**BEFORE THE**

**VIRGIN ISLANDS PUBLIC SERVICES COMMISSION**

**DOCKET NO. 613**

**REBUTTAL TESTIMONY OF HUGO V. HODGE, JR.**

**ON BEHALF OF**

**THE VIRGIN ISLANDS WATER AND POWER AUTHORITY**

**REGARDING THE PETITION FOR PERMANENT RATE RELIEF**

**FOR THE WATER SYSTEM**

**July 26, 2013**

**Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

**A.** My name is Hugo V. Hodge, Jr. and my business address is: Virgin Islands Water and Power Authority, 9720 Estate Thomas, Subbase, St. Thomas, U.S. Virgin Islands 00802.

**Q. HAVE YOU HAD AN OPPORTUNITY TO REVIEW THE TESTIMONY FILED BY GEORGETOWN CONSULTING?**

**A.** Yes.

**Q. WHAT DO YOU WISH TO SAY IN RESPONSE?**

**A.** The PSC's Technical Consultants, Georgetown Consulting Group ("Georgetown") have made certain recommendations to the PSC with which the Authority strongly disagrees and therefore asks the Commission to reject them.

**Q. WHY DO YOU URGE REJECTION?**

**A.** Because some of them invade the exclusive statutory province of the Authority and some of them will not serve the interests of the ratepayers or the Authority. However, before I addressing the recommendations with which we disagree, it is important to first state what the Authority agrees with. At page 13 of their testimony, they recommend the following:

> Revenues to recover OPEB expenses should be provided as a revenue requirement. As with the electric [system] we recommend that all OPEB revenues be placed in a separate account, expenses be paid from the account and the excess

> revenues over the pay-as-you-go expenses remain in a
> separate
> account.
> …
> We recommend that all OPEB-related revenues be placed in a separate or escrow account, from which withdrawals can be made only for the purposes of either funding current OPEB costs, or for payment to a trustee assuming an OPEB trust is established. The PSC should review the operation of the separate account at least annually for compliance, and WAPA should provide quarterly reports together with its LEAC filings.

The Authority accepts this recommendation. While we do not agree that the Commission can order the Authority to create a separate account, because its role by statute is limited solely to setting the Authority's rates, nevertheless, the Authority believes the proposal is reasonable and consents to the creation of the separate account. Our rate consultant, Henry Thomas, will address the issue of whether the revenue should be provided in a surcharge or as recommended by Mr. Oliver in his rate design testimony.

**Q. ARE THERE OTHER RECOMMENDATIONS WITH WHICH YOU AGREE?**

**A.** Yes. Georgetown has recommended that Line Loss revenues should go into a separate account, with withdrawals made only for funding projects for line loss approved annually by the PSC. The Authority believes that a line loss surcharge is appropriate for addressing line losses and that the Line Loss Surcharge should be reviewed and approved annually.

Quarterly review is not meaningful because it is too short a period of time in which to evaluate performance.

However, the Authority does not agree and does not consent to the Line Loss revenues being placed into a separate account, with withdrawals made only for funding projects approved annually by the PSC. The injection of the PSC into the process of determining which line loss projects should be undertaken would infringe upon the statutory powers and exclusive ability of the Authority's Governing Board and management to manage the operations of the utility, and could adversely affect the utility's operations and cash flow. The Authority's Governing Board and management have greater familiarity with the Water System's needs, including line losses, than the PSC. By statute and as a matter of sound utility management, they must be the ones to make the determination as to which projects deserve the highest priority and funding. The role of the PSC, on the other hand, is to set the Authority's rates. In doing so, it can examine project requirements, the collection and use of funds, the status of the projects including the budgets, actual expenditures, variances in the expected cost and date of completion of projects. This information can and should be provided by the Authority to the PSC for its review and the Commission can make recommendations to the Authority that will be carefully considered. But the PSC cannot have a say in the approval process that involves deciding which line loss projects should be funded.

The Authority also agrees that the PSC should review the line loss program annually, or even semi-annually, but this review should be done with the understanding that the Authority's ability to meet a commitment to a multi-year line loss project depends on the certainty of the source of funding.

