE and SAMCO in 2009. He also added that SAMCO's current rates went into effect in August 2015, and the final agreed to rates were lower than the increase initially requested by SAMCO (3% increase instead of 5%). Mr. Cochran provided an exhibit, Petitioner's Attachment KWC-R-2, comparing the rate increase requested by SAMCO and the final agreed to rate during each year from 2010 to 2015. Mr. Cochran testified that during HSE's 2015 review of SAMCO's rate increase request, a rate study was conducted to determine whether SAMCO charges rates that continue to be competitive with the regional market. The rate study, Petitioner's Attachment KWC-R-3, compares SAMCO's rates to seven other firms in the region. Based on the rate study, Mr. Cochran concluded that SAMCO's rates were well below the rates charged by other firms. He also concluded that SAMCO's 2015 rates are competitive and in many cases below the rates charged by other similar firms.

Mr. Cochran also testified regarding Ms. Stull and Mr. Parks's suggestion that it would be cheaper for HSE to provide SAMCO's services in-house. According to Mr. Cochran, many of HSE's projects are specialized and require more experienced engineers. He testified that the IDEM maintenance requirements, as outlined in the Agreed Order with the Indiana Department of Environmental Management ("IDEM") (Petitioner's Attachment KWC-4), have made the system even more complex. One or two in-house engineers would not have the expertise and would not be able to handle the multitude of project areas required to maintain HSE's system. Mr. Cochran added that the cost of performing these engineering services in-house would be substantially higher than the costs suggested by Mr. Parks. Additionally, Mr. Cochran testified that HSE would also have to pay for a substantial amount of equipment which has significant costs associated with it including maintenance, repairs, and storage. He also testified that there would be additional overhead costs that HSE would incur by bringing the services in-house, including additional office space, trucks, warehouse, and other property for new employees and storage of equipment, property taxes, and benefits for new employees. In addition, Mr. Cochran testified that by his estimation, there are at least 18 municipalities/waste districts/regional sewer districts that have contracted private utility contractors to operate their facilities. He added that when taking into consideration all of these factors, HSE's use of SAMCO is cost-effective, reasonable, and below the market in many instances.

Mr. Cochran also testified regarding Ms. Stull's recommendation that SAMCO's charges be consistent with the NARUC guidelines. Mr. Cochran agreed that the rates charged by an affiliate should not exceed prevailing market prices. He disagreed with Ms. Stull as to whether the rates charged by SAMCO to HSE should be the lower of at cost (fully allocated) or prevailing market prices. Mr. Cochran testified that the guidelines themselves suggest that they may not be

appropriate for every situation. For example, the guidelines state that they are not intended to be rules and regulations prescribing how cost allocations and affiliate transactions are to be 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 affiliate transactions. Mr. Cochran testified that the rates charged for services provided by SAMCO are competitive with, and in many cases lower than, the rates charged by other engineering companies in the region. According to Mr. Cochran, HSE has been able to monitor the local market to ensure the rates HSE pays SAMCO are competitive with the market. This is supported by the fact that SAMCO's rates remained the same from 2010 through 2014. He testified that SAMCO has 19 other clients representing more than 40% of its business, which also supports his research indicating that SAMCO's rates are extremely competitive in the region. Additionally, Mr. Cochran testified that HSE does not subsidize any of SAMCO's operations, that HSE's employees operate independently from SAMCO's employees, that HSE does not give preference to or discriminate in favor of SAMCO, and that HSE and SAMCO do not participate in any joint advertising. Mr. Cochran concluded that HSE's relationship with SAMCO is a big reason for HSE's rates remaining competitive with and in many cases below the rates charged by other central Indiana wastewater utilities, as shown by Petitioner's Exhibit No. Administrative Notice 1.

