

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION

Complainant,

v.

WASTE CONTROL, INC.

Respondent.

DOCKET TG-140560

COMMISSION STAFF ANSWER  
TO WCI'S PETITION FOR  
ADMINISTRATIVE REVIEW

**I. INTRODUCTION**

**A. Overview**

1 The Commission Staff (“Staff”) and Waste Control, Incorporated (“WCI” or “Company”) (collectively “Parties”) have spent approximately 21 months and two dockets<sup>1</sup> engaged in a lengthy and, often times, contentious general rate proceeding.<sup>2</sup> The Parties did settle a number of issues in late 2014, the Initial Order approved the settlement,<sup>3</sup> and all Parties continue to support the partial settlement.

2 Four issues remain in dispute, and the Commission’s Initial Order largely sided with Staff’s position on all four of those disputed issues. The extensive evidentiary record,

<sup>1</sup> For reference, WCI initially filed its general rate case as TG-131794 in September 2013. The Commission dismissed that filing as inadequate on March 25, 2014. The Company then re-filed its general rate proceeding as Docket TG-140560 on April 4, 2014.

<sup>2</sup> Washington Refuse and Recycling Association (“WRRA”) is also an intervening party in this proceeding.

<sup>3</sup> *WUTC v. Waste Control, Inc.*, Order 12 (Initial Order), p. 8 ¶22 (June 8, 2015).

longstanding Commission precedent, and basic regulatory accounting principles support the Initial Order's findings and conclusions.

3 Staff recognizes that the Commission's obligation is to set fair, just, reasonable, and sufficient rates, and the adoption of Staff's three factor allocator or affiliate rents transactions methodology in this case does not permanently bind the Commission or the solid waste industry to those specific calculations across all cases and circumstances. Staff's recommendations are, however, the most fair and reasonable proposals in this case and the Commission should adopt the entirety of the Initial Order as a Final Order.

#### **B. Summary of Remaining Issues**

4 The ALJ's Initial Order addressed the four remaining issues:

1. Shared Utilities Expense, Adjustment R-6D. WCI has numerous affiliates. The Company and its affiliates share facilities. Staff and the Company dispute the amount of utility expenses from those shared facilities that should be allocated to WCI. The Initial Order adopted Staff's allocation methodology and allowed WCI to recover \$15,424 of shared utility expenses in rates.
2. Affiliate Land Rents, Adjustment R-6E. WCI leases its facilities from affiliated entities. Staff and the Company dispute the allowable amount of affiliate land rents between WCI and its affiliate landlords. The Initial Order adopted Staff's calculation and allowed WCI to recover \$85,217 for affiliate rent transactions in regulated rates.
3. Rate Case Expenses, Adjustments P-2 and P-3. Staff and the Company dispute the amount of rate case costs that should be recoverable in rates. The Initial Order found the rate case costs imprudent and adopted Staff's proposal to allow the Company to recover 100% of costs for the informal audit process in Docket TG-131794, 50% of costs for the formal adjudicative proceeding in Docket TG-131794, and 50% of costs for the formal adjudicative proceeding in Docket TG-140560.
4. Investigation Fees. Staff and the Company dispute whether the Commission should require WCI to pay the costs of Staff's investigation fees.<sup>4</sup> The Initial Order required the Company to pay \$43,818.82 for investigation fees.

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<sup>4</sup> Supplemental Testimony of Melissa Cheesman, Exhibit No. \_\_\_\_ (MC-13T), p. 7 lines 8:11 (Feb. 2, 2015); Initial Brief on Behalf of Staff, p. 29 ¶68 (Nov. 7, 2014).

5           The first two issues noted above, Shared Utilities Expense and Affiliate Land Rents, are fairly straightforward accounting disputes that relate to affiliate transactions and cross-subsidies. The Initial Order found in favor of Staff on these substantive accounting issues because of both expert testimony and a series of very basic accounting concepts that are well-understood and well-documented in regulatory ratemaking. The Company's arguments on these accounting issues are simply misguided and inaccurate.

6           The third and fourth issues listed above are slightly different. The disputes surrounding Rate Case Expenses and Investigation Fees are largely unique to this proceeding. Under the circumstances in this case, where the Company filed a statutorily inadequate rate case in Docket TG-131794 and then took illogical positions in both Docket TG-131794 and TG-140560, Staff argued, and the Initial Order found, that the Company should not be able to recoup all of its rate case costs from ratepayers. The Initial Order also imposed Investigation Fees on the Company under RCW 81.20.020.

## II. SHARED UTILITY EXPENSE

### A. Initial Order Findings

7           The Initial Order found that WCI's first proposals were unsubstantiated and the Company's final proposal contravened generally accepted allocation principles.<sup>5</sup> Both conclusions are accurate and fully supported by the evidentiary record.

### B. Background

8           WCI and its affiliates share certain facilities and employees. Those facilities incur utility expenses for power, water, etc. The Parties disputed the proper allocation of those utility expenses between WCI and its affiliates. Staff advocated allocating common, indirect

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<sup>5</sup> Initial Order, pp. 12-13, ¶33; Initial Order, p. 31 ¶90 (Findings and Conclusions (8)).

utilities costs using a three-factor allocator.<sup>6</sup> Staff's "three factor" recommendation allocates common utilities costs on the basis of each entity's overall impact on those shared costs.<sup>7</sup> The *overall* impact is measured by size and scope of each affiliate's *overall* operations. The concept is transparent and reasonable. The Company's proposals were either unsupported, not actually provided at all, or contravene fundamental accounting principles and Commission precedent.

### C. Company's Proposals

#### 1. "1-divided by 3"

9 First, in its direct testimony, the Company proposed to allocate shared utilities expense based on the number of affiliates sharing a facility. For example, if three affiliates share space, WCI advocated a one-third (1/3) allocation of shared utilities expenses for each entity without any further analysis.<sup>8</sup> The Company did not provide any support, data, or even an explanation for the "1-divided by-3" methodology anywhere in the record. The Initial Order thus reasonably concluded that such a proposal was unsupported and unreasonable.

#### 2. The Imaginary Square Footage Proposal

10 In rebuttal testimony, the Company advocated the use of another, unspecified allocation methodology apparently based on square footage.<sup>9</sup> But WCI did not propose a narrative of its methodology, supporting data and calculations, or even the resulting

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<sup>6</sup> The Initial Order accurately summarizes Staff's three-factor allocator. Initial Order, pp. 9-10 ¶¶23-24. Staff's testimony also explained the purpose and methodology of its allocator several times throughout the record. *See, e.g.*, Testimony of Melissa Cheesman, Exhibit No. \_\_\_ (MC-1T), p. 15:9 – p. 17:11 (July 18, 2014).

<sup>7</sup> Cheesman, MC-1T, pp. 15:6 – 17:19 (July 18, 2014).

<sup>8</sup> Cheesman, MC-1T, p. 18: 3-9 (July 18, 2014).

<sup>9</sup> *See* