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December 23, 2009

TO: Ms. Kate Whitney

FROM: Mandi Shulund Hinman

RE: Docket Nos. D2005.11.163 and D2005.11.164-Utility Solutions, LLC

Enclosed is the original Prefiled Direct Testimony and Exhibits of Paul R. Schulz on Behalf of the Montana Consumer Counsel in the docket listed above. Thank you.

Cc: Service List

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

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IN THE MATTER of the Application of Utility Solutions, LLC to Implement Initial Rates and Charges for Water Service in its Elk Grove Subdivision, Gallatin County, Montana Service Area	)))))	UTILITY DIVISION DOCKET NO. D2005.11.163
IN THE MATTER of the Application of Utility Solutions, LLC to Implement Initial Rates and Charges for Waste Water Service in its Elk Grove Subdivision, Gallatin County, Montana Service Area	)))))	UTILITY DIVISION DOCKET NO. D2005.11.164

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Prefiled Direct Testimony and Exhibits of

Paul R. Schulz

on Behalf of The

Montana Consumer Counsel

December 2009

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND ADDRESS.

A. My name is Paul R. Schulz. I am employed as a Rate Analyst with the Montana Consumer Counsel (MCC). Our offices are located at 616 Helena Ave., Helena, MT 59602-1703.

Q. PLEASE DESCRIBE YOUR QUALIFICATIONS AND EXPERIENCE.

A. I hold a B.A. degree in Economics from Colorado State University and a M.S. degree in Accounting from the University of Virginia. I've attended the Regulatory Studies Program, or "Camp NARUC," at Michigan State University as well as "The Basics" course in water utilities put on by the Center for Public Utilities at New Mexico State University. For six years I worked in different industries in the private sector in internal auditing, accounting, and accounting analysis positions. In addition, I was employed for over a year as a Budget Analyst with the Montana Department of Labor and Industry prior to my employment at the Consumer Counsel commencing in March, 2009. I'm also licensed as a CPA in the State of Colorado.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony is to present the results of my review of the testimony and schedules submitted by Utility Solutions, LLC (Utility Solutions) in support of its request to increase rates for water service by $206,776.91, for a total revenue requirement of $327,498.82, and for sewer service by $183,646.53, for a total revenue requirement of $356,304.55, as well as my review of its responses to data requests from the MCC and the Montana Public Service Commission (MPSC) Staff. I've also discussed items from this docket with company personnel and the company's consultant to obtain additional information and explanations. My testimony includes suggested modifications to some of the figures as presented by the Company. My analysis indicates that Utility Solutions will have an opportunity to earn a fair and reasonable return with an overall revenue requirement of $238,077 for the water utility and $251,877 for the wastewater utility as outlined in Exhibits PRS-1 & PRS-10.

Q. PLEASE SET OUT IN NARRATIVE FORM ANY ADJUSTMENTS YOU FEEL ARE APPROPRIATE.

A. The suggested adjustments follow by subject area. Exhibits supporting the following recommendations are attached and marked as PRS-1 through PRS-18. The exhibits are referenced below except for Exhibits PRS-4 and PRS-13 which show the calculations for nonincome taxes and Exhibits PRS-8 and PRS-17 which show the calculations for working cash for the sewer and water utilities respectively.

RATE BASE CALCULATIONS

There were some complicating factors in determining rate base for Utility Solutions. Upon the sale of the utility to Utility Solutions, Utility Solutions agreed to the Real Covenants applicable to the Elk Grove subdivision which include a provision in paragraph 3d, essentially limiting rate base at the time of sale to $1,500,000. Utility Solutions divided that $1.5M evenly between the sewer utility and the water utility. This provision is discussed on page four of Ms. Barrow's testimony for the water utility and page four for the sewer utility. The adjustments made to arrive at this figure are shown on Work Paper 1 of Ms. Barrow's testimony for both the water and sewer portions of the utility. As discussed in Ms. Barrow's testimony, depreciation expense was taken on the excluded amount. In its 2008 annual reports for both the water and sewer utilities, Utility Solutions made major upward adjustments to the 2007 figures for Utility Plant in Service. The Utility indicates in its response to MCC-013 that amounts for the plant accounts in the 2007 Annual Report cannot be reconciled and that an adjustment was made to remove interest expense that had been capitalized in the plant accounts. Given these factors, I chose to reconstruct figures for the water and sewer rate bases (See Exhibit PRS-7) using the restated numbers provided by the utility in the response to data request MCC-071 which shows a complete history of utility plant and depreciation. Exhibits PRS-7 and its twin PRS-16 include detailed calculations for Utility Plant and depreciation. Exhibit PRS-16 is identical to PRS-7 but is used as a reference worksheet for some of the water utility exhibits. After making the adjustments and modifications discussed in the following paragraphs I arrived at a rate base of $833,900 for the water utility and $682,537 for the sewer utility.