Mr. Krohn responded to Ms. Stull's recommendations to capitalize certain operating expenses and to her adjustments to operating expenses. Mr. Krohn disagreed with her recommendation to capitalize test year engineering fees. Mr. Krohn testified that Ms. Stull's recommendation to capitalize certain engineering fees is inconsistent with HSE's capitalization policy and GAAP. He also testified that Ms. Stull's adjustments are based on an arbitrary application of assumed percentages attributable to costs that she purports to be capital costs and on an arbitrary calculation of purported SAMCO profit margins. According to Mr. Krohn, the arbitrary adjustments made by Ms. Stull result in a reduction of nearly $1.5 million in actual operation, maintenance, and asset management costs. Mr. Krohn concluded that the methods used by the OUCC in making the adjustments are not fixed, known, and measurable. He added that the adjustments are speculation and not based on market surveys or other substantial evidence. Moreover, the adjustments have not been consistently applied over HSE's 25 years as an operating utility.

d. Commission Discussion and Findings. HSE's position, as set out in its evidence, is that: 1) the OUCC's elimination of 20% of test year expense was arbitrary and not fixed, known, and measurable; 2) the adjustments related to the 10% management fee are arbitrary, not supported by the evidence, and are normal fees charged by other engineering firms like SAMCO as demonstrated by the market surveys and contracts entered into the record by HSE; 3) 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 reviewed, are at or below the contract rates the affiliate charges other customers, and are the result of a market study based upon competitive pricing, as shown by the market survey conducted by HSE; 4) the cost of performing the affiliate services in-house would be substantially higher than suggested by the OUCC, and the OUCC's adjustments related to HSE performing the services in-house are speculative and not fixed, known and measurable when compared to the test year operating expenses of HSE; and 5) HSE's operations and maintenance expense is the only evidence in 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.

As noted by the OUCC, NARUC guidelines call for affiliate pricing to be at market price, or the fully allocated cost, whichever is lower. Here, HSE presented evidence that shows SAMCO's rates are at or below the rates charged by other similar firms, but presented no evidence concerning what SAMCO's fully allocated cost actually is. While we agree with HSE that the OUCC's 20% ($690,506) downward adjustment is arbitrary, the Commission would note that it is HSE, not the OUCC, which has the burden to prove its costs are reasonable. Because HSE failed to produce any evidence concerning SAMCO's fully allocated cost, the Commission is unable to determine whether the market prices charged by SAMCO, while at or below costs of its competitors, are at or below SAMCO's fully allocated cost.

Similarly, while the 10% management fee may be customary in the industry, SAMCO has failed to provide any evidence of what the actual fully allocated management cost is. In the absence of any evidence of actual cost, we decline to include the proposed management fee in rates.

Despite the failure to provide fully allocated cost information, we decline to deny recovery of all SAMCO-related expenses. Regardless of what entity performs the services tasked to SAMCO, those service are reasonable and necessary to the provision of utility service. The issue is the level of expense that should be approved in light of the evidence of record. Because HSE failed to demonstrate SAMCO's fully allocated costs, the Commission declines to approve Petitioner's proposed $115,498 ($54,728+60,770) 3% increase in its contract operations cost with SAMCO, and accepts the OUCC's proposed $62,330 10% management fee reduction. Accordingly, we find SAMCO's pro forma Contract Services-Other expenses are $2,003,649 and its pro forma Contract Services-Engineering expenses are $1,822,762.

In its next rate case, we direct HSE to offer evidence supporting SAMCO's fully allocated cost so that the Commission may determine the appropriate level of SAMCO expenses that should be included in HSE's rates. Further, we direct HSE to file with the Commission all current affiliate agreements within 30 days of the date of this Order.

3. Income Tax Expense.

a. Petitioner's Evidence. Mr. Mares testified that the shareholders of HSE have paid over the years HSE has been in existence both federal and state income taxes attributable to the income of HSE. He added that these amounts represent taxes that were actually paid to the federal and state taxing authorities based upon earnings and income generated by HSE. Mr. Mares testified that he established the tax rate to be used in HSE's cost of service calculation by using the methodology approved by the Commission in HSE's last rate case in Cause No. 43761. The Commission's methodology, according to Mr. Mares, is based on the individual shareholder's rates used by the taxing authorities during the test year as if no other income is earned by the shareholder other than HSE income. Based on this methodology, Mr. Mares calculated a combined federal and state tax rate of 27.43%, which was used in Mr. Krohn's cost of service calculation to compute federal and state income taxes for HSE. 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 test year 2014. HSE included the applicable pages of each shareholder's federal and state tax returns with its case-in-chief. Mr. Mares attached an exhibit that showed the calculation of the 27.43% combined tax rate. Mr. Mares also testified regarding the tax benefits of HSE being an S-Corporation compared to a C-Corporation. Mr. Mares determined that HSE's combined federal and state tax rate if it were a C-Corporation would be 41%. Mr. Mares concluded that HSE's combined tax rate of 27.43% as an S- Corporation compared to the C-Corporation rate of 41% demonstrates a tax advantage to HSE's ratepayers of HSE being a S-Corporation.

