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FILING CLERK

PETITION BY HOMEOWNERS UNITED FOR RATE FAIRNESS TO REVIEW AUSTIN RATE ORDINANCE NO. 20100607-055	§ § § §	**BEFORE THE PUBLIC UTILITY COMMISSION OF TEXAS**

CROSS-REBUTTAL TESTIMONY

OF

JUNE M. DIVELY, CPA, CFF, Cr.FA, FABFA

ON BEHALF OF THE

OFFICE OF PUBLIC UTILITY COUNSEL

FEBRUARY 20, 2013

378

SOAH DOCKET NO. 473-13-0935
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CROSS-REBUTTAL TESTIMONY
OF JUNE M. DIVELY, CPA, CFF, Cr.FA, FABFA

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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is June M. Dively. My business address is 3 Lakeway Centre Ct., Suite 110, Lakeway, Texas 78734.

Q. ARE YOU THE SAME JUNE M. DIVELY THAT PREVIOUSLY FILED DIRECT TESTIMONY IN THIS CASE?

A. I am.

II. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to rebut the testimony of Commission Staff Witness Tietjen in regard to problems with using the Debt Service Coverage ("DSC") method for determining cost of service.

III. PROBLEMS WITH USING THE DSC METHOD FOR DETERMINING COST OF SERVICE

Q. PLEASE EXPLAIN THE DSC METHOD FOR DETERMINING COST OF SERVICE.

A. The DSC method multiplies a municipal utility's required debt service payments by a given coverage ratio to determine the amount of cash basis income required by the utility before deducting interest expense. Once the amount of cash basis income is determined, other sources of funds are subtracted to determine the amount of return that should be collected through revenues.

Q. DO YOU AGREE WITH THE USE OF THE DSC METHOD?

A. Yes and no. As discussed in my direct testimony, it is important to focus on substance over form. Merely applying a DSC ratio to debt service requirements does not necessarily yield a just and reasonable revenue requirement. In fact, applying a *just and reasonable* DSC ratio to debt service requirements does not necessarily yield a just and reasonable revenue requirement. I do agree, however, it is important to evaluate the reasonableness of the resulting municipal revenue requirement using a DSC analysis. But it is equally as important to evaluate the reasonableness of the results of using the DSC method.

For example, the results of the retail rate revenue requirements proposed by both Staff and I yield the same DSC ratio of 2.15. However, there is a $47,696,349 difference in our calculated cost of service, as shown in Table 1.

Table 1

Comparison of Revenues Resulting from DSC Method

	JMD	Staff	Difference
Net Income plus depreciation expense	335,283,065	360,886,306	
Total debt service, as adjusted	155,919,836	167,854,096	
Debt service coverage ratio	2.15	2.15	
Cash-Basis Net Income			
Revenues (Cost of Service)	1,115,824,377	1,163,520,725	**(47,696,349)**
Less: Total Expenses	(936,255,451)	(927,445,540)	
Subtotal	179,568,926	236,075,186	
Add back depreciation expense	136,149,836	117,214,512	
Plus other sources of cash flowing through income:			
Interest and dividend income	7,596,609	7,596,609	
Add cash flows from refund of investment in OSER	11,967,694		
Net Income plus depreciation expense	335,283,065	360,886,306	

On page 15, lines 7-9, Staff Witness Tietjen states that a municipally owned utility, such as AE, needs sufficient return dollars, or margin, over and above its actual operating expenses to meet its cash needs. In principal, I agree with Mr. Tietjen; however, I do have a qualification. Rates should be set to provide sufficient return dollars, or margin, over and above its actual *utility* operating expenses to meet its *utility* cash needs, and to provide proper matching of revenues with utility expenses and invested capital. Therefore, adjusting debt service to include only amounts appropriately matched with and supporting the appropriate components of rate base is imperative.

Q. HAS STAFF WITNESS TIETJEN PROVIDED ANY EVIDENCE THAT THE REVENUE REQUIREMENT RESULTING FROM THE APPLICATION OF THE 2.15 DSC METHOD IS JUST AND REASONABLE?

A. No. Mr. Tietjen recommends a DSC value of 2.15 but does not provide any evidence that his resulting revenue requirement is just and reasonable.

Q. HAVE YOU ANALYZED THE RESULTS OF MR. TIETJEN'S RESULTING REVENUES REQUIREMENT?

A. Yes. My analysis shows that the return on cash capital resulting from Mr. Tietjen's calculations is not just and reasonable. Table 2 below shows Staff's return on cash capital as compared to my return on cash capital, assuming 60% of AE's capital structure is supported by debt.

Table 2		
Analysis of Return on Cash Capital		
Description	JMD	Staff
Return on Cash Capital		
Rate of Return	7.90%	9.97%
Less Debt Component	-3.86%	-3.80%
Equity Component	4.05%	6.17%
Percentage of Capital Structure	40%	40%
Return on Cash Capital	**10.12%**	**15.41%**
Cost of Debt		
Interest Expense per AE	93,289,941	93,289,941
Adjustments	- (755,316)	- (245,982)
Total Interest Expense	92,534,624	93,043,959
Principal Balance per AE (AE response to OPUC 10-33)	1,551,783,060	1,551,783,060
Adjustments (60% of rate base adjustments)	- (112,439,531)	- (83,352,915)
Principal Balance	÷ 1,439,343,529	÷ 1,468,430,145
Cost of Debt	6.43%	6.34%
Percentage of Capital Structure	÷ 60%	÷ 60%
Debt Component in Rate of Return	3.86%	3.80%

The Commission has recently approved an IOU return on equity of 9.8%[1], making 10.12% reasonable. A 15.41% return on cash capital, however, is unreasonable on its face in the current economy. Additionally, AE should not be allowed to inflate its rates and obtain an unreasonable return on cash capital merely through use of its chosen methodology for determining return.

