

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

ELECTRONIC APPLICATION OF BLUEGRASS)
WATER UTILITY OPERATING COMPANY)
LLC FOR AN ADJUSTMENT OF SEWAGE) CASE NO. 2022-00432
RATES)

SUPPLEMENTAL TESTIMONY OF

DAVID DITTEMORE

ON BEHALF OF

THE OFFICE OF THE ATTORNEY GENERAL

JULY 18, 2023

Q. Please record your name, business address, and occupation.

1 A. My name is David N. Dittmore. My business address is 609 Regent Park Drive, Mt.
2 Juliet, TN, 37122. I am a self-employed consultant specializing in utility regulatory
3 matters.

4 **Q. Did you cause pre-filed testimony to be submitted in this docket?**

5 A. Yes.

6 **Q. What is the purpose of your Supplemental Testimony?**

7 A. The purpose of my Supplemental Testimony is to discuss the implications of the
8 Company's response to Attorney General request 1-61. This supplemental response was
9 provided as a result of the Commission's Motion to Compel order issued June 29, 2023.
10 I will provide an alternative capital structure for the Commission's consideration.

11 **Q. What information was sought by the Attorney General's office in request 1-61?**

12 A. Request 1-61 sought to obtain the parent's financial statements of U.S. Water LLC.

13 **Q. Did Bluegrass provide the requested information?**

14 A. No. On July 6, 2023, the Company responded as follows:

15 *"Bluegrass does not possess and is not in control of, any audited, or unaudited,*
16 *financial statements for U.S. Water, LLC. To the best of Bluegrass Water's*
17 *knowledge, such information is maintained solely by U.S. Water, LLC."*

1 The Company responded similarly when asked to calculate U.S. Water's weighted cost
2 of debt calculation.¹ Response 1-61 was provided due to the Commission's Motion to
3 Compel order and was supplied after I filed my Direct Testimony on June 30, 2023.

4 **Q. Why are the financial statements of U.S. Water LLC relevant in this proceeding?**

5 **A.** U.S. Water LLC is the parent company of CSWR LLC (CSWR), which is the parent
6 company of Bluegrass Water Utility Operating Company (Bluegrass).² The financial
7 statements of CSWR's parent may reveal the source of the capital used to finance CSWR
8 and in turn, Bluegrass.

9 The Commission is tasked with establishing just and reasonable rates in this proceeding.
10 The Commission cannot carry out its responsibility without determining the costs of
11 financing the Bluegrass Rate Base.

12 **Q. If the Commission doesn't know the actual sources of financing of the Bluegrass**
13 **Rate Base, should it simply adopt a capital structure comprised of components**
14 **representative of the water or wastewater industry?**

15 **A.** No. Ratepayers are facing monthly bills for wastewater service of nearly \$100/month
16 under the Company's proposal. The Commission should not adopt a rate of return that
17 may exceed the Company's actual financing costs simply due to the unwillingness of
18 the Company to produce pertinent information. The Commission and the Company's

¹ See Response to Attorney General Data Request 2-62.

² See Exhibit 1 to the Direct Testimony of Josiah Cox.

1 ratepayers deserve to understand the underlying nature of the Company's financing to
2 understand what profit margins would be generated by the present request.

3 **Q. What is an appropriate standard the Commission should use in adopting the**
4 **capitalization ratios in this proceeding?**

5 **A.** I recommend that the Commission establish a rate of return in this proceeding that
6 represents the lower of the Company's actual financing costs or the rate of return based
7 upon a hypothetical capital structure representative of the industry in general.

8 **Q. Why is this 'lower of' standard for determining the rate of return appropriate in**
9 **this proceeding?**

10 **A.** The application of this standard is necessary to ensure ratepayers are not incurring
11 excess costs and that such rates are cost-based. The 'lower of' standard ensures that the
12 financing costs within the revenue requirement are no greater than the Company's actual
13 costs. Secondly, it ensures that those actual costs are within the range of reasonableness
14 for the industry. Establishing a rate of return based on a hypothetical capital structure
15 representative of the industry average only when actual costs are higher acts as a limiting
16 factor and creates an incentive for the company to keep financing costs low.

17 **Q. Does the adoption of industry average capitalization rates incentivize utilities to**
18 **finance their operations with debt at the parent level?**

19 **A.** Yes. There is a risk that the actual financing costs will be less, perhaps significantly less
20 than industry averages. The risk from the use of a hypothetical capital structure to

1 establish rates is that the parent company will maximize its use of debt which is
2 subsequently 'counted' as equity in the rate-setting process. This transformation of debt
3 costs (incurred by owners/investors) to an equity return (incurred by ratepayers) may
4 occur when regulators adopt an industry average capitalization methodology. This
5 process of transforming debt costs into an equity return is referred to as double
6 leveraging. This regulatory issue may occur when a hypothetical capital structure or a
7 subsidiary entity's capital structure is used. Capital provided by a parent company to a
8 subsidiary is recognized as equity on the subsidiary's books, regardless of its true source.