b. OUCC's Evidence. Ms. Stull testified that as an S-Corporation, HSE has no state or federal income tax liability. She testified that since HSE incurs no tax liability, it is inappropriate for HSE to recover income taxes as a component of its revenue requirement. She also testified that HSE had no net income in 2014. Ms. Stull testified that there is case law addressing the issue of S-Corporation recovery of income taxes. According to Ms. Stull, an appellate court ruling upheld the disallowance of income taxes for a S-Corporation (South Haven Waterworks Cause No. 39225). Additionally, Ms. Stull testified that there are benefits that would accrue to ratepayers if HSE were a C-Corporation. For example, HSE would have deferred income taxes, which would be included as a zero cost source of capital in HSE's capital structure (or as a reduction to rate base). This would reduce HSE's cost of capital and the net income required for HSE to earn a fair return on rate base, which would result in lower rates.

c. Petitioner's Rebuttal Evidence. Mr. Mares responded to the testimony of Ms. Stull. Mr. Mares disagreed with Ms. Stull's position that income tax should be excluded from the cost of service calculation. Mr. Mares testified that the Commission's approved methodology for allowing income tax expense in Cause No. 43761 was not based on HSE's test year income. According to Mr. Mares, the methodology approved by the Commission calculated income tax expense after pro forma adjustments had been made to revenues and expenses of HSE that were fixed, known and measurable and reflected net income at an approved rate of return on rate base. Mr. Mares testified that this is the methodology used by HSE in the current proceeding. Mr. Mares also testified that when HSE has positive net income, its shareholders pay income tax expense related to HSE's earnings. For example, HSE's shareholders paid income taxes related to HSE for calendar year 2013. Mr. Mares provided the relevant parts of HSE's shareholders' 2013 tax returns to show that the shareholders actually paid taxes on HSE income in 2013. Mr. Mares disagreed with Ms. Stull's testimony regarding the appellate court ruling in the South Haven Waterworks case. According to Mr. Mares, Ms. Stull makes no reference to the Commission's subsequent order in HSE's last rate case in Cause No. 43761. In that order, the Commission concluded that income taxes can be recovered as an expense when evidence has been provided demonstrating taxes will actually be paid by the shareholders of the utility on income generated by the utility. Mr. Mares also disagreed with Ms. Stull's testimony that ratepayers would benefit if HSE was organized as a C-Corporation. Mr. Mares testified that the computed federal and state tax rate of 27.43% used in the cost of service calculation is much lower than the C-Corporation combined state and federal rate of 41%. He also testified that the Commission discussed in Cause No. 43761 benefits of S-Corporations as compared to C-Corporations and concluded that the S-Corporation structure tends to benefit both shareholders and ratepayers, under current tax laws, by avoiding higher C-Corporation tax rates.

Mr. Cochran also responded to Ms. Stull's assertion that HSE should not be allowed to recover its income tax liability. Mr. Cochran testified that HSE's shareholders paid state and federal income taxes during the test year, and that as an S-Corporation, HSE's shareholders will continue to have state and federal income tax liability. Mr. Cochran testified that if HSE were to convert to a C-Corporation, HSE's tax liability would be substantially higher, which would be detrimental not only to HSE, but also to HSE's ratepayers. Mr. Cochran also testified that if HSE were denied the ability recover its income tax expense in revenue, it would have an adverse effect on both the ratepayers and HSE's shareholders. HSE would inevitably convert to a C-Corporation, which would result in higher taxes for HSE, and in turn, HSE's customers would pay more tax expense.

