**BEFORE THE**
**VIRGIN ISLANDS PUBLIC SERVICES COMMISSION**
**DOCKET NO. 613**

**REBUTTAL TESTIMONY OF HENRY L. THOMAS**

**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 Henry L. Thomas I and my business address is: 341 North Maitland Avenue, Suite 300, Maitland, Florida 32751.

**Q. HAVE YOU FILED DIRECT TESTIMONY IN DOCKET NO. 613?**

**A.** Yes. I filed direct testimony in the Docket 613 on November 15, 2012 along with the testimony of Mr. Hugo Hodge and Mr. Julio Rhymer on behalf of the Virgin Island's Water and Power Authority's (the "Authority" or "WAPA") request for permanent rate relief for the Water System.

**Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?**

**A.** My testimony will respond to certain issues related to the direct testimony of the PSC Technical Consultants filed on July 3, 2013.

**Q. HAVE YOU REVIEWED THE DIRECT TESTIMONY FILED BY THE PSC TECHNICAL CONSULTANTS?**

**A.** Yes. I have reviewed the combined/panel testimony of Mr. Jamshed K. Madan, Mr. Larry R. Gawlik and Mr. Michael D. Dirmeier, (the "Panel Testimony") as well as the testimony of Mr. Bruce Oliver (collectively, the "PSC Technical Consultants"), all of which was which was filed on July 3, 2013.

**Q. CAN YOU BRIEFLY SUMMARIZE YOUR INTERPRETATION OF THE TESTIMONY OF THE PSC TECHNICAL CONSULTANTS?**

**A.** Yes. The direct testimony filed jointly by the PSC Technical Consultants including Mssrs. Madan, Gawlik, and Dirmeier addressed:

1) the timing of WAPA's rate filing, the status of certain activities that have not been undertaken as required by the Global Settlement including the assertion that the PSC was never provided WAPA's strategic business plan to indicate how it would expand service to areas not currently served concluding on page 13, starting on line 6 that "the PSC cannot rely on WAPA to undertake what it represents it will do in this proceeding;
2) included recommendations for five adjustments to WAPA's test year revenue requirements that lowered the amount of the requested rate increase by $2,872,709.

The testimony of Mr. Oliver discussed:

1) WAPA's fixed versus variable cost structure and indicated that a cost of service study has not been provided as a basis for setting rates;
2) recommended certain changes to the language included in the Large User Incentive Water Rate (Rate Schedule LUW);
3) generally agreed with WAPA's proposal to reduce the rates for Standpipe Service that included some additional recommendations regarding the application of stand-pipe service rate;
4) recommended increases in WAPA's Miscellaneous Service Charges;

5) included recommendations for adjustments to WAPA's Test Year revenue calculations.

**Q. DO YOU HAVE A POSITION ON THE ISSUES RAISED BY THE PSC TECHNICAL CONSULTANTS REGARDING THE TIMING OF WAPA'S RATE FILING AND THE STRATEGIC BENEFIT OF EXPANDING THE WATER DISTRIBUTION SYSTEM TO AREAS NOT CURRENTLY SERVED BY WAPA?**

**A.** Yes I do**.** While it is correct that this is the first permanent base rate increase requested since 2009, it is clear that the past rate relief granted by the PSC in that case, as well as the rate relief granted in the emergency rate relief that became effective on August 1, 2012 were not adequate to resolve the issues related to the Water System's financial performance. The impact of the worldwide economic downturn and the closing of the Hovensa refinery on St. Croix and competition for Stand Pipe water sales to water haulers were major issues that resulted in a significant decline in water sales by approximately 20% from FY2010 to FY2012. This unanticipated and continued decline in sales played a major factor in the revenue deficiencies that have occurred in recent years. It should be noted that while the Water System did not meet the Debt Service Coverage requirement of the Bond Resolution associated with the Trust Indenture all required debt service payments have been made on a timely basis.

Further, WAPA has initiated a request for emergency rate relief as well as permanent rate relief a total four times since 2008 in response to the requirements of the Trust Indenture associated with currently outstanding debt. While much has been stated by the PSC Technical Consultants about the period of time that WAPA has "stayed out" and WAPA's "exorbitantly" high cost of water there was no acknowledgement of the environment or context in which WAPA's Water System operates and the factors that contributed to the dismal financial performance and the perceived high cost of water service that were and are beyond WAPA's control. The facts that are related to WAPA's cost of water service and recent financial performance were specifically discussed in WAPA's direct testimony and in response to the discovery process. These facts include, among other things:

1) the significant decline in water sales discussed above over the past several years;
2) the increased price of oil that increased the cost of energy associated with water production costs;
3) the rocky and hilly terrain in which WAPA must construct it's underground facilities at a relatively high cost compare with most public Water Systems;
4) the fact that the Water System is essentially a "Standby System" because of the historical requirement to include a significant sized cistern in every home constructed in the U. S. Virgin Islands, which means that the customers connected to the System actually use very little water and have demonstrated a preference for using water collected in the cisterns as the primary source for their household water needs.

This customer usage behavior relegates the WAPA Water System to a back up water source making the recovery of WAPA's operating and infrastructure costs difficult at best. As a result, the water service is a very unique type of water service compared to the water service that the PSC Technical Consultants are familiar with in their own personal situation or their work with most other Water Systems.

The PSC Technical Consultants offered absolutely no supporting evidence for their conclusion that WAPA's cost of water service is "**exorbitantly expensive"** (pg. 32, line 8 and 9 of the Panel testimony in view of this unique operating circumstance, which properly recognized means that the nature and level of the service provided by WAPA and its associated cost is very atypical in comparison to the type and level of service provided by the vast majority of public water systems and while it may be expensive in comparison to their personal perception of water cost such a damning conclusion by the PSC Technical Consultants should be properly supported by fact);

5) the fact that V.I Law does not allow for the Water System to charge a monthly base charge so that customers contribute to the cost of Water System service even when they do not use any water in order to recognize the cost of having a system available upon demand and in readiness to serve that is essentially under-utilized relative to the infrastructure required to provide this service;

6) the fact that V.I. Law does not require mandatory connection to the Water System where water lines are available to provide service making it impossible to economically expand the water distribution system; and
7) the fact that WAPA faces competition from unregulated water suppliers for service provided to private water haulers.

