

**BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION**

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

WASTE CONTROL, INC., G-101,

Respondent.

DOCKET TG-140560

**REBUTTAL TESTIMONY OF
LAYNE C. DEMAS
FOR WASTE CONTROL, INC.**

AUGUST 20, 2014

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1 **I. WITNESS BACKGROUND**

2 **Q. WOULD YOU PLEASE STATE YOUR NAME AND PROVIDE YOUR**
3 **BUSINESS ADDRESS FOR THE RECORD?**

4 A. Yes. My name is Layne Demas. My address is 3715 N. Proctor, Tacoma, WA 98407.

5 **Q. WHAT IS YOUR BACKGROUND OR EXPERIENCE RELEVANT TO YOUR**
6 **TESTIMONY IN THIS MATTER?**

7 A. I retired as a regulatory analyst from the Washington Utilities and Transportation
8 Commission, (“UTC”) in November, 2011 after a 25 year career beginning in October,
9 1986. I graduated from the University of Puget Sound in 1976 with a Bachelors of Arts
10 degree in Business Administration. I am a Certified Public Accountant for occupational
11 purposes in the State of Washington.

12 **Q. WOULD YOU PLEASE DESCRIBE YOUR PERTINENT EXPERIENCE AT THE**
13 **UTC?**

14 Yes. As a regulatory analyst for the Commission, I conducted numerous studies and
15 accounting examinations related to tariff filings and other regulatory filings by businesses
16 regulated by the Commission, particularly solid waste collection companies, various
17 other transportation companies and water utilities. I was the lead staff analyst for the
18 UTC on each filing of Olympic Pipeline Company since 2003 and was the lead analyst in
19 the U.S. Ecology filings since 1995 until my retirement.

20 **Q. REGARDING SOLID WASTE GENERAL RATE CASE FILINGS, WHAT IS**
21 **YOUR PARTICULAR EXPERIENCE?**

22 A. I have performed scores of audits on solid waste collection companies regulated by the
23 UTC, both class A and class B, and have been closely involved in applying the Lurito-
24 Gallagher methodology in rate case assessments since its instigation by the Commission
25 in 1988.

1 **II. ROLE AND PURPOSE OF TESTIMONY**

2 **Q. PLEASE DESCRIBE YOUR ROLE IN SUBMITTING REBUTTAL TESTIMONY**
3 **ON THE COMPANY’S BEHALF IN THIS CASE**

4 A. Yes. I was given a few discrete assignments here. First, I was asked to review recent
5 general rate case files at the Commission for privately-held solid waste collection
6 companies going back over the last three or so years.

7 **Q. FOR WHAT PURPOSE?**

8 A. To review staff workpapers attached to the companies’ filings in an effort to
9 evaluate/compare previous Staff-identified cost allocators in relation to this case for
10 Land/Building Rents expenses and particularly, treatment of debt, cost of equity and
11 return on investment approaches in those filings in attempt to reconcile the approach
12 taken by staff in this Waste Control, Inc., (“WCI”), filing. I was also to determine the
13 cost allocations in the sampled rate cases to separate regulated from nonregulated
14 operations.

15 **Q. AND WHAT DID YOU FIND?**

16 A. I reviewed a total of twelve rate case files. I was looking for any and all references to the
17 issues described above. I found several cases with consistency in the allocation factors
18 used in separating regulated and nonregulated expenses. The methods used by WCI in its
19 general rate case are consistent with what I found in the workpaper files. In general, the
20 capital structure, cost of debt, and return on equity as filed by WCI echo the few rate case
21 files I found that had similar transactions. In every case, the return on equity was set at
22 15%. Unfortunately, this specific information is not always presented uniformly
23 throughout all rate cases I inspected with approximately three covering each of the topics
24 above but often not the same three filings. However, even though the relatively sparse
25 information I was identifying in these cases was somewhat disappointing, the underlying
organization of each of the cases I reviewed was quite similar to WCI’s filed case. Also,
in not one case of the twelve I reviewed were the methodologies such as proposed by

1 Staff here for allocations, treatment of debt, cost of equity and return on investments
2 utilized by Staff there in those other filings.