d. Commission Discussion and Findings. We previously addressed treatment of S-Corporation taxes in Cause No. 43761, and decline the OUCC's invitation to reconsider our conclusion in that Cause, with the exception of the appropriate federal rate applicable to each shareholder. HSE included in its cost of service calculation an effective income tax rate based upon the Commission's methodology approved in Cause No. 43761. In that proceeding, the Commission found the appropriate method to determine actual federal income taxes is based on the individual shareholder's rates used by the Internal Revenue Service during the test year as if no other income is earned by the shareholder. Using the Commission's approved methodology from Cause No. 43761, HSE calculated a combined federal and state tax rate of 27.43% to be used in its cost of service calculations.

During the hearing, the OUCC established that HSE's shareholders have differing filing statuses, such as married filing jointly. In Cause No. 43761, it appears that the Commission calculated HSE's tax rate using the tax rates applicable for single filing status. We find that it would be more appropriate to use the actual filing status of each HSE shareholder to calculate the tax rate. In doing so, HSE's combined federal and state tax rate shall be 26.82%.

C. 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	$12,006,679
Less: Cash Operating Expenses	(11,307,530)
Less: Depreciation and Amortization Expense	(170,153)
Net Utility Operating Income Before Income Taxes	528,996
Allowance for Income Taxes	(131,361)
Net Utility Operating Income After Tax	$ 397,635

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 $397,635. We have previously found HSE's rate base is $5,142,991. A return of $397,635 represents a rate of return of 7.7% on the rate base. We find that this is insufficient to represent a reasonable return, and therefore, Petitioner's present rates are unreasonable.

13. 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 $139,305 or a 1.17% increase in its revenues, resulting in total annual operating revenue of $12,145,984. This represents a 9.60% return on rate base of $5,142,991. This revenue is reasonably estimated to allow Petitioner the opportunity to earn net operating income of $493,727 as follows:

Original Cost Rate Base	$5,142,991
Times: Weighted Cost of Capital	9.60%
Required Net Operating Income	493,727
Less: Adjusted NOI at Current Rates	397,635
Increase in NOI Required	96,092
Times: Gross Revenue Conversion Factor	.449702
Recommended Revenue Increase	$ 139,305
Percentage Increase	1.17%

This increase results in a customer's monthly charge of $35.04 per EDU.

14. Increase to System Development Charges.

A. Petitioner's Evidence. Petitioner proposed an increase to its SDC of $450 for a total SDC charge of $2,850 per EDU ($3,650 in the Flatfork CTA). Mr. Krohn testified that the purpose of the increase is to recover a portion of the increased costs since HSE's current SDCs were approved in Cause Nos. 43435 and 43761. As noted in Cause No. 43435, the purpose of HSE's SDC (as with all SDCs) is to provide a revenue stream outside of HSE's retail rates and charges that are fair and equitable to all parties. Mr. Krohn provided as evidence an updated version of the incremental cost method analysis used by HSE in Cause Nos. 43435 and 43761 to support the increase to the SDCs, as shown in Petitioner's Attachment OWK-3.

B. OUCC's Evidence. Ms. Stull testified that the OUCC was in agreement with the proposed changes to HSE's SDCs. She recommended the Commission approve the proposed SDCs.

C. Commission Discussion and Findings. Petitioner submitted evidence supporting its SDC calculations. The incremental cost method analysis used by HSE supports the proposed increase to HSE's SDC in all of its service areas. Therefore, we find the $450 increase to be reasonable and supported by the evidence. HSE shall have an SDC of $2,850 in all service areas excluding the Flatfork Creek CTA. The Flatfork Creek CTA shall have an SDC of $3,650.

15. Fats, Oils and Grease Program.

A. Petitioner's Evidence. Mr. Cochran testified that HSE is implementing a FOG management program to help reduce the amount of FOG that accumulates in HSE's system. He testified that the FOG management program is part of HSE's efforts to comply with IDEM requirements and to improve overall system operation and maintenance. Mr. Krohn testified that as part of the FOG program, HSE proposes a $30 monthly charge applicable to customers defined to be a "FOG Facility," which HSE defines as "any non-residential Customer or combination of

Customers utilizing the same pretreatment device which uses or generates FOG." In addition to the $30 monthly charge, HSE proposed that customers found to be in violation of the FOG program rules will be subject to monthly inspections at a cost of $90 per inspection.