Furthermore, it should be noted that WAPA's relatively high cost of rate regulation also certainly contributes to the high cost of water compared to that of other publicly-owned Water Systems that are considered to be regulated by their Board of Directors or City Commissions. It should be recognized that WAPA's Water System is a relatively small utility system serving only approximately 12,000 customers of which 85% are residential customers and which, as noted above, use very little water. Based on the current schedule it will have taken approximately one year to implement permanent water rates for the Water System since the date of WAPA's initial filing. In my experience the length of time needed to achieve rate relief is unprecedented for a small publicly-owned water system and this delay which is sometimes referred to as "regulatory lag" is an unspoken downward adjustment to WAPA's cost recovery. In my opinion the high cost of Water System regulation along with the complexity and length of the process are contributing factors in WAPA's failure to file more often for rate relief. Further, the rate relief recommended by the PSC Technical Consultants is so deficient that if it is adopted by the PSC in whole will without a doubt result in the need to perpetually file rate cases pan caking them one right after another, and while this strategy may serve the financial interests of the PSC Technical Consultants, it does little to benefit the customers of WAPA's Water System.

The Water System rate case discovery process consisted of three sets of reports totaling approximately 100 questions, many of which contained multiple requests that essentially resulted in only three valid adjustments. These adjustments amounted to a decrease in the base rate request over interim rates of 1.7% from 5.9% to 4.2%in terms of overall dollar impacts that are being proposed by the PSC Technical Consultants. While the discovery included numerous requests for things such as system maps, etc., the PSC testimony did not appear to rely on much of the information and testimony that was provided and did not even clearly address the magnitude of the significant capital requirements faced by the Water System and the benefits of such investment in the Water System infrastructure.

The PSC Technical Consultant's regulatory approach, and certain findings and recommendations are more consistent with the regulation of large investor-owned utilities that are profit making enterprises. The PSC Technical Consultants regulatory approach is not appropriate for a small non-profit publicly-owned water system serving only 12,000 customers such as the Authority's Furthermore, the unsupported reference to WAPA's "exorbitantly expensive" cost of water service is completely out of context, grossly misleading and counterproductive to the regulatory process.

**Q. HAS WAPA PROVIDED THE PSC WITH A WATER SYSTEM BUSINESS PLAN?**

**A.** Yes. WAPA initially developed a formal Water Business Plan which was dated April 2008 and provided to the PSC. At that time the Business Plan addressed several items including:

1) the need for rate adjustments; the proposal to implement large user incentive rates to expand the Water System; the inter-utility cost allocation process and certain distribution capital needs identified at that time.

Subsequent to that report the Authority initiated a strategic business initiative to change from water production using IDE technology to purchasing water from Seven Seas, Inc. based on Seawater Reverse Osmosis ("RO") technology, prepared a comprehensive capital improvements plan with the help of the environmental engineering firm of Reiss Engineering, evaluated changes to the intra-utility cost allocation process consistent with the purchased water alternative to water production and included all of this in the water rate case filed in Docket 604 including a executable version of its five year financial forecast, which represents the most up to date version of the financial aspects of the Business Plan.

In spite of the PSC Technical Consultant's conclusion that "the PSC cannot rely on WAPA to undertake what it represents to do" with respect to the Water System WAPA has: 1) successfully implemented the Large User Incentive rates that were approved by the PSC and have resulted in additional large users connecting to the Water System and the potential for more such customers in the future where it is economically feasible; 2) has successfully negotiated a contract to purchase RO produced water from Seven Seas that will produce significant saving now and in the years to come, which has been fully implemented on St. Thomas on schedule and is in the final construction stages on St. Croix; (this project was done with the full knowledge and approval of the PSC); 3) prepared a comprehensive distribution capital improvements plan with the help of the environmental engineering firm of Reiss Environmental Engineering, which included a ranking of priorities to manage these expenditures so as to minimize rate impacts (this was provided to the PSC as part of the current rate case; 4) has diligently and successfully pursued grants to make significant distribution system capital improvements that will not increase the burden on rate payers (over $_____ million in grants have been approved to date); and 5)has prepared and filed a permanent water system rate case that includes a revised production cost allocation process consistent with the operational strategy of purchasing of its water supply requirements and includes the latest five year financial forecast results, which represents the most up to date strategic plan (this rate case was filed over eight months ago); and has filed for a reduced Water System LEAC in the last two quarters that represents the initial benefits of WAPA strategic water supply initiatives.

In reference to the specific indication that WAPA has not provided a "Business Plan" to expand the water distribution system to areas that are not currently served by the Water System, WAPA has indicated in its direct testimony and in responses to the discovery process that water system expansion is not economically feasible and would result in higher rates to existing customers with the exception of one opportunity to serve several large customers on the east end of St. Thomas. Based on the facts of the situation (high cost of construction, water typically used as a stand-by service resulting in very low use per customer, no mandatory requirement to connect when the distribution facilities are made available, no ability to legally assess a connection charge or "impact fee" to recover the cost of expanding facilities) it should be readily apparent that a study is not necessary to understand why WAPA's Water System can't grow its way out of its financial situation. The revenues gained from expanding the distribution system will simply not allow WAPA to recover the investment required to facilitate system expansion.