**Q. WHAT ABOUT GEORGETOWN'S RECOMMENDATION OF A MANAGEMENT AUDIT, AND THAT THE RFP FOR IT SHOULD BE ISSUED BY NO LATER THAN APRIL 1, 2014**?

**A.** The Authority agrees with this recommendation. A management audit is a useful management tool that may provide independent advice to management and the WAPA Board of possible improvements in policy or practice.

**Q. WHAT THEN DO YOU DISAGREE WITH?**

**A**. Georgetown recognizes that the Water System owes the Electric system a little over $10 million for prior period operations, which the Authority proposes it recover over a period of 6 years. See Exhibit JAR-4 line 6. However, Georgetown recommends disallowance of this debt for rate-setting purposes. It asserts that the cost of retiring this loan should not be allowed or considered in setting rates because:

First, expenses from prior years are not permissible generally by regulatory bodies to be recovered as a current revenue requirement. Generally accepted ratemaking principles do not permit retroactive ratemaking. WAPA clearly states that these are prior period operating expenses and therefore should not qualify. Further, regulatory protocol would have required WAPA to make the request for rate making treatment at the time the expenses were being incurred and propose the treatment requested. No request was made to the PSC at that or any other time other than in this rate proceeding.

In response, however, we note that Georgetown offers no specific citation to or support in generally accepted accounting principles or law for the disallowance of this debt by one department of a publicly owned utility to another. Indeed, each of their assertions is unsupported by any such reference.

**Q. WHAT DO YOU MEAN?**

**A.** Let us examine their assertions one by one. The consultants assert, "First, expenses from prior years are not permissible generally by regulatory bodies to be recovered as a current revenue requirement. " But the Authority is not seeking this. What it is seeking is recognition of the allocation, for accounting and financing purposes, of the loan made by one department of the utility to another. The debt allocation and amortization arising from the allocation of fuel and other expenses between two departments of one utility is not an exact science. Thus, while this debt arguably may not be "permissible generally" it can be addressed by allowance of the debt repayment with appropriate procedures and policy in place. To reduce the likelihood of this happening again, the Authority intends to review its allocation methodology and budgeting to make sure that this kind of debt does not arise again, except in accordance with an approved intracompany loan policy.

Second, the consultants assert, “Generally accepted ratemaking principles do not permit retroactive ratemaking. WAPA clearly states that these are prior period operating expenses and therefore should not qualify.” However, Georgetown cites no GASB or generally acceptable accounting principle applicable to a publicly owned utility. Moreover, had the Water System borrowed the money from a commercial lender, it would have had to pay interest, fees and other costs which it did not incur because the Electric System and Water System share one checkbook. Their departments are separate for accounting and financing purposes only. What is needed, therefore, is not disallowance of the intracompany loan or its repayment but instead a clear expression of Governing Board Policy, consistent with applicable accounting and financing requirements, to address intracompany loans so that the PSC can be assured that the Authority’s management is operating consistent with Governing Board policy.

Third, the PSC consultants assert: “Further, regulatory protocol would have required WAPA to make the request for rate making treatment at the time the expenses were being incurred and propose the treatment requested. No request was made to the PSC at that or any other time other than in this rate proceeding." In response, the Authority points out that there is no published PSC rule or regulatory protocol that states that in its rate setting, it requires utilities to make the request for rate making purposes at the time the expenses were being incurred, or shortly thereafter. If this is to be an absolute rate-setting requirement, then it should be reflected in PSC rules and regulations as a matter of due process. The Authority acted in accordance and not inconsistent with existing published PSC Rules and Regulations.