3 **Q. WHAT WAS YOUR OTHER GENERAL ASSIGNMENT?**

4 A. I was asked to generally assess the Staff's WCI capital structure recommendations and
5 Lurito-Gallagher inputs and rationale based on my knowledge of Lurito-Gallagher
6 methodology and to look closely, in light of all of the above, at three specific allocation
7 issues: Land Rent, the Three-Factor Allocation method and Staff's recreated results of
8 operations for the City of Kalama.

9 **III. SELECTED TOPICS FOR RESPONSE IN STAFF'S CASE**

10 **1. Land and Building Rents**

11
12 **Q. CAN YOU PLEASE SUMMARIZE WHY YOU BELIEVE THE STAFF'S
13 RESTATING ADJUSTMENT OF \$81,233 IS FLAWED?**

14 B. A. In my view, the Commission staff has used erroneous assumptions and flawed
15 analyses in the three identified components of Waste Control Inc.'s land rent adjustment:
16 debt to equity ratio (capital structure), cost of debt, and return on equity.

17 **Q. WHAT ARE THE DIFFERENCES BETWEEN STAFF AND WCI IN THE DEBT
18 TO EQUITY RATIO AND WHY IS IT IMPORTANT?**

19 A. To start off, Staff made the fundamental incorrect assumption that all assets rented by
20 HBI and HBII to affiliate companies, were leveraged with debt, when in fact only the
21 covered parking and warehouse space was financed subject to a mortgage. The table
22 below shows the difference in Staff's assumptions and the Company's analysis of these
23 debt instruments and calculations.

Demas Table No. 1

Property	Staff Assumptions Source: Staff Data Request No. 5 Response, May 23 and 28, 2014				Company Analysis Source: Exhibit JD-43			
	Debt percentage	Equity percentage	Cost of Debt	Return on equity	Debt percentage	Equity percentage	Cost of Debt	Return on equity
1150 3 rd Ave-Comm	93.67%	6.33%	1.93%	12.52%	0%	100%	NA	15%
950 3rd Ave – Covered Parking	93.67%	6.33%	1.93%	12.52%	75.34%	24.66%	2.635 %	15%
1150 3 rd Ave-Outside parking	93.67%	6.33%	1.93%	12.52%	0%	100%	NA	15%
Warehouse	53.80%	46.20%	4.28%	13.1%	40.99%	59.01%	5.27%	15%
4 parcels N. of MRF	93.67%	6.33%	1.93%	12.52%	0%	100%	NA	15%
657 W. Scott, Woodland	93.67%	6.33%	1.93%	12.52%	0%	100%	NA	15%

Q. AND WHAT WERE SOME OF YOUR THRESHOLD OBSERVATIONS?

A. As can graphically be seen from the above, Staff assumed that all properties except the warehouse properties were subject to the capital structure of HBI. The warehouse properties were assumed to be the same as the capital structure of HBII.

Q. WHY IS THIS INCORRECT?

A. Commission Staff’s assumption that any of the properties rented by WCI are subject to HBI and HBII capital structure is erroneous in that Staff is using the capital structure for entities that carry a large amount of debt for projects and investments that have no bearing on the actual properties being leased to WCI. HBI financed the building of a transfer station and is heavily leveraged as a result as is normal for large capital projects.

1 It isn't fair, just, reasonable, nor sufficient to penalize and seek to dilute the actual rents
2 paid by WCI because of the affiliates' debts on unrelated assets.

3 **Q. DID STAFF USE THE SAME LOGIC IN ITS COST OF DEBT ANALYSIS?**

4 A. Yes. Commission Staff has apparently erroneously attempted to employ a cost of debt
5 based on the overall debt of HBI and HBII. As shown in the table above, only two of the
6 assets are actually carrying any debt. As previously discussed, the cost of debt for these
7 two assets should not be calculated based upon debt incurred by HBI and HBII for
8 investments and projects that have no bearing on the operating assets rented to WCI.