**Q. WHAT IS YOUR POSITION REGARDING THE FIVE ADJUSTMENTS RECOMMENDED BY PSC TECHNICAL CONSULTANTS PANEL TESTIMONY?**

The PSC Technical Consultants recommendation to disallow $2.178,533 of Water System Test Year revenue requirements for rate setting purposes associated with an intracompany loan provided by the Electric System and a loan drawn on the Water

System's $5,000,000 line of credit held by First Bank and Banco Popular used to pay certain operating expenses in Fiscal Year 2011.

With respect to the loan from the Electric System, WAPA's electric and water system share many common costs primarily associated with administration and customer service. These shared common costs are essentially paid out of the same disbursement account or "checkbook" and then a portion is allocated to the Water System after the fact. The reason for the liability and the subsequent loan from the Electric System is that Water System cash flow in the recent past has not met the projections relied upon in rate setting process primarily due to a significant decline in water sales, therefore, funds were not currently available to make a cash payment to the Electric System from current revenues.

Also, the Water System's cash reserves were minimal at best and the amounts due to the Electric System greatly exceeded the cash reserve levels available at that time. The total amount due to the Electric System is $10,071,196 and the amount due related to the line of credit is $2,500,000. WAPA's rate request proposes to recover the cost of the amount due to the Electric System over a six (6) years and the amount due on the line of credit over five (5) years.

First, it should be noted that the PSC Technical Consultants **erroneously** recommended denial of the recovery of the loan payments in the Water System rate request, while simultaneously reducing the Electric System rate request by the same amount of the proposed loan payments. **You can't have it both ways!** If the amounts for repayment of the Electric System loan are denied in the Water System rates the Electric System rates must be **increased** by the same amount **NOT DECREASED**!

Second, The PSC Technical Consultants have characterized WAPA's request as "retroactive ratemaking" and seek to justify the disallowance of these amounts based on regulatory precedent, specifically citing a case that was ruled upon by the Missouri Court of Appeals. It should be clearly noted that in the PSC Technical Consultant's testimony the definition of retroactive ratemaking cited as being relied on by the court was stated as "the setting of rates which permit a utility to recover past losses or which require it to refund past excess profits collected under a rate that did not perfectly match **expenses plus rate of return** with the rate actually established." (emphasis added) It is clear that this ruling is based on the regulation of a private utility enterprise that is operated to earn profits for shareholders and regulated as a public utility monopoly.

The regulation of the privately-owned utility rates is intended to ensure that the shareholders earn a reasonable rate of return and do not use their monopoly powers to achieve excessive profits, while at the same time ensuring that the returns are adequate to attract investor capital. In the case cited by the PSC's Technical Consultants the utility obviously experienced higher than anticipated costs/and or lower revenues and sought to restore a targeted profit level (i.e., rate of return) that was not achieved during the prior operating period in question.

The definition also clearly states the premise that it is also not appropriate to require the utility to refund excess profits when earned. Since rates are based on estimated sales revenues and costs there will never be a perfect match of revenues and expense and the conclusion that should be drawn from this ruling is that a regulated privately-owned utility should not be required to refund excess profits when they are achieved nor should they be allowed to recoup profits that fall short of the rate of return allowance targeted in the rate setting process.

I do not believe that this precedent as cited is applicable to non-profit governmental or publicly-owned utility systems such as the Authority's or to the proposed repayment of intracompany loans or lines of credit used by utilities to satisfy short term cash flow needs. First, the case cited by the PSC Technical Consultant has nothing to do with the recovery of an intracompany loan or borrowing from a line of credit to pay for operating expenses. The ruling is specifically related to whether or not a for profit, privately-owned regulated utility can retroactively recoup profit levels that were not achieved in a prior accounting period due to variances in financial performance from what was anticipated in the rate setting process. I see no relevance of this argument to WAPA's specific situation.

Further, it is quite troublesome that the PSC Technical Consultant with all of their years of experience would concoct this esoteric and flawed argument to deny the Authority the ability to recover prudent and reasonable costs related to loans that were properly incurred and accounted for and based on the approval of the Authority's Board of Director's exposing the Water System to extreme financial consequences.

Utility systems such as WAPA's are referred to by lenders as "closed systems" meaning that there are no investors that contribute capital and that would benefit from excess profits or are able to absorb lower than expected profits. All of the monies received by the Water System and similar publicly-owned utility systems are used to pay operating expenses; fund debt service and capital needs or are held as cash reserves. None of the monies collected leave the Water System fund and there is no transfer of "profits" to the V.I. Government.

WAPA's only source of funds, other than grants, is from revenues derived from utility operations. If the cash flow from operations exceeds that expected in the rate setting process the money stays in the system and ultimately benefits the ratepayer by making more funds available for cash reserves, if appropriate, or future capital reinvestment. Conversely, if the costs exceed revenues these funds must ultimately be provided by ratepayers or the utility has no way to meet its financial obligations and expenditures needs. Municipally or governmentally-owned utilities faced with the situation where costs exceed revenues typically draw upon existing cash reserve funds or meet the shortfalls by borrowing from a line of credit or through intra-utility loans or intra-governmental loans. For example, my client the City of Winter Garden, Florida's water and sewer system recently borrowed $4.2 from the Public Works Department to meet funding shortfalls and is paying this loan back over 2 years. Similarly, the City of Crystal River, Florida is currently proposing to make a five year loan from the City's General Fund to the Water and Sewer System to allow the utility system to phase in higher rates over time.

The "retroactive ratemaking" argument is not applicable to WAPA's situation nor is it appropriate to disallow this request. I have worked for well over 100 publicly-owned non-profit utilities during my career and have never seen this "retroactive ratemaking" argument applied in a situation similar to WAPA's. In fact municipally-owned utilities have commonly used intrautility or intragovernmental loans to defer or phase-in rate of their governing boards. In some cases municipal utilities allow a water system to subsidize another utility such as a wastewater system based increases based on the approval on a decision made by the governing board. In the case of <u>privately-owned</u> regulated utilities such subsidies are not typically allowed by regulatory agencies. The point being that publicly-owned utilities are not typically subject to the same regulatory treatment as those enterprises that are in the business to make a profit.