Q. GIVEN THAT BOTH YOU AND STAFF WITNESS TIETJEN YIELDED A DSC RATIO OF 2.15, CAN YOU EXPLAIN THE DISPARITY IN YOUR RECOMMENDATIONS?

[1] *Application of Entergy Texas, Inc. for Authority to Change Rates, Reconcile Fuel Costs, and Obtain Deferred Accounting Treatment*, Docket No. 39896, FOF 64 (Nov. 2, 2012); *Application of Lone Star Transmission, LLC for Authority to Establish Interim and Final Rates and Tariffs*, Docket No. 40020, Order, FOF 70A - 72A (Feb. 12, 2013).

A. Yes. I believe the root cause of the disparity is that Mr. Tietjen did not test his resulting return calculation for reasonableness. On page 8, lines 3-13, of his testimony, Mr. Tietjen explains his opinion regarding the problems with the use of the Cash Flow method for establishing revenue requirement:

> Although the Cash Flow approach is listed in the Commission's rate filing package as one of a number of return-dollar methodologies on which a utility may rely in developing its request, I believe that its use – more than the use of the other methods specifically included in the rate filing package – can be fraught with questions about its underlying assumptions. The basic reason for this opinion is that the return determined using the Cash Flow method is **ultimately a "plug-in" number**; that is, the Cash Flow method allows a utility to assert the total amount of return necessary to pay for all its cash needs, and that resulting amount is – *ipso facto* – the amount that the utility claims as the return that it "requires" in its revenue requirement. The bottom-line is that a utility's demonstration and justification of its desired return amount is a foregone conclusion because it is a mathematical inevitability.
>
> [Emphasis added.]

I agree with Mr. Tietjen's opinion regarding the use of the Cash Flow Method, but a similar argument can be made regarding the use of the DSC method, when its results are not tested for reasonableness. The DSC method also yields a "plug-in" number. You simply take your debt service requirements and multiply by a DSC ratio. After doing this calculation it is easy to overlook the reasonableness of the individual components of return, and ultimately the return on cash capital.

Q. IF YOU AND STAFF WITNESS TIETJEN HAD STARTED WITH THE SAME DEBT SERVICE REQUIREMENT, WOULD YOU HAVE ENDED UP WITH IDENTICAL RECOMMENDATIONS?

A. No, because other factors come into play. Table 3 compares my calculated rate of return with that of Staff Witness Tietjen. Although it is true that we would have identical amounts for the *Return on and Return of Invested Capital*, we deduct different amounts for depreciation expense and interest income.

Table 3			
Analysis of Differences Between Proposed Returns			
Description	JMD	Staff	Difference
Debt Service	155,919,836	167,854,096	(11,934,260)
Reserve Requirements		31,641,489	(31,641,489)
Amount Available for General Fund Transfer	87,034,301	73,312,074	13,722,227
Internally Generated Funds	72,764,625	88,078,647	(15,314,022)
Return on and Return of Invested Capital	315,718,762	360,886,306	(45,167,544)
Less: Depreciation	(136,149,836)	(117,214,512)	(18,935,324)
Less: Interest Income		(7,596,609)	7,596,609
Adjusted Return	179,568,925	236,075,185	(56,506,260)
Adjusted Rate Base	÷ 2,271,776,761	÷ 2,368,402,910	(96,626,149)
Rate of Return	7.904%	9.968%	

Mr. Tietjen did not propose an adjustment to AE's depreciation rates. A flawed assumption made by AE is that depreciation expense has no impact on total cost of service. While I agree this may be true using the pure Cash Flow method because the same amount is added to expenses and subtracted from return, an incorrect depreciation expense amount misstates the amount of return being provided to the utility. As shown in Table 3, depreciation expense is deducted from total return. This deduction takes place to remove the amount of return that represents a return of invested capital (both cash and principal on debt) rather than a return on invested capital. In this case, Mr. Tietjen has deducted only AE's depreciation expense of $117,214,512 and overstated AE's return by $18,935,324, the adjustment I made to depreciation expense. I also removed the deduction of interest income from AE's return to provide for additional internally generated cash flows. This is not an adjustment made by Staff.

Q. DO YOU HAVE ANY FINAL COMMENTS REGARDING PROBLEMS WITH USING THE DSC METHOD FOR DETERMINING COST OF SERVICE?

A. The methodology used to determine cost of service and the resulting retail rate revenue requirement in this case should not be a bigger driver than the reasonableness of the results. The reasonableness of any "plug-in" numbers, whether using the Cash Flow Method, the DSC method, or the Traditional method, should be evaluated using the guidance provided by PURA and the Commission Rules. As addressed by the Commission in its order for Docket No. 31462, *Application of City of Austin D/B/A Austin Energy to Change rates for Wholesale Transmission Service* (June 9, 2006):

> It should be noted that while the non-IOU TCOS RFP allows a utility to file using one of several different methods to determine its transmission revenue requirement, the Commission's mandate under PURA is to ensure just and reasonable rates. Therefore, the Commission is not bound by the utility's choice of method for calculating rates if that method produces unjust or unreasonable rates. The Commission has in the past, and may in the future, order a utility's transmission rates to be set by a method other than the method the utility chose when it filed its rate package.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.