B. OUCC's Evidence. Ms. Stull testified that the OUCC accepted HSE's proposed $30 monthly FOG charge and the $90 FOG inspection fee.

C. Commission Discussion and Findings. We find HSE's proposed FOG management program to be reasonable and supported by the evidence. As Mr. Cochran notes in his testimony, many sewer utilities have implemented similar FOG programs including the City of Carmel and City of Fishers. FOG reduction is an important part of improving overall system operation. Additionally, we find the $30 monthly charge for customers that qualify as a "FOG Facility" to be appropriate. We also find the $90 inspection fee for customers in violation of the FOG program to be appropriate.

16. Changes to Rules and Regulations.

A. Petitioner's Evidence. Mr. Cochran testified that HSE proposed several changes to its rules and regulations including new rules for Inflow and Infiltration reduction and a tree dripline rule. He also testified that HSE updated its Customer Complaint process rules to be consistent with the Commission's rules. HSE also proposed several miscellaneous changes, including changes to the Service Pipe Connection rules.

B. OUCC's Evidence. Mr. Parks testified regarding HSE's proposed changes to its Service Pipe Connection rules. Mr. Parks testified that HSE's proposed change to revised Rule 65 appears to change the responsibility to install and maintain the portion of the service line from the utility to the customer. He testified that the change is significant because the cost to repair a failure in a service lateral that occurs outside of the customer's property would now be borne by the customer instead of HSE. Mr. Parks testified that HSE did not explain what the rule revision is intended to accomplish.

C. Petitioner's Rebuttal Evidence. Mr. Cochran responded to the concerns raised by Mr. Parks. Mr. Cochran testified that it was not HSE's intent to burden a customer with street excavation and repair costs due to the proposed revisions. Mr. Cochran testified that HSE is willing to modify proposed Rule 65 to address Mr. Parks's concern. Mr. Cochran included a revised Rule 65 in his rebuttal testimony.

D. Commission Discussion and Findings. We find HSE's revised rules and regulations related to Inflow and Infiltration reduction and tree dripline to be appropriate. The rules will help improve overall system operation. We also find the revisions made to the Customer Complaint process rules to be consistent with the Commission's rules and therefore reasonable. We agree with Mr. Parks's concerns regarding HSE's proposed changes to the Service Pipe Connection rules. HSE in response to Mr. Parks's concerns proposed a revised Rule 65, which we find reasonably addresses Mr. Parks's concerns. Therefore, HSE shall include in its rules and regulations the revised Rule 65 proposed by Mr. Cochran in his rebuttal testimony. HSE shall file its revised Rules and Regulations with its new schedules of rates and charges in accordance with the findings of this Order.

17. Apartment Community Billing Practices.

A. Apartment Association Evidence. Ms. Petersen testified regarding HSE's billing practices for apartment communities whereby HSE charges a flat rate per apartment unit regardless of occupancy. She testified that HSE's billing practices allow HSE to collect 100% from the apartment communities regardless of the occupancy of the unit. Ms. Petersen testified that HSE's billing of apartment communities on a 0.7 per EDU basis regardless of occupancy is unreasonable. Ms. Petersen explained that the 0.7 EDU factor does not account for built-in vacancies and is based solely on design or maximum flows. She explained that the apartment communities' actual usage is less than 0.7 EDUs per unit per month.

According to Ms. Petersen, HSE's billing practices require the apartment community manager to continue to pay sewer bills for units that are not presently leased. If the community manager were to pass on the costs of such a practice, then a tenant's bill would fluctuate every month, not based on usage, but based solely on the occupancy of the community. Ms. Petersen testified that, in her opinion, HSE seems to be over collecting by billing the community a flat rate based on the number of apartment units without accounting for occupancy of those units. Ms. Petersen testified that it is rare for an apartment community to have 100% occupancy. Based upon her review of data maintained by the Apartment Association's member communities, Ms. Petersen testified that the aggregate occupancy of all of the Apartment Association's members is approximately 92%. Based on this data, it was Ms. Petersen's opinion that the Apartment Association's member communities frequently have less than 100% occupancy, yet the member communities are billed as if they were at 100% occupancy.