To use of this esoteric and misapplied regulatory argument in support of the Panel's recommendations to the PSC is misguided and fiscally irresponsible and does not serve the best interests of the Authority or its ratepayers.

**Q. WHAT ABOUT THE LINE OF CREDIT LOAN?**

**A.** The purpose of the line of credit is to allow WAPA flexibility in managing the Water System's cash flow needs. The $2.5 million note is held by First Bank and Banco Popular. There is no other source of funds to repay this obligation other than rate revenues. The testimony of the PSC Technical Consultants explicitly acknowledges this fact and offers no solutions on how to resolve the issue of repayment of this loan if the PSC accepts their recommendation to deny the allowance of the expense in rates. This loan was made by a third-party banking institution and a recommendation that results in the failure to satisfy this obligation is clearly not prudent.

**Q. WHY WAS A MULTI-YEAR PAYMENT PROPOSED TO REPAY THESE DEBTS?**

**A.** The Authority's rate proposal was intended to get the Water System on the path to financial recovery in a balanced and sustainable manner. The proposal includes amounts to fund three items in addition to operating expenses. These three items included:

**1)** repayment of the loans from the Electric System and the line of credit;

2) the funding of capital expenditure needs related to improving operating efficiency aimed at reducing system line losses; and
3) increasing the Water System's cash reserves.

As provided in the Direct Testimony of Mr. Hodge, the Authority has identified over $60 million in distribution system capital improvement needs and has also targeted a minimum cash reserve balance equal to 45 days of operating expenses. However, since significant progress has been made in transitioning the Water System from a water producer based on its outdated IDE technology to water purchases based on more modern and efficient Seawater Reverse Osmosis technology, the benefits of this transition will pass directly to through the Water LEAC and as a result of no longer needing to fund the operation, maintenance and asset reinvestment of the IDE water production units that are recovered through based rates.

This transition should be complete by the fall of 2013 and WAPA's management and Board of Directors wanted to ensure that rate payers would experience an immediate benefit in the form of lower rates while at the same time recommending a modest increase in base rates over the currently effective interim rate levels. Thus, the Water System's capital funding requirements and cash reserve targets were modified downward to accommodate this strategy while improving the operational efficiency, quality of water service and overall financial position of the utility.

The capital plan as proposed in the rate filing is heavily reliant on Federal Government grants and a modest amount of pay as you go funding from rates and the projects proposed for funding over the next five years are almost exclusively targeted toward a line loss reduction program because these investments will result in lower purchased water costs and these benefits will pass directly to the Water System customers in the form of lower Water LEAC charges.

With respect to the cash reserve levels, the targeted 45 days of operating expense is not projected to be achieved during the next five years. The five year financial forecast included in the rate proposal projects a cash reserve level of only 23 days of operating expenses.

As a result of this strategy a balance was struck of paying off the Electric System loan over six years and the line of credit in five years so as to not adversely affect the goal of stable/ modestly lower water rates in the near future and satisfying the Water System's essential capital reinvestment and financial needs.

**Q. WHAT WOULD THE CONSEQUENCES BE IF WAPA IS NOT ALLOWED TO RECOVER THE EXPENSES ASSOCIATED WITH THE TWO LOANS?**

**A.** While the PSC Technical consultants assert that their proposed rates would place the Water System on the path to financial health their recommendation for denial of the recovery of these expense in rates severely undercuts that conclusion. As discussed in detail in Mr. Rhymer's rebuttal testimony, based on the PSC Technical Consultants proposed denial of the recovery of the cost of the intracompany loan and the line of credit and the resulting rate levels, the Water System would face the alternatives of choosing to default on the loans which would severely impact the financial health and credit rating of both the Electric and Water Systems or alternatively funding the loan repayments by paying back the amounts from monies designated in the Test Year revenue requirements to fund capital and operational improvements related to line loss reductions, which investments and expenses will reduce future Water System LEAC charges and/or limit the restoration of the Water Systems cash reserves which will perpetuate the Water System's financial crisis.

If a reasonable attempt is not made to repay the Electric System loan and the Authority continues to carry this loan on its balance sheets the Authority's auditors will ultimately require the Authority to write-off the loan and that would require the Electric and Water System to restate past financial performance and adversely impact the financial condition and credit rating of both the Electric and Water Systems.

**Q. WHAT DO YOU CONCLUDE REGARDING THE RECOMMENDATION OF THE PSC TECHNICAL CONSULTANTS TO DENY THE RECOVERY OF EXPENSES ASSOCIATED WITH THE ELECTRIC SYSTEM LOAN AND LINE OF CREDIT?**

**A.** Inclusion of the amounts associated with the repayment of these loans is critical to the financial health and future viability of both the Water and Electric System and is correct from the regulatory perspective and fiscally responsible. The PSC Technical Consultants **erroneously** denied the amounts associated with repayment of the Electric System loans in the Water System rates, while reducing the Electric System rate request by the same amounts. As I stated previously, **you can't have it both ways!** If the amounts for repayment of the Electric System loan are denied in the Water System rates, the Electric System rates should be **increased** by the same amount **NOT DECREASED**.

Similarly it is **incorrect and inconsistent** for the PSC Technical Consultants testimony to assert that it is recommending that **"revenues be provided for essential operations as well as provide a path back to financial stability"** (page13, lines 17 and 18 of the Panel testimony) while at the same time denying cost recovery would most certainly undercut that conclusion. Again in the conclusions of the Panel testimony of the PSC Technical Consultant's starting on page 23 it is suggested that **"there is much to be done to reduce overall water costs and improve service"** while their conclusions obviously fail to recognize the severely adverse effects of their recommendations to deny recovery of repayment of the intra-company loan and the line of credit.