9 **Q. AS AN ASIDE, DO YOU HAVE ANY VIEW AS TO WHETHER THE STAFF
10 SHOULD HAVE PERFORMED IN ITS COST OF DEBT ANALYSIS A
11 WEIGHTED COST OF DEBT STUDY IN CALCULATING THE RETURN ON
12 LEASED PROPERTIES?**

11 A. Yes, and it appears that Staff did not do so.

13 **Q. HOW AND WHY DO YOU TYPICALLY PERFORM AN ANALYSIS OF THE
14 WEIGHTED COST OF DEBT?**

14 A. Preparing a cost of debt study based on each separate debt instrument involved and the
15 percentage of debt outstanding times the interest rate when added together calculates your
16 weighted cost of debt. This insures the accuracy of the applicable cost of debt analysis in
17 any featured time interval. A weighted debt analysis may or may not have had any
18 material effect on the debt cost used in this case, but is simply one more standard
19 analytical tool that should be employed for thoroughness.

20 **Q. HOW DID STAFF CALCULATE ITS RETURN ON EQUITY AND WHY IS IT
21 INCORRECT?**

22 A. Commission staff simply selected two publicly traded companies and attempted to argue
23 that the results for these two companies apply to a small privately-held company. Staff
24 used a sample of a Real Estate Investment Trust (Annaly Capital) and a truck leasing
25 company, (Realty Income Corp.), from a Value Line DCF study of equity returns for
certain publically-traded companies to determine what an appropriate return on equity
should be. Please see the table below for illustration of this analysis.

1 **Q. DID STAFF ACTUALLY USE A DISCOUNTED CASH FLOW ANALYSIS**
2 **METHOD TO CALCULATE AN APPROPRIATE COST OF EQUITY?**

3 A. No. Staff mentions using the DCF approach when, in fact, they actually used the results
4 from the Value Line analysis verbatim and simply added the earnings growth and
5 dividend yield as seen in the table below. The sum of the two results is nothing remotely
6 representative of what a small private company should earn on its equity.

7 Demas Table No. 2

Company	Value Line earnings growth		Value Line dividend yield		Staff return on equity
Annaly Capital	-.08%	+	12.6%	=	12.5%
Realty Income Corp.	8.65%	+	4.5%	=	13.15%

12 Source: Staff Exhibit MC-6, in Tab Schedule 4, R-6E.

13 **Q. CAN YOU COMMENT PLEASE ON THE 15% COST OF EQUITY FACTOR V.**
14 **THE DIMINISHED VALUE PROPOSED BY STAFF HERE?**

15 A. The Commission has long used a 15% return on equity for affiliated transactions. Not
16 because of any exhaustive quantitative analysis, but simply for the lack of a better
17 thoroughly vetted number. Dr. Lurito, in his testimony supporting the Lurito Gallagher
18 Operating Ratio formula, justifies a much larger equity return for solid waste companies
19 as is readily observed in the formula itself. He recognized the associated risks a smaller
20 company faces in a regulated environment. The 15% ROE, by its relatively modest
21 return, has obviously been a fair return by not allowing overearning and not being
22 confiscatory, either.

23 **2. The Three-Factor Allocation Method**

24 **Q. PLEASE REVIEW AGAIN HOW THE COMMISSION STAFF PROPOSES TO**
25 **ALLOCATE COMMON COSTS BETWEEN THE REGULATED SOLID WASTE**
COMPANY, WASTE CONTROL, INC. AND THE OTHER NONREGULATED
AFFILIATE COMPANIES IN ITS TESTIMONY.

1 A. In my opinion, the UTC Staff has here, for instance in MC-7, invented a novel set of
2 allocation factors to allocate common costs between a regulated solid waste company and
3 its affiliates. The method is appropriately named the “Three-Factor Allocation Method.”
4 The three factors, as noted in the Testimony of Melissa Cheesman, are: revenues,
5 number of employees and net book value of fixed assets.