CAPITALIZED PERMITS, FEES, & LICENSES

In the Company's filing, Statement C-Utility Plant Accounts, Utility Solutions water utility shows $168,079.66 for Licenses & Permits capitalized and the sewer utility shows $170,007.07 in capitalized licenses and permits. The exhibit which the company provided as part of their response to MCC-009 shows the allocated purchase price analysis performed by the accounting firm Galusha, Higgins, & Galusha (GH&G) at the time Utility Solutions purchased the utilities. This analysis shows $336,052.99 in unallocated purchase price that could not be tied to any particular asset. This amount was subsequently split evenly between the water utility and the sewer utility and included in plant group 302-Licenses & Permits Capitalized. The even allocation of this amount between the water and sewer utilities can also be observed in the Company's response to MCC-071 under Permits, Fees, and Licenses at 8/8/03. This amount was assigned to capitalized Licenses and Permits even though the analysis done by GH&G does not indicate any invoices supporting that amount and accordingly classified it as unallocated purchase price. Consequently, the $336,052.99 appears to effectively be purchase premium or goodwill. The Utility may contend that this amount represents payment for intangible assets; however, the figure arrived at is simply a 'plug' figure that makes up the difference between the purchase price and the original cost figure that is supported by invoices. There is no documentation supporting this amount as what was actually paid for permits, fees, and licenses. Ratepayers should not be burdened with paying for an unsupported purchase premium with no clear valuation of any benefits. This amount was already removed from rate base by use of the agreed upon $1.5M figure for rate base but it was being included in the calculation of depreciation expense. Therefore, I removed this amount from rate base and then reduced the amount for the capital reduction per the purchase agreement. I excluded the depreciation for the $336,052.99 in capitalized permits, fees, and licenses in my calculations for depreciation expense and accumulated depreciation (see Exhibits PRS-3, PRS-6, PRS-7, PRS-12, and PRS-15).

DISPOSAL BEDS

In response to data request MCC-017, the utility provided Utility Solutions' Summary of Allocated Plant. Disposal Beds, the destination of effluent from the wastewater treatment plant, are booked at a cost of $173,596.32 and are allocated entirely to the regulated sewer utility. During an audit visit at Utility Solutions, John Close, Operations Manager for Utility Solutions, indicated to me that the disposal beds are used for the total effluent from the wastewater treatment plant. That would make sense as there are no other disposal beds. The utility is not separating the effluent from the Four Corners County Water and Sewer District (FCWSD) from the effluent from the regulated Elk Grove subdivision. Given that both the regulated and non-regulated sewer utilities are using the disposal beds, the plant value for this asset should be allocated between the two along with the associated depreciation. The Utility has allocated one third of the treatment plant to Elk Grove and two thirds to the non-regulated area. I recommend using this same allocation (see Exhibits PRS-3 and PRS-6) with the disposal beds and allocating one third or $57,865.44 to the regulated area and two thirds or $115,730.88 to the water district.