Ms. Petersen explained that HSE's billing practice requires apartment communities to pay for sewage service regardless of actual usage and regardless of whether the units are even occupied. The apartment manager can either pay the bill himself and ultimately pass the costs on through higher rent, or pass the costs of unoccupied units on to the residents of the occupied units. In either scenario, residents of the apartment units are paying for sewage service which they are not using. And, HSE is all the time collecting more money for sewer service than it actually provides to the apartment communities. In her opinion, the methodology causes the not-fully-occupied community to subsidize the costs of other customers on the system.

Ms. Petersen testified that she has additional concerns with HSE's billing practices. She is concerned that HSE forces the apartment communities to act as the billing agent for HSE. She testified that if HSE continues to bill the member communities regardless of occupancy, then the communities are likely to be unwilling to continue to operate in the capacity of billing agent and instead let HSE bill the tenants who are the actual customers. Ms. Petersen also testified that she is concerned about HSE's method of calculating rates on a non-metered basis. Ms. Petersen recommended that, at a minimum and as a condition of receiving a rate increase, HSE should be required to modify its tariff so that it cannot bill for unoccupied apartment units. She testified the member communities would be willing to report occupancy numbers on a monthly basis to HSE. Ms. Petersen also testified that HSE should be required, as a condition of receiving a rate increase, to reduce its non-metered rate and then adopt a variable consumption rate so as to more closely approximate the cost to serve its various customers.

B. Petitioner's Rebuttal Evidence. Mr. Cochran responded to Ms. Petersen's recommendations. Mr. Cochran testified regarding how HSE currently bills its apartment community customers. Mr. Cochran explained that HSE's bills all of its customers on an EDU basis and that 1 EDU is equivalent to 9,000 gallons per month, or approximately 300 gallons per day. A single family residence is billed on a monthly basis at 1.0 EDU. Customers with usage of less than 300 gallons per day are billed at a reduced EDU factor. According to Mr. Cochran, HSE's EDU billing factors are in HSE's tariff, which has been approved by the Commission. Mr. Cochran testified that apartment communities are billed at a reduced EDU factor of 0.7 EDU, which is a billing rate substantially lower than a single family residence. Mr. Cochran also testified that HSE's EDU billing factors are based on the IDEM technical standards rules for sewer collection systems ("IDEM Standards"), which are found at 327 IAC 3-6. The IDEM Standards, according to Mr. Cochran, establish average daily flow rates for one bedroom apartments of 200 gallons per day and 300 gallons per day for two bedroom apartments. Larger apartment units have design flow requirements of more than 300 gallons per day. Mr. Cochran testified that based on the IDEM Standards, HSE would be authorized to charge a higher rate to apartment communities based on a higher EDU factor of 0.83. Mr. Cochran also testified that HSE performed an analysis of design flow information submitted by the apartment communities prior to construction of each community showing an average design flow for the communities of 258 gallons per day, or an EDU factor of 0.86. Based on this analysis and the IDEM Standards, Mr. Cochran concluded that the apartment communities are already receiving a reduced rate.

Mr. Cochran also testified regarding his concerns with the billing methodology proposed by Ms. Petersen. He testified that it would create an administrative burden on HSE in calculating monthly bills for apartment communities. HSE would have to change its billing practices for all apartment communities served by HSE, not just the six members represented by the Apartment Association. Mr. Cochran also testified that HSE would have to rely on the apartment communities to send the occupancy information to HSE every month and that HSE would have no way to verify the information. He testified that the Apartment Association's offer to audit the occupancy information reported by the apartment communities was subject to conditions, such as HSE paying for the audit if the reported occupancy information was accurate. In addition, Mr. Cochran testified that HSE would have to recalculate its EDUs system wide to reflect changes in revenue and increased operating costs. Additionally, Mr. Cochran testified that HSE believes its current billing methodology is reasonable and consistent. According to Mr. Cochran, HSE's billing methodology is similar to the method used by the apartments to bill their tenants. He testified that the apartments use several different methods to bill their tenants and that those methods are based on an estimation. Mr. Cochran also testified that the apartment communities do not give credit to their tenants for any time the tenant is absent from the apartment. The tenant pays for water or sewer service whether the tenant uses it or not. Mr. Cochran testified that it is not possible to measure sewage flows for low flow situations like apartments and that meters capable of measuring such small flows do not exist, and if they did, the cost to retro-fit them in existing structures would be cost prohibitive. Mr. Cochran concluded that HSE's billing methodology is reasonable and added that the methodology is based on standards and measurements specified by State law.