6 **Q. PLEASE DESCRIBE THE DIFFERENCE AMONG THESE ALLOCATORS AND
7 THEIR VALIDITY IN YOUR VIEW.**

8 A. While looking at Staff’s allocator revenue, it is easy at first glance to see why this
9 allocator is not appropriate. It is a classic “apples and oranges” comparison if you
10 compare revenues of disparate companies to allocate common expenses. Each company
11 within Waste Control’s affiliate group is entirely different in its orientation and largely in
12 its operations. Different rates are charged to a different type of customer base. The next
13 Staff allocator, number of employees, does have some value in allocating certain fixed
14 general and administrative overhead expense. Finally, the third criteria net book value of
15 fixed assets is, for me, a real puzzler. Net book values, again, are the depreciated net
16 book value of the deployed assets. With each affiliated company owning different types
17 of equipment and properties with differing lives and various dates of entering service,
18 there is nothing to uniformly measure that has anything to do with the separate entities’
19 paying their fair share of common costs as is the goal of most allocated expense
20 categories.

21 **Q. WHAT IS THE BEST ALLOCATOR FACTOR TO ATTRIBUTE COMMON
22 COSTS BETWEEN AFFILIATED COMPANIES IN YOUR VIEW?**

23 A. To allocate disparate entities, more static or fixed allocators are required, something all
24 companies share as common cost. The most likely scenario is with affiliated companies
25 sharing office and parking space as Waste Control does here. The question is how you
fairly separate these fixed costs appropriately amongst all companies. As noted, the
second criterion, number of employees does have some value in separating certain shared
overhead costs. Others may include but not be limited to, square footage of shared land

1 and buildings, in addition to number of employees and previously assigned costs. The last
2 method is a more simplistic approach that takes the percentage of regulated to non-
3 regulated operating expense and assigns this percentage to certain overhead accounts.
4 The goal in this selection is to determine which common costs exist and find an equitable
5 way of allocating those common costs.

6 **Q WHAT IS THE RESULT OF USING ALLOCATOR METHODS?**

7 A. The goal of this exercise is to clarify any misconceptions as to what is a good allocator
8 and why it qualifies as such. Selection of allocators is not simply a preconceived exercise
9 in attempting to defend an allocator after the fact that obviously skews results in favor of
10 one adjustment or party. Rather, the selection is an exercise in objectivity. What is the
11 fairest means of allocating common costs? Ironically, the selection of other allocator
12 criteria instead of the “Three-Factor” method used by Staff could very well result in
13 fewer expenses being allocated to the regulated company and in that situation actually
14 lowering revenue requirements. Regardless of the outcome, the Commission and any
15 other analyst should apprehend the correct methods of allocating costs and discern
16 whether they are consistent and accurate rather than establishing criteria with no credible
17 basis in practice. In my view, the “Three-Factor Allocation” method used by Staff in its
18 testimony is a rather contrived and self-serving approach to attributing shared operating
19 expenses to achieve an intended outcome.

20 **3. Kalama Operations**

21
22 **Q. BASED ON YOUR FAMILIARITY AND UNDERSTANDING OF THE**
23 **OPERATIONS OF WASTE CONTROL, INC. HOW WOULD YOU**
24 **CHARACTERIZE THE CITY OF KALAMA WITH RESPECT TO THOSE**
25 **OPERATIONS?**

A. Kalama is a small city contract within WCI’s larger regulated service territory within
Cowlitz County.

1 **Q. BASED ALSO ON YOUR UNDERSTANDING OF THE GENERAL RATE CASE**
2 **WORKPAPER RULES, AND SPECIFICALLY WAC 480-07-520(4)(d), DO YOU**
3 **CONCUR WITH THE COMPANY’S ORIGINAL INCLUSION OF KALAMA**
4 **OPERATIONS IN TOTAL COMPANY REVENUES?**

5 A. Yes, I do, and I understand they combined those results of operations as consistent with
6 rule and previous Staff advice.