Much of what is "needed to be done to lower costs and improve service" be will require significant capital reinvestment in the Water System. While a significant level of system improvement grants is currently available to the U.S. Virgin Islands and other

U. S. Territories and the Authority's capital plan relies heavily on these funds in the near term; there is a requirement for increasing the level of internally funding a portion of these costs over time, as well as borrowing in the future which will be severely hampered if the PSC Technical Consultant's fiscally irresponsible recommendation related to this issue is accepted.

Even if you believe that the PSC Technical Consultant's retroactive ratemaking argument has some merit in this situation, which I strongly do not, this approach seems to be quite academic and does not consider the real world issues faced by the Authority or the operational, financial and ratemaking practices of non-profit governmentally owned utilities. It is much easier to criticize from the heights of an ivory tower than be required to provide solutions that work in the real world.

**Q. DO THESE COMMENTS REFLECT THE ENTIRETY OF WAPA'S POSITION RELATIVE TO THIS ISSUE?**

**A.** No they do not. Both Mr. Rhymer's and Mr. Hodge's rebuttal testimony additionally addresses in significant detail, among other things: 1) issues related to the proper interpretation of this request (i.e., it is not a request to recover a prior period expense but instead should more properly be viewed a request to recover loans that were properly incurred by the Water System and approved by the Governing Board; 2) applicable accounting standards that should be applied regarding the accounting and proper recovery of these costs and the lack of PSC rules and regulations that apply specifically to this matter of uses of intracompany loans and lines of credit; 3) past precedents regarding similar situations in **this jurisdiction**; 4) the potentially disastrous consequences of the PSC accepting this recommendation, and 5) WAPA management's perspective of the PSC Technical Consultants' documented attempt to attach unreasonable and overreaching requirements on WAPA's management and Governing Board in return for their support of WAPA's cost recovery proposal.

**Q. WHAT IS YOUR POSITION REGARDING THE PSC TECHNICAL CONSULTANT'S ADJUSTMENT REGARDING THE PROPER LEVEL TO FUND IN RATES RELATED TO OTHER POST EMPLOYEE BENEFITS ("OPEB") EXPENSE?**

**A.** First, the PSC Technical Consultants and WAPA agree that the Governing Board's decision to begin cash funding the estimated annual Net OPEB funding shortfall, which was formally accrued as an expense but not paid into the OPEB fund, must now be recovered through rates and recognized in the Authority's debt service coverage test. Further we agree with their position that the amount to be included in the Water System rates should reflect the most recent Actuarial Report for the year ending June 30, 2012, which was completed subsequent to the Authority's rate filing in November 2012; and that such updated amounts are lower than the assumption relied upon in the initial Water System rate filing.

However, the adjustment amount as recommended in the PSC Technical Consultants testimony is **not correct**. The combined amount of the Electric and Water Systems' total estimated OPEB expense in Fiscal Year 2014 is $4,912,906 as shown on page B-3 of the OPEB Actuarial Report. Based on current wage and salary levels for each System the amounts that are properly allocated to each System are $3,979,453 for the Electric System and $933,453 for the Water System. The Water System amount must be further adjusted to reflect the production operating expense adjustments included in WAPA's Water System rate filing due to the fact that WAPA will be purchasing 100% of the Water System requirements in the near future and the fact that labor expenses that are the responsibility of the Water System associated with the production of water will be reduced by $1,915,122.

Thus, it is proper to also reduce the associated labor-related benefits including OPEB accordingly.

The $1,915,122 that was removed from Water System labor costs and shifted to the Electric System labor expense represents approximately 12.5% of total Water System labor costs prior to the labor-related production cost adjustments. Therefore, the proper amount to include related to the Water System's Test Year OPEB expense is $694,062 or 87.5% of $933,453. This represents a $428,651 decrease compared to the amount of $1,122,713 included in Exhibit HLT-1. The PSC Technical Consultant's recommended adjustment is $616,412 and thus is $187,761 too high.

**Q. WHAT IS YOUR POSITION ON THE PSC TECHNICAL CONSULTANT'S PROPOSED ADJUSTMENT REGARDING SETTING THE REVERSE OSMOSIS PRODUCTION RATE AT 100% AS IT RELATES TO WAPA'S PROPOSED ADJUSTMENTS TO**

**DIRECT AND ALLOCATED WATER PRODUCTION COSTS INCURRED IN THE TEST YEAR USED TO ESTABLISH PERMANENT RATES?**

**A.** The PSC should not accept this recommendation. The Test Year costs that are in question will actually be incurred in Fiscal Year 2014, therefore, adjusting these amounts will adversely impact the Water System's financial position, cash flow, debt service coverage and cash reserve balances going forward. While the PSC Technical Consultants are correct in stating that the timing of WAPA's transition to RO purchases will occur at approximately the same time as the currently anticipated implementation date of the PSC adopted permanent rates, it should be noted that the rate case filed by the Authority assumed implementation of the permanent rates in July 2013.

Thus, the financial results for Fiscal Year 2014 are already diminished by the inordinate amount of time that the PSC Technical Consultants took to review WAPA's rate filing and the lengthy discovery and regulatory process. This delayed implementation is in itself a significant and unspoken negative adjustment to the Authority's near term cash flow and Business Plan projections shown in Exhibit HLT-10 for the Fiscals Years 2014 through 2018.

No adjustments to WAPA's initial permanent rate request were made to account for wage and salary cost increases beyond the Test Year, (i.e., Fiscal Year 2014) as well as the projected escalation in OPEB costs, other employee benefits and operating costs as a result of inflation. Thus, the inclusion of this partial year cost/expense allocation in the Test Year revenue requirements, which was projected to end after Fiscal Year 2014, was one of the factors in being able to demonstrate that the proposed rate was sustainable over the next several years and produce the cash flow needs identified in the Authority's capital improvement plan and allow for an increase cash reserve levels in a timely fashion.