9 **Q. Can you provide an example of how double leveraging might maximize returns for**
10 **a regulated utility?**

11 **A.** Yes. Exhibit SDND-1 provides an illustrative example of how double leveraging can
12 maximize equity returns for utility investors.

13 In the first section, I copied the Company's requested capital structure and applied the
14 return, including the impacts of income taxes, to the Company's proposed Rate Base,
15 producing a return on Rate Base of \$775,000.

16 In the next section, I have attributed the full \$2.9 million of Bluegrass Notes Payable to
17 the Capital Structure, the same value the Company has used to compute its
18 Capitalization Ratio for Long Term Debt. I have assumed that the remaining balance
19 necessary to finance Rate Base (residual financing) comprises 75% debt and 25%. For
20 this calculation, I have used the Company's claimed cost of debt of 6.8% for this
21 additional layer of imputed debt. The result produces an overall rate of return, inclusive

1 of income taxes, of 8.02%. The level of equity financing Rate Base under this illustration
2 is \$872,000. The return requested (\$775,000), less Interest Expense based upon the
3 level of debt in the imputed capital structure, produces a return on equity of \$400,000
4 (gross of income tax), or approximately \$300,000 net of income taxes. The Net Income
5 of \$300,000 applied to the imputed equity return produces a return on equity of 34.43%.

6 **Q. Are the calculations in Exhibit SDND-1 based upon the significant assumption that**
7 **this 'residual' financing is 75% debt financed?**

8 **A.** Yes. The results above are heavily dependent upon this assumption. My analysis is for
9 illustrative purposes. Due to the Company's failure to provide the requested
10 information, I don't have access to the actual nature of the financing, so I do not know
11 the precise benefit of the Company's shareholders from its proposals.

12 **Q. How did the Company develop its Capital Structure?**

13 **A.** The Company's capital structure is based upon the weighted costs associated with the
14 Bluegrass' specific \$2.9 million financing, with the remainder capitalization of
15 approximately \$4.6 million identified as Common Equity.³

16 **Q. Is there any basis to conclude that the \$4.6 million in financing is exclusively**
17 **equity?**

³ The balance of Common Equity is the same as identified in response to PSC 1-27, referenced as the balance of 'Capitalization' for Kentucky-CSWR as of February 28, 2023. This February balance is identical to the underlying balance of Equity as of December 31, 2022, reflected in response to AG 1-60, represented as support for the Company's proposed capital structure. However, the Kentucky-CSWR total capitalization is only \$4.6 million, far less than the underlying Rate Base of that proposed by either Bluegrass (\$6.4 million) or that of the Attorney General's office (\$5.6 million) in this proceeding.

1 A. No.

2 **Q. Has the Company acknowledged that Bluegrass does not provide its own**
3 **financing?**

4 A. Yes, as explained in my direct testimony.⁴

5 **Q. In your direct testimony, you indicated that Customers should pay rates based**
6 **upon an accurate determination of capitalization components. Hypothetically if a**
7 **Company had 100% equity, would it be reasonable to establish a rate of return**
8 **based upon a 100% equity capital structure?**

9 A. No. The standard for determining a rate of return for ratemaking purposes should be the
10 lower of actual costs or the hypothetical capital structure based upon industry averages,
11 as mentioned earlier in my testimony. In this case, the Company has thwarted efforts to
12 determine the actual costs of its financing.

13 **Q. Based upon the Company's lack of response to response 1-61, do you have an**
14 **alternative capital structure option for the Commission's consideration?**

15 A. Yes.

16 **Q. How did you compute this alternative capital structure?**

17 A. I relied upon the capitalization balances in response to PSC 1-27, the Balances on
18 Bluegrass' Balance Sheet as of February 28, 2023. The components include the \$2.9
19 million Bluegrass financing, Long-Term Liabilities payable to Associated Companies and

⁴ Testimony of David Dittmore page 27: 8-9, June 30, 2023.

1 Common Equity. For this analysis, I've applied a 6.8% cost of debt to the Long-Term
2 liability balance. This results in an overall rate of return of 7.27% on a nominal basis, or
3 7.77%, inclusive of income taxes.

4 **Q. Is there any assurance that the amounts identified as Common Equity are truly**
5 **equity?**

6 **A.** No.

7 **Q. What is the impact of this proposal on the original revenue requirement supported**
8 **in your direct testimony?**

9 **A.** Adopting this methodology reduces the revenue requirement by \$243,000 based on the
10 Rate Base I support. This compares with the sum of the impacts of Scenarios 1, 2, and 3,
11 totaling \$198,000 supported in my direct testimony. The net reduction in the revenue
12 requirement from this proposal is \$45,000 from that provided in my direct testimony,
13 producing a net rate increase recommendation of \$474,000.