7 **Q. WHAT IS YOUR VIEW OF THE STAFF’S SEPARATION IN THIS**
8 **PROCEEDING OF KALAMA REVENUES?**

9 A. I don’t think they were compelled to perform that separation nor do I think their resulting
10 separation of Kalama revenues was logical or accurate.

11 **Q. CAN YOU ELABORATE ON THAT?**

12 A. Yes. As generally described above, I believe the Staff has used incorrect allocation
13 factors to generate a 107% operating ratio in the test period. In my years as an analyst of
14 solid waste collection company filings, it would be highly unusual for any regulated solid
15 waste collection company who negotiates a city contract to incur as significant a loss as
16 that operating ratio reflects, particularly because the rates charged in Kalama are identical
17 to those in the regulated territory.

18 **Q. WHAT ALLOCATION FACTORS DID STAFF USE TO ALLOCATE KALAMA**
19 **RESULTS?**

20 A. Based on my review of their testimony in this proceeding, Commission Staff employed a
21 customer count and customer pickup methodology for allocating almost all of the
22 Company’s operating expenses again, resulting in a 107% operating ratio. In any event,
23 it is very difficult to achieve an accurate expense allocation for such a small “carve-
24 out/niche” of the Company’s operations and the Staff-derived operating ratio in MC-6, p.
25 3 is, in my opinion, indicative of that problem.

26 **Q. WITH REGARD TO THE RATIONALE FOR STAFF ALLOCATORS IN THE**
27 **CITY OF KALAMA, WHAT ARE YOUR OBSERVATIONS?**

28 A. The Staff concluded the Company route hours compilation was unreliable so they
29 apparently went to the City of Kalama and obtained the number of WCI customers billed

1 by the City. Staff then decided to use the City of Kalama customer statistics to produce
2 their allocation of operating expenses. "Number of customers" as an allocator can be
3 useful for some limited overhead costs such as a customer service center which receives
4 calls from both regulated and nonregulated customers.

5 **Q. WHY IN YOUR VIEW ARE THE STAFF ALLOCATORS USED FOR KALAMA**
6 **INCORRECT?**

7 A. Largely because of a basic fact. As noted, the municipal boundaries of Kalama sit in a
8 largely rural area of Cowlitz County. It takes more time and miles driven to pick up the
9 same number of customers in rural Cowlitz County than it does in the more densely
10 populated town of Kalama. The costs to serve customers in the rural area and the City
11 are entirely different, with the rural areas incurring much more cost, based on my
12 experience.

13 **Q. ARE THERE OTHER INFIRMITIES YOU WOULD NOTE IN USING**
14 **CUSTOMER PICKUPS AND CUSTOMER COUNTS FOR ALLOCATORS?**

15 A. Based on my experience and my recent review of privately-held garbage company solid
16 waste filings, it was further confirmed that the allocators used to separate regulated from
17 nonregulated operations are a measure of activity allocators versus static allocators.
18 Measuring hours (either truck or driver) to allocate regulated and nonregulated
19 operational expenses is much more realistic than just using customer count data, for
20 instance, which does not take into account the obvious differences in operating conditions
21 of regulated and nonregulated territories previously touched upon.

22 **Q. WHAT ADVANTAGES DO TRUCK OR ROUTE HOURS PROVIDE INSTEAD?**

23 A. Route hours, which can be either truck hours or driver hours, give a much more realistic
24 allocation between regulated rural and contract city operations. Since the rates assessed
25 again are the same here for both regulated customers and Kalama residents, we definitely
need to be able to differentiate between the cost to serve Kalama versus the higher cost to
serve rural regulated customers.

1 **Q. HAVE YOU BEEN ABLE TO IDENTIFY A MORE ACCURATE ROUTE HOUR**
2 **(TRUCK OR DRIVER) STATISTICAL STUDY FOR THE CITY OF KALAMA?**

3 A. Yes, in response to the Staff's testimony and its critique of the paucity or inconsistency of
4 data, the Company has prepared a more refined route analysis should the Commission
5 somehow decide to continue to separate Kalama operations. This study also allows for a
6 more reasonable route hour-based allocation of operating expenses in my opinion as
7 described by Ms. Davis's rebuttal testimony. By that revised calculation using route
8 hours, the operating ratio for separated Kalama operations is now approximately 89%.