While the adjustment in this case appears to be mathematically correct, in light of the delay in the timing of the rate implementation, it can be concluded that the proposed rate reduction adjustment will only delay the PSC Technical Consultant's desire to increase operational efficiency and improve the quality of service and get the Authority back on the path to financial health.

**Q. WHAT IS YOUR POSITION ON THE PSC TECHNICAL CONSULTANT'S PROPOSED ADJUSTMENT REGARDING UNCOLLECTIBLE EXPENSE ALLOCATION FROM 2.87% OF PROJECTED REVENUES TO 2.0% OF PROJECTED REVENUES?**

**A.** We do not recommend that the PSC accept this adjustment. The PSC Technical Consultants make the argument that the adjustment should be made based on the fact that actual bad debt write-offs vary from year to year and the Authority has budgeted a lower amount in Fiscal Year 2011 and Fiscal Year 2012 than the amount that was used in the Test Year revenue requirement. The Panel testimony further asserts that the recent actual experience is not "normal" because the Authority's customers are experiencing difficulty paying their bills due to economic conditions.

The basis for WAPA's inclusion of an uncollectible allowance was based on the actual accrual booked in Fiscal Year 2012. These accruals are designed to reflect the actual bad debt write-off experienced by the Authority and while the actual bad debt write-offs do vary the data set forth on page 38, on lines 11 through 13 show that the accrual for uncollectibles is actually increasing each year from Fiscal Year 2009 through 2012, which indicates that the amounts written-off for bad debt as increasing over this time.

While it may not be "normal" as perceived by the PSC Technical Consultants due to adverse economic factors it is grounded in the reality of the current economic situation. Further for the Test Year the dollar amount of the adjustment is more that the difference between 2.87% and 2.0% because the PSC Technical Consultant applied the 2.0% allowance to a revenue estimate that excludes the estimated cost of fuel allocated to water that is anticipated to be incurred in the Authority's Fiscal Year 2014 LEAC charges, as well as all of the other recommended adjustments. Therefore, the amount of proposed adjustment assumes acceptance by the PSC of all of the recommended adjustments.

**Q. WHAT IS YOUR POSITION ON THE PSC TECHNICAL CONSULTANT'S PROPOSED ADJUSTMENT TO ACHIEVE A 1.75 DEBT SERVICE COVERAGE (DSC) TARGET AND IS THIS AN**

**ACCEPTABLE STANDARD FOR SETTING RATES FOR THE WATER SYSTEM?**

**A.** The Panel Testimony filed by the PSC Technical Consultants states both that WAPA's proposed DSC standard is 2.15, or that alternatively WAPA did not provide any standard. It is the position of WAPA that the setting of rates on a DSC standard alone is not appropriate. In over thirty years of working with publicly-owned utility systems that issue revenue bonds, I have never seen or been involved with a utility that set rates solely on the basis of achieving a debt service coverage target or minimum debt service requirement objectives. Certainly, the Bond Resolutions that are adopted by these utilities as part of their Trust Indenture include DSC **minimum requirements** and as such the proposed rate levels are tested for compliance and many of these utilities adopt **minimum targets** (such as the Authority's Governing Board has adopted) that are intended to support a minimum sustainable financial position. These minimum financial performance targets almost always exceed the minimum requirements of the Bond Resolution, which is financially prudent; however, to suggest that such a using a minimum DSC target as the determining factor in setting rates is a gross oversimplification of the issue. Municipally and publicly-owned utility systems similar to WAPA's set rates on a cash expenditure or needs basis taking into account Bond Resolution compliance and financial performance goals while ensuring that the rates can meet the various cash obligations associated with operating expenses, debt service principal and interest payments, capital reinvestment appropriately funded from rates, maintenance of cash reserve levels and other legal and required transfers.

As discussed at length in WAPA's response to the discovery process a number of measures of financial performance are used to evaluate the financial sustainability of utility systems and go into a credit rating that essential to the ability to issue debt capital at reasonable interest rates.

These factors among others include DSC, cash reserve balances, debt to equity ratios and free cash as a percentage of depreciation and my experience is that utilities that fund the appropriate level of cash expenditures needs almost always satisfy industry financial performance standards.

**Q. SO WHAT IS THE APPROPRIATE LEVEL OF CASH EXPENDITURE NEEDS THAT SHOULD BE FUNDED FROM RATES?**

**A.** I will preface my answer by first stating that WAPA's Technical Consultants view their DSC coverage adjustment as a positive adjustment, but that is only true because their DSC recommendations are premised upon their recommendation to disallow approximately $2.2 million in revenue requirements associated with repayment of the intracompany loan and the line of credit obligation. I submit that if the Authority is not allowed rate relief to achieve revenues necessary to avoid defaulting on these obligations then any discussion of 1.75 DSC being appropriate is moot for all the reasons stated previously in my testimony and that of Mr. Rhymer and Mr. Hodge on this issue. The notion of achieving satisfactory financial performance measures when these obligations cannot be satisfied is very misleading. WAPA's Water rate proposal and corresponding financial and capital funding plan includes:

1) payment of operating expense;
2) payment of the intracompany loan to the Electric System;
3) payment of the line of credit liability;
4) funding certain capital improvements on a pay as you go basis; and
5) restoring a minimal level of operating and capital cash reserves.

Taken as a whole the funding of these items is estimated to achieve a 2.15 DSC on an annualized Test Year basis; but that DSC amount is a result of the Authority's proposed funding needs and management priorities and not the standard used to set rates.

The Authority's Governing Board and management views repayment of the intracompany loan and the line of credit as critical requirements and to achieve the goal of getting the Water System on a sound financial basis. As such the rate proposal and the use of monies derived from rates place a high priority on "cleaning up" the Authority's balance sheet and this is proposed for funding over the next five to six years.