14 **Q. Does this conclude your supplemental testimony?**

15 **A.** Yes. However, I reserve the right to supplement my testimony if necessary.

Bluegrass Water Company
Case No. 2022-00432
Impact of Double Leveraged Capital Structure
Office of the Attorney General

Exhibit SDND-1

Line No.	Item	Capitalization Rate 1/	Cost	Weighted Cost	Gross-up Factor 2/	Gross of Tax Return
1	I. Bluegrass Proposed Capital Structure					
2	Long-Term Debt	38.84%	6.80%	2.64%	1	2.64%
3	Common Equity	61.16%	11.65%	7.13%	1.3324	9.49%
4	1/ Company ROR Schedule			9.77%		12.13%
5	2/ Exhibit DND-10 (Only the Common Equity return requires gross-up), excludes Company's Bad Debt gross-up					
6	Proposed Rate Base (000's)					6,388
7	Requested Return on Rate Base (000s)					\$ 775
8	Implied Equity Level (000s)					\$ 3,907

9	II. Assume U.S. Water Actual Capital Structure 75% Debt/25% Equity					
10	Bluegrass Capital Structure would be comprised of \$2,900,000 of Bluegrass Debt, with residual capitalization at 75% debt/25% equity.					
11	Long-Term Debt	86.35%	6.80%	5.87%	1	5.87%
12	Common Equity	13.65%	11.65%	1.59%	1.35	2.15%
13	Total Capitalization	100%		7.46%		8.02%
14	Proposed Rate Base (000's)					6,388
15	Requested Return on Rate Base (000s)					\$ 512
16	Debt Portion	\$ 375				
17	Equity Portion	\$ 137				

18	Earned ROE under 85% Debt/15% Equity financing (000s)	
19	Bluegrass Requested Return	\$ 775
20	Interest Expense @ 85% Debt Level	\$ 375
21	Return Available for Equity	\$ 400
22	Less: Taxes	\$ (100)
23	Return After Tax	\$ 300
24	Equity @ 15% Level	\$ 872
25	After-Tax Return	34.43%

26	Total Capitalization	\$ 6,388	
27	Less: Bluegrass Debt	\$ (2,900)	
28	Net Residual Capitalization	\$ 3,488	
29	Debt Portion of Residual Capitalization	\$ 2,616	
30	Equity Portion of Residual Capitalization	\$ 872	
31	Total Debt	\$ 5,516	86.35%
32	Total Equity	\$ 872	13.65%
		\$ 6,388	

Tax Rate	
State Tax Rate	5.00%
Income subject to Federal Tax	95.00%
Federal Tax Rate	21.00%
Effective Federal Tax Rate	19.95%
Combined Tax Rate	24.95%

Bluegrass Water Company
Case No. 2022-00432
Alternative Capital Structure
Office of the Attorney General

Exhibit SDND-2

Item	Amount	Capitalization	Cost 1/	Weighted Cost	Gross-Up Factor - 1.3324	Pre-Tax Cost
Bluegrass Proposed Capital Structure Exhibit DWD-1						
Notes Payable to Associated Companies	N/A	38.84%	6.80%	2.64%	1	2.64%
Common Equity	N/A	<u>61.16%</u>	11.65%	<u>7.13%</u>	1.3324	<u>9.49%</u>
Total		100.00%		9.77%		12.13%

1/ Proposed by Company

**Bluegrass Balance Sheet @ 2/28/2023
PSC 1-27**

Notes Payable	\$ 2,900,000	21.54%	6.80%	1.46%	1	1.46%
Long-Term Liabilities Payable to Associated Companies	\$ 8,513,372	63.24%	6.80%	4.30%	1	4.30%
Common Equity	<u>\$ 2,047,639</u>	<u>15.21%</u>	9.90%	<u>1.51%</u>	1.3324	<u>2.01%</u>
Total	\$ 13,461,011	100%		7.27%		7.77%

**Adjustment Associated with Alternative Capital Structure
Applied to Attorney General Rate Base**

	Company Request Pre-Tax Return	Attorney General Proposed Pre-Tax Return
Pre-Tax Return	12.13%	7.77%
AG Proposed Rate Base (000s) Ex DND-5	<u>5,560</u>	<u>5,560</u>
Required Return	675	432
Adjustment to Reflect Bluegrass Capitalization at 2/28/23	(243)	
Less: Adj. Supported in Direct Testimony		
Scenario 2		(54)
Scenario 3		(108)
Adjust ROE to 9.9%		(36)
	<u>(198)</u>	
Reduction in Proposed Revenue Requirement	(45)	