Finally, the consultants state "We do not deny that the $10 million [loan] is a cash obligation of the water department because of the loan from the electric department, but to be a revenue requirement would need the PSC to provide extraordinary treatment to waive a generally accepted regulatory principle." In making this statement, the consultants fail to recognize that they have never raised this issue concerning debt of the Authority before . It is they who propose extraordinary treatment by recommending disallowance of a debt by one department of the Authority to another. Given that this is the first time the issue is being raised, even assuming its validity for the sake of argument, the Authority submits that the PSC should allow it. Approximately $8 million of the $10 million was outstanding in the 2009 rate case and no issue was made then by Georgetown that its treatment was inappropriate. Also, CFO Julio Rhymer has advised that no issue as to the treatment of the loan has been raised by the Authority's auditors under GASB or generally accepted accounting principles. If they had objected to its treatment, they would have made a finding regarding it and they have not done so. For the details concerning the devastating effect that disallowance of the loan would have on the Authority, see the rebuttal testimony of the Authority's CFO Julio Rhymer.

**Q. HAS GEORGETOWN RAISED AN ISSUE AS TO WHETHER THE INTRACOMPANY LOAN WAS NOT PRUDENT?**

**A.** No, it has not because the intracompany loan was prudent. The purchase of fuel oil and other expenses cannot be delayed until a rate increase has been obtained. The $10 million loan was a result of an allocation of expenses to the Water System that were unanticipated and the Authority expected to correct and recover upon the filing of a rate case. That filing has now occurred and it is the desire of the Authority to address this issue and to adjust its allocation methodology and policy to make sure that this does not happen again.

**Q. IS THERE ANYTHING ELSE YOU WOULD LIKE TO ADD?**

**A.** Yes. According to the PSC'S consultants, the payment of Water System expenses by the Electric System should have been addressed within the year in which they occurred or shortly thereafter. However, the PSC consultants' approach is hyper-technical and does not reflect real world realities and the difficulties of operating an electric utility and a water system in the Territory. The Electric System did not pay the expenses of the Water System; it loaned it the money with which to do so. The PSC consultants' approach would suggest that it is per se imprudent for one system to lend to another for a period beyond the end of the fiscal year. That is simply not so. This is addressed extensively in the testimony of Julio Rhymer.

**Q. DOES THE AUTHORITY HAVE A SIMILAR POSITION WITH RESPECT TO THE $2.5 MILLION LINE OF CREDIT?**

Yes. Georgetown makes a similar and equally extraordinary argument with respect to the Water System's repayment of a $2,500,000 use of its $5,000,000 line of credit obtained from First Bank and Banco Popular, which was used to pay operating expenses in FY2011. Repayment of the line of credit increases the revenue requirement in this proceeding by $500,000. The borrowing pursuant to the line of credit was a prudent use of the line of credit. In order to provide safe and reliable power, the $2.5 million line of credit of the Water System was utilized to pay necessary and appropriate operating expenses. The alternative would have been to shut the Water System down, and discontinue the production and distribution of water while the Authority sought a rate increase. Typically, getting a rate increase takes at least 8 months. Thus, it was prudent for the Water System to use its established line of credit.

It is important to recognize that the Electric System and the Water System share one checkbook. When a bill such as fuel arises, there is not time to see whether a portion of the cash balance allows the Water System to pay its share of the fuel cost. This is a matter for later allocation between the two systems. What is at issue here is the need for an accounting adjustment so that the accounting records and rates of both systems going forward are sound and, in the long-term, neither subsidizes the other.

**Q. WHAT WOULD BE THE EFFECT OF DISALLOWANCE OF BOTH LOANS ON THE WATER SYSTEM?**

**A.** Disallowance of the loans would require that the books and records of both the Electric System and the Water System be restated for a number of prior fiscal years. This would be expensive to do. The Water System is extremely small relative to the Electric System and would have to share this unnecessary cost. More importantly, disallowance has the potential to bankrupt the Authority's Water System, according to the Authority's CFO, because it would force recognition of the debt as an expense on the books of the Water System. The potentially devastating adverse cost of doing so does not warrant taking this action and will not generate any material benefit to ratepayers or to the Authority. Accordingly, the Authority strongly suggests to the Commission that it not accept the recommendation of Georgetown to disallow recovery of the loans by the Water System for rate setting purposes.