Equally important is the objective of reinvesting capital into the Water System infrastructure primarily targeted to improved operational efficiency related to line loss reduction. For every one thousand gallons of reduced line losses the Authority saves approximately $8.00. As shown in the proposed capital funding plan included in Mr. Hodge's direct testimony the current availability of federal grants from the EPA and the USDA, among others, anticipated and/or approved for water distribution system improvements is significant and those monies in addition to approximately $1.5 million in annual average funding from rate revenues will be sufficient to fund the Authority's highest and most essential priority capital needs over the next several years and will significantly reduce Water System line losses which will directly benefit the Authority's ratepayers through reduced LEAC charges.

Finally and of equal importance the Authority's rate proposal includes approximately $800,000 per year in Test Year annual revenue requirements to begin to restore operating and capital cash reserves. Operating and capital cash reserves are needed for unforeseen contingencies, to avoid the need for future intracompany loan or line of credit draws and to bridge the lead/lag gap that occurs in the receipt of approved grant funds which in some instances are reimbursed to the Authority after the monies are spent.

Taken as a whole, the rate relief required to fund all of these critical priorities as identified in the rate proposal submitted to the PSC is intended to put the Authority's Water System back on the path to financial health. As the obligations associated with the intracompany loan and the line of credit are satisfied, the rate levels proposed by WAPA should be sufficient to close the gap between a reasonable cash reserve target and the levels achieved during the period when these loan obligations are being paid and to increase the internal funding of capital needs to level commensurate with capital reinvestment associated with the ongoing requirements of the Water System including making monies available to fund future debt service as needed to minimize the rate impact of capital funding on rates.

At this time it is clear that the Authority's Water System would not be able to obtain reasonable financing terms to accomplish the funding of its significant funding capital needs through the issuance of long term debt. The full achievement of the capital funding needs and the restoration of a reasonable level of cash reserves has been tempered by the desire to ensure that the proposed base rate increases will be less than the anticipated reduction in the LEAC charges included in customer's water rates in the near future.

**Q. WHAT IS THE GOAL OF THIS STRATEGY?**

**A.** The goal of this strategy is to make sure that the customers begin to see a benefit from the transition from a water production strategy to a purchased water strategy. Thus WAPA's proposal balances rate stability with the pressing needs and obligations of the Water System. If the currently identified capital needs and financial considerations were the only objectives considered the requested rate increase would indeed be much larger.

The Authority's rate proposal is well thought out and if approved will result in a plan to improve the quality and cost of service and achieve financial stability in a practical and common sense manner. Hypothetically, if the Authority did not need to fund the obligations associated with the intracompany loan and the line of credit, the rate proposal would have advanced the restoration of cash reserves and capital funding because that would be the prudent thing to do. Thus, without the obligations associated with these intracompany and line of credit loans a positive adjustment as recommended by the PSC Technical Consultants to achieve a 1.75 DSC would not be necessary as the recovery of additional funding associated with the unfunded capital costs and the restoration of cash reserve balances would exceed the 1.75 DSC target.

**Q. DID THE PSC TECHNICAL CONSULTANTS PROVIDE ANY EVIDENCE OF THE APPROPRIATENESS OF USING A DSC STANDARD OF 1.75 TO SET WATER RATES?**

**A.** No. Other than using the minimum standard as adopted by WAPA's Governing Board, in light of their recommendation to disallow approximately $2.2 million in revenue requirements and without any consideration of other pressing needs that could and should be funded absent these obligations which is **<u>not the same as an appropriate rate setting standard</u>**.

Another point which is not relevant or tied to the Water System financial obligations and funding needs is that the 1.75 DSC standard has historically been used to set Electric Rates. This is not a compelling argument for the reason that compared to the Electric System, the Water System senior lien debt is low in proportion to total Water System revenue requirements, therefore, the amount of annual cash flow above operating expenses and debt service payments that .75 times (1.75-1.0 for debt service payment) annual senior lien debt produces does not consider the Water System's real world funding needs.

This very "mechanical approach" to establishing rate levels along with the other recommended adjustments to the Authority proposal will effectively undermine and negate the goals of Authority's Governing Board and management related to improving the Water System quality of service and restoring the utility to a sound financial basis. Further, The PSC technical Consultants have provided a single piece of evidence of a similar DSC standard being used as the primary driver in the rate setting of privately or publicly-owned water systems.

**Q. HAVE YOU REVIEWED THE TESTIMONY SUBMITTED BY MR. BRUCE OLIVER?**

**A.** Yes I have.

**Q. WILL YOU PLEASE SUMMARIZE YOUR POSITIONS ON MR. OLIVER'S SUBMITTAL**?

**A.** I will start with the area where Mr. Oliver and I are in agreement. First, I agree with his findings about the volumetric risk that WAPA faces and its unique operating environment. While I also generally agree with Mr. Oliver's discussion of fixed versus variable costs I find that his limited analysis of this issue is based on data from Fiscal Year 2008 and much has changed in the Water System's cost structure since that time including the implementation of a water purchase agreement with Seven Seas that essentially results in the Water Systems' water supply and treatment costs being effectively all variable costs due to the fact that the water is being purchased entirely under a volumetric rate.

Since this issue was not actually addressed in Mr. Oliver's proposed rate design this fixed versus variable cost analysis is best left to a future discussion; especially if the legislature made changes to the law regarding the concept of Water System base charges.

The idea of revenue decoupling is technically correct based on the process being implemented through a rate structure including a minimum monthly base charge based on the cost associated with the readiness to serve but until the law changes these discussions are more theoretical than practical. These ratemaking concepts have long been an industry standard that are advocated by groups such as the American Water Works Association.

There has been some discussion about the PSC Technical Consultants willingness to go before the V.I. Legislature along with WAPA's management to explain the cost recovery and equity benefits of allowing WAPA's Water System to follow industry standard ratemaking and this should be further explored with the PSC to determine if it is practical to advocate proper utility ratemaking in an attempt to change to political will.