9 **Q. ASSUMING THE COMMISSION DETERMINES NOT TO SEPARATE**
10 **KALAMA OPERATIONS FROM COMPANY-WIDE OPERATIONS, WHAT**
11 **WOULD BE THE EFFECT IF KALAMA WAS COMMINGLED INTO THE**
12 **COMPANY'S TOTAL RESULTS OF OPERATIONS?**

13 A. Again, I would advocate against separating out Kalama operations. The result would be
14 that all of Kalama's revenue and allocated expenses would revert back to WCI's results
15 of operations. Depending on which separated results the Commission considered the
16 most accurate, either Staff's 107% operating ratio or the Company's 89%, it could then
17 either reduce or increase WCI's revenue requirement. Using the Company's separated
18 Kalama results and combining this result with WCI company-wide results would have the
19 effect of lowering the overall revenue requirement which is a compromise the Company
20 may be willing to make.

21 **Q. IS THERE ANY OTHER OUTSTANDING ISSUE THAT NEEDS ADDRESSING**
22 **WITH RESPECT TO STAFF'S KALAMA CONCLUSIONS?**

23 A. Yes. A brief comment on Staff's disposal tonnage pro forma adjustment in P-5A.

24 **Q. WHAT CONCERNS DO YOU HAVE WITH THAT PARTICULAR**
25 **ADJUSTMENT?**

A. The Staff used Meeks weights to allocate disposal tons to Kalama on a per customer
basis.

Q. HOW WOULD THAT AFFECT THE ALLOCATION THEY PROPOSED?

1 A. Meeks weights are a starting point for use in rate design. The Commission’s Cost of
2 Service model starts with Meeks’ per can rates. In every case, the number of customers
3 times the Meeks weights do not equal the disposal tons. The Cost of Service model
4 basically just reduces or increases the weights evenly throughout all service levels so the
5 product of pickup times adjusted by weight equals the actual disposal tons.

6 **Q. HOW WOULD THAT AFFECT THE COMPANY HERE?**

7 A. The Staff allocation uses Meeks can weights times the number of pickups. Recalling that
8 its allocator in Kalama was based on customer counts or number of pickups, in this case,
9 the Staff calculates more disposal tons allocated to Kalama that actually should remain in
10 company-wide WCI operations. The actual disposal tons and number of customer
11 pickups are the constants. Again, the can weights are the variable and are always
12 changing.

13 **V. SUMMARY/CONCLUSIONS**

14 **Q. COULD YOU BRIEFLY SUMMARIZE WHAT YOUR CONCERNS ARE IN**
15 **TERMS OF THE ISSUES YOU HAVE CRITIQUED WITH RESPECT TO**
STAFF’S CASE?

16 A. Obviously first, is the introduction by Staff of novel, untried and ultimately flawed
17 criteria in establishing adjustments for affiliated land rents on the basis of three input
18 components upon which their proposed return is derived. Secondly, the Staff has
19 introduced a new “Three-Factor Allocator” criteria in place of more established,
20 consistent and accepted approaches using the allocators previously mentioned. Third, the
21 use of customer count data obviously has a significant effect in skewing calculations of
22 regulated and nonregulated operation expenses in the City of Kalama. In Kalama, the
23 wholesale separation of Kalama revenue and expenses that relies upon customer counts
24 and pickup numbers dramatically reconfigures the Company’s results of operations in a
25 way that is indefensible to consistent ratemaking methodological calculations. The
impact of Staff attempting on its own to separate out Kalama results is ultimately a

1 bootstrapping exercise designed to support quantitative results that have no basis in
2 ratemaking reality in my opinion.

3 **Q. DOES THAT CONCLUDE YOUR TESTIMONY HERE?**

4 A. Yes it does.

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