**Q. IS THERE PRECEDENT FOR SUCH DISALLOWANCE?**

**A.** None that the Authority has found in the case of a publicly owned utility such as WAPA, which can only obtain cash flow by borrowing or seeking a rate increase. The PSC consultants concede in their testimony at page 18 that there is no other source available to a publicly owned utility, other than borrowing or rate relief. Yet they assert nonetheless that somehow a publicly owned utility such as WAPA, should be judged by stateside standards applicable only to privately owned ones. If repayment of the $10 million loan to the Water System and the $2.5 million line of credit loan is disallowed, this would be without precedent in the area of regulation of publicly owned utility regulation. Georgetown has not pointed to any instances where such disallowance has occurred for a publicly owned utility.

**Q. WOULD DISALLOWANCE OF REPAYMENT OF THE $10 MILLION DEBT TO THE ELECTRIC SYSTEM HAVE ANY EFFECT ON THE ELECTRIC SYSTEM? IF SO, WHAT WOULD BE THE EFFECT?**

**A.** The effect would be substantial.  Georgetown has taken the position in this docket that the PSC should disallow a base rate increase to the Water System in order to repay the Electric system the $10 million owed to it and to pay off the Water System's $2.5 million line of credit.  Georgetown's disallowance approach in this docket is totally inconsistent with Georgetown's allowance position in the Electric System base rate case (Docket 612), which is to <u>allow</u> receipt of the very same $10 million loan by the Electric System, which the Electric System has indicated in Docket 612 testimony that it plans to use to fund needed capital projects.  If the Water System's rates are not increased to allow it to pay the Electric System back, then electric rates will have to be increased to generate sufficient funds in order to allow it to borrow and pay off $10 million in bond financing the Electric System would need in order to undertake the capital projects it would have otherwise undertaken from repayment by the Water System of the Electric System's $10 million loan to the Water System.  This means that Electric System rates will have to be increased beyond what the Authority requested in its petition for an electric rate increase. The Authority rejects this suggestion.

**Q.  DOES DISALLOWANCE OF THE LOANS FOR RATE SETTING PURPOSES MEAN THAT THE LOANS BECOME NULL AND VOID?**

**A.** No. Disallowance of revenue from a rate increase to the Water System that would allow it to pay back the Electric System does not mean that the $10 million loan will be written off internally by the Authority in that the Water System will still owe it to the Electric System. But disallowance will adversely affect the Electric System's ability to undertake the capital projects it planned to undertake with the funds. And for the Water System, disallowance will mean that the debt will not be written off as a liability and nonpayment of this debt will have to be disclosed to holders of Water System bonds. This may jeopardize the credit status of the Water System's bonds, lead to possible bankruptcy or, at a minimum, lead to higher borrowing costs in the future. CFO Julio Rhymer will address this issue in more detail in his testimony.

**Q. WHAT WILL DISALLOWANCE MEAN FOR RATEPAYERS?**

**A.** Inevitably, higher future borrowing costs of the Water System will have to be borne by Water System ratepayers because its credit standing will suffer if the $10 million loan and the $2.5 million line of credit loan are not paid off; it will also mean higher rates for Electric System ratepayers in order to obtain the bond financing to fund $10 million in capital projects that would have been funded by the Water System repayment of its loan. Simply put, the Authority has no other source of funds other than borrowing money or raising funds through rates. Georgetown has indicated that it is open to resolving the $12.5 million loan amount as a regulatory matter if the Authority can provide assurance that the issue will not set a precedent or happen again. As the Chief Executive Officer of the Authority, I can represent that it has no desire to set a precedent or cause this issue to arise again. What is needed is not disallowance of the intracompany loan or its repayment but instead a clear expression of Governing Board Policy, consistent with applicable accounting and financing requirements, to address intracompany loans.

**Q. IS THERE ANYTHING ELSE YOU WOULD LIKE TO ADD?**

**A.** Yes. The Authority is making great strides in transitioning away from the production of water, and as a result has significantly lowered the cost of water to its ratepayers in years to come. It will soon no longer be involved in the production of water, only in its distribution. If the rate increase is granted, the Authority plans to undertake a Water System line loss program to find and reduce leaks in its water distribution system, to the benefit of its ratepayers. The requested rate increase will provide the revenue stream necessary to accomplish that and should be granted .

**Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

**A.** Yes.