C. Commission Discussion and Findings. The Apartment Association recommended that HSE modify its tariff so that unoccupied units cannot be billed. The Apartment Association testified that the member communities would be willing to provide the occupancy

information on a monthly basis to HSE and offered to have that information audited by an independent auditor. The Apartment Association also testified that HSE should be required to reduce its non-metered rate and then adopt a variable consumption rate so as to more closely approximate the cost to serve its various customers. HSE did not agree with the Apartment Association's recommendations. HSE testified that the billing methodology proposed by the Apartment Association will create an administrative burden on HSE in calculating monthly bills. HSE also testified that it would have to change its EDU calculations system-wide to reflect changes to revenue and operating costs, which would affect all customer classes. HSE testified that the proposed billing methodology does not seem reasonable since the Apartment Association already is billed at a reduced EDU billing factor of 0.7 EDU. HSE also testified that its billing EDUs are reasonable, are consistent with State standards, and are included in its tariff which has been approved by the Commission.

It is important to note that sewer service, like other utility services, involves costs to the utility irrespective of usage. In other words, part of the cost of sewer service is the availability of service when it is needed. Many of the costs that HSE incurs are incurred even if no customer uses sewer service. From a cost-causation perspective, the ultimate bill that an apartment complex pays may not change if units were excluded from billing, or if volumetric billing were introduced, because the rate per remaining units or the volumetric rate of occupied units would increase by a corresponding amount to pay the cost of service for the complex.

We find that HSE's current billing methodology is reasonable and consistent with how multi-unit buildings are typically billed by regulated sewer utilities. HSE provided evidence that its EDU billing factors are based on IDEM Standards and are applied consistently to its customers. HSE also provided evidence that the apartment communities are already receiving the benefit of a reduced billing rate based on the 0.7 EDU factor that applies to apartment communities.

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 1.17%, or $139,305, in accordance with the findings herein, which rates and charges shall be designed to result in annual net operating income of $493,727.

2. Petitioner's system development charges shall be revised by $450 to $2,850 in all service areas excluding the Flatfork Creek CTA, and by $450 to $3,650 in the Flatfork Creek CTA.

3. Petitioner's FOG management rules, $30 monthly FOG charge, and $90 inspection fee for customers in violation of the FOG rules are hereby approved;

4. Petitioner's rules for Inflow and Infiltration reduction, tree dripline rules and changes to other miscellaneous rules are approved, subject to the revisions to Service Pipe Connections as proposed by HSE.

5. HSE's current billing methodology as to apartment communities to be reasonable and also find HSE's current EDU billing factors to be appropriate and supported by the evidence.

6. HSE shall file under this Cause, within 60 days of this Order, a written version of its capitalization policy.

7. Petitioner shall file new schedules of rates and charges along with its revised rules and regulations with the Water/Wastewater Division of the Commission on the basis of the findings set forth herein, and in accordance with the Commission's rules. Such new schedules of rates and charges and revised rules and regulations shall be effective upon filing and approval by the Water/Wastewater Divisions and shall apply to sewer usage from and after the date of approval and shall cancel all previously approved rates and charges and rules and regulations.

8. To the extent this Order requires future actions or filings, those requirements may be modified for good cause by the Presiding Officers.

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

STEPHAN, FREEMAN, HUSTON, AND ZIEGNER CONCUR; WEBER ABSENT:

APPROVED: NOV 09 2016

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

Mary M. Becerra

Mary M. Becerra
Secretary of the Commission