2009 IMPROVEMENT TO THE WASTEWATER TREATMENT PLANT

In the Company's filing, Statement C-Utility Plant Accounts, Utility Solutions sewer utility shows a pro forma adjustment of $25,020 added to the treatment plant in 2009. The Utility's response to data request MCC-038 indicates that this amount represents capitalized engineering services and time spent by management on sewer treatment plant expansions. The Utility's response to data request MCC-071, which shows Elk Grove plant depreciation restated as of November 4, 2009, shows no improvements to the water treatment plant in 2009. In addition, the company's response to MCC-039 indicates that there were no physical improvements to the treatment plant placed in service in 2009. These engineering and management expenses for expansion should not be capitalized until the associated expansion is in service or at least until construction has begun and a pro rata share of these expenses could be capitalized as construction progresses (See Exhibit PRS-6). Otherwise, ratepayers would be paying for a return of and a return on expenses related to planned expansion that may or may not take place. That is a business risk that should be borne by the utility. If expansion never occurs the utility would bear the expense because they undertook the risk/reward profile of expansion. If expansion does occur, then the utility would be rewarded at such time for that investment decision.

INCONSISTENCY IN WASTEWATER TREATMENT PLANT DEPRECIATION

The Utility's response to MCC-071 indicates that the wastewater treatment plant is being depreciated over 15 years, whereas the improvements to that plant as well as the associated disposal beds and mains are all being depreciated over 25 years. The Utility is also proposing to depreciate over 25 years the engineering and management expenses related to sewer treatment plant expansion that they wish to capitalize as discussed in the previous paragraph (see response to MCC-038). For the water utility, all of the plant from the distribution facility to the mains is being depreciated over 25 years. One might argue that the mains have a different useful life than the treatment plant but in this case even the 2007 improvement to that plant is being depreciated over 25 years. It is inconsistent for an improvement to an asset to be assigned an initial depreciable life greater than the asset it is improving. The IRS' Modified Accelerated Cost Recovery System (MACRS) does classify a municipal wastewater treatment plant as 15-year property. However, this is for an accelerated depreciation method designed to provide tax advantages in the early years of an asset's life. It is not designed to represent actual useful life or depreciation for regulatory purposes. For regulatory purposes, straight line depreciation over the useful life of an asset is the usual approach. Consequently, I suggest that depreciation for the wastewater treatment plant be calculated using straight-line depreciation with a 25 year life, consistent with the treatment of other similar assets of Utility Solutions. Likewise, the accumulated depreciation balance for the wastewater treatment plant should also be adjusted. This change would reduce current annual depreciation expense by $10,574 and reduce end of 2008 accumulated depreciation by $57,277 (See Exhibit PRS-3).

DEPRECIATION ADJUSTMENTS

The adjustments I have proposed in the preceding paragraphs are including in the accumulated depreciation and depreciation expense figures that I derived which are shown in exhibits PRS-3 and PRS-12. These exhibits show the overall depreciation figures used in the Utility's initial filing. Other than those totals from the initial filing, it should be noted that I used the Utility's response to data request MCC-071 as the starting point for most of my figures for plant and depreciation. That exhibit shows restated figures for Elk Grove plant and depreciation. Statement D-Accumulated Depreciation and Amortization for the sewer utility in the initial filing contains some inaccuracies, most notably the figures for accumulated depreciation and current year depreciation on the wastewater treatment plant. The restated figures also include some other adjustments which are addressed in footnotes at the bottom of the response to MCC-071.

INCOME TAXES

Utility Solutions is requesting recovery of income tax expense of $47,006.71 for the water utility and $29,582.11 for the sewer utility. Utility Solutions is a Limited Liability Corporation and as such does not pay income tax. Utility Solutions is a pass-through entity for tax purposes and it is the members of Utility Solutions that will include their proportionate share of Utility Solution's income or loss on their own tax returns. The Utility even makes this point in their response to MCC-008. The regulated entity in this proceeding is Utility Solutions, not its individual members. For the tax years that Utility Solutions has reported a loss, the members of Utility Solutions have had a tax benefit, not the ratepayers. Recovery from ratepayers for an income tax liability that may or may not exist depending on each LLC member's tax situation should be disallowed (See Exhibits PRS-5 and PRS-14).