With respect to Mr. Oliver's testimony and recommendations regarding the rates for Standpipe service he appears to understand WAPA's situation and concurs with WAPA's recommendations to lower Stand Pipe rates charged to private water haulers. I also agree with his proposal to give WAPA more flexibility in negotiating these rates within a range of prices, if it is necessary to meet the competitions' prices and regain Stand Pipe sales. The proposal to tie further reductions that may be necessary to compete in this market to a haulers willingness to enter in to an agreement for a minimum level of purchased does not seem to be practical in view of the fact that the competition for this service does not use this pricing approach, and private haulers are not the end-users to the water, as in the case of the large incentive users. The private haulers are small businesses that sell water on demand to customers. The uncertainty of trucked water deliveries due to numerous factors would almost certainly result in the private haulers being unwilling to take the risk of this proposed pricing arrangement even for a further reduced price.

I agree with Mr. Oliver's proposal to remove "experimental" from the language in the LUW tariff as well as his recommendation that WAPA should continue to extend the contracts associated with this service on a five year basis and not let them lapse. Also the proposal to reexamine these rates based on market conditions from time to time is a worthy goal.

I agree with Mr. Oliver's recommendation to increase miscellaneous service charges by 35% and to undertake a review of the cost of providing miscellaneous services and have made an adjustment to include $149,000 of additional revenue in WAPA's base rate proposal.

**Q. WHAT IS YOUR POSITION ON THE ADJUSTMENTS MR. OLIVER RECOMMENDS TO THE REVENUE CALCULATIONS AND THE UNDERLYING BILLING DETERMINANTS USED IN THE LUW REVENUE CALCULATION?**

A. I agree with the adjustment of approximately $58,000 in annual revenues from based on correcting billing errors associated with past service and the application of the charges for the LUW customer on St. Croix and its impact on the projected revenue calculations. In my revised exhibits HLT-1, HLT-6, HLT-7, HLT-8, HLT-9 and HLT-10 which are attached to this testimony, I have made an allowance to existing rare revenues for this correction along with an adjustment for the updated and corrected revised OPEB expense discussed previously herein.

**Q. WHAT IS YOUR POSITION ON THE ADJUSTMENTS MR. OLIVER RECOMMENDS TO THE REVENUE CALCULATIONS AND THE UNDERLYING BILLING DETERMINANTS USED IN THE CALCULATION OF TEST YEAR RESIDENTIAL REVENUES UNDER EXISTING RATES?**

A. I do not agree with this adjustment and would recommend that the PSC should not accept it. First, Mr. Oliver's algebraic calculations are correct based on the data provided relative to revenues, customers and sales; however, his conclusion that the average price used for forecasting Test Year revenues from residential customers is impossible is based on the premise that the reported revenues, water sold and customers are correct and consistent with one another. The reported revenues used to calculate the average price in WAPA's rate proposal are taken directly from WAPA's financial statements, the reported sales and customers are taken from billing reports and clearly based on Mr. Oliver's math there appears to be an error in the calculation; however, it is more likely that the problems can be found in the inconsistency of the three data sets with respect to things like billing adjustments and the number of bills rendered as reported on a historical basis and how these inconsistencies impact his analysis. The reason that it is not appropriate to make his suggested adjustment is that the number that you should have the most accuracy and confidence in is reported revenues and the manner in which we developed the projections did not depend on the breakdown of gallons of water sales being divided into the two rate tiers or the customer numbers. The projected Test Year revenue cannot assumed to be incorrect strictly on the basis of the algebraic calculations shown in Mr. Oliver's testimony. The overall projected percentage growth in revenues from FY2012 to the Test Year is consistent with the projected percentage growth in sales and the starting point for the revenue projection is tied to actual reported revenues, therefore the calculations may be simple compared with the rigorous approach that a rate analyst would prefer but that lack of precision does not necessarily translate to a lack of accuracy and the numbers were prepared using the best available data.

**Q. DO YOU AGREE WITH MR. OLIVER'S ADJUSTMENT TO STANDPIPE SALES REVENUE?**

A. No, as stated, his lack of understanding about how WAPA's pricing numbers were derived lead him to make erroneous assumptions about the need for an adjustment. The price associated with Stand Pipe rates before the interim rate adjustment was $21.60 per kgal and $21.87 after the interim adjustment. We proposed the 18% reduction to the interim rate reducing the price calculation to $17.93 and then increased the Stand Pipe base rates 5.4% over the interim rate level which is the percentage increase in the base rates less the line loss surcharge of $0.71 per kgal which shouldn't be billed to Stand Pipe customers.

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

A. Yes it does.

**Q. WHAT IS THE FINANCIAL IMPACT TO THE AUTHORITY IF THE PERMANENT RATES ARE NOT ADOPTED?**

**A.** The Authority will be unable to fully fund its operating, capital, and financial needs. It would jeopardize the ability for the Water System to pay back deferred liabilities owed to the Electric System and the ability to fund capital improvements that will ultimately reduce future water costs through reductions in line losses.

**AFFIDAVIT**

**ATTACHMENTS:**

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| Revised Exhibit: WAPAHLT1: | Summary of Test Year Adjustments |
| Revised Exhibit: WAPAHLT6: | Projected Water Business Plan Changes to Inter-Company Transactions |
| Revised Exhibit: WAPAHLT7: | Determination of Test Year Rate Adjustment |
| Revised Exhibit: WAPAHLT8: | Schedule of Existing and Proposed Rates |
| Revised Exhibit: WAPAHLT9: | Summary of Existing and Proposed Bill Comparisons |
| Revised Exhibit: WAPAHLT10: | Projected Test Year Results Based on Proposed Rates |
| Revised Exhibit: WAPAHLT11: | Projected Adequacy of Proposed Rates for the Forecast Period (through FY2018) |