CAPITAL STRUCTURE

Statement A for both the water and wastewater utilities in the pre-filed direct testimony of Sandra Barrows on behalf of Utility Solutions shows that the company is 100% leveraged. The company is suggesting use of a 55% equity/45% debt hypothetical capital structure. Based on a return of equity of 10.0% and cost of debt of 5.80%, the company proposes an overall rate of return of 8.11%. Utility Solutions has an actual capital structure of 0% equity/100% debt. A 5.80% overall rate of return is a true reflection of the utility's cost of capital (See Exhibits PRS-9 and PRS-18). The use of a hypothetical capital structure in this case serves no purpose but to manufacture a rate of return that enriches the utility at ratepayer expense for equity that it does not possess.

LOAN FEES

Statement G (O&M expenses) for both the water and wastewater utilities in the pre-filed direct testimony of Sandra Barrows on behalf of Utility Solutions includes loan fees of $949.49 for the water utility and $1704.05 for the sewer utility. Total loan fees incurred as part of the borrowing from Stockman Bank of Montana (see response to MCC-028) amounted to $6,288. This amount was allocated among the regulated and non-regulated water and sewer utilities based on 2008 operational expenses (see response to data request MCC-028). According to the utility's consultant, these fees were included as part of O&M expenses because the loan proceeds were used to fund ongoing operations. Nonetheless, these fees do not represent recurring O&M expenses. Once Utility Solutions has new MPSC approved rates in place, operations will be supported by water and sewer rates and there will be no need for 'operational' loans. Ratepayers would then be paying for a phantom expense. These fees could be capitalized and amortized over the life of the loan. However, this change merely memorializes the cost of these fees in amortization expense rather than O&M expense because the loan in question was for one year so the entirety of the fees would be amortized in a single year. These expenses should be removed as a known and measurable change (See Exhibits PRS-2 and PRS-11). At the time of filing, it was clear that Utility Solutions was requesting a rate increase to support operations without the need for additional loans. Ratepayers will be supporting operational expenses through rates; they should not have to pay for fees from non-existent or unnecessary loans in the future.

PETTY CASH

Statement G (O&M expenses) for both the water and wastewater utilities in the pre-filed direct testimony of Sandra Barrows on behalf of Utility Solutions includes petty cash of $1,618.07 for the water utility and $1614.28 for the sewer utility. In response to data request MCC-027, the Company indicates that petty cash is used for "customer change, small office supply or system materials purchases, equipment rental and gas purchase for property maintenance, and non-FedEx mailings". The use of petty cash for customer change does make sense as this would be an instance of small amounts of cash required for a spontaneous need. However, some of the other uses listed seem unnecessary. The Company already has such accounts as Materials/Supplies, Chemicals, Rental Equipment/Property, Other Equipment Expense, Postage/Printing, Miscellaneous Expense, and Office. It would seem that the other listed petty cash expenses could be posted to one of these accounts. The sizes of the transactions are not an issue as a mere $29.74 was recorded in the Other Equipment Expense account for the sewer utility. Going forward, I suggest that the utility seriously limit the use of the petty cash account and instead record expenses in an appropriate account. Given the extent of the expenses in some other accounts such as Other Equipment Expense of $29.74 or Rental Equipment/Property Expense of $315.16 for the sewer utility, I think that

$500 annually for petty cash for the sewer utility and $500 for the water utility would be sufficient. My concern over petty cash is that it is a catch-all account susceptible to abuse. When cash is used for expenses lumped into one account there is less accountability and transparency.

ADVERTISING

Statement G (O&M expenses) for both the water and wastewater utilities in the pre-filed direct testimony of Sandra Barrows on behalf of Utility Solutions includes advertising expense of $182.39 for the water utility and $130.36 for the sewer utility. Montana Code Annotated (MCA) 69-3-307 does not allow recovery for advertising by public utilities unless it is specifically related to issues of conservation and safety. I recommend that the amounts listed above be removed from O&M expenses (See Exhibits PRS-2 and PRS-11).

Q. DOES THIS COMPLETE YOUR TESTIMONY?

A. Yes.

CERTIFICATE OF SERVICE

I certify that a copy of the forgoing Prefiled Direct Testimony of Paul R. Schulz has been served upon the following persons by first class mail this 23rd day of December 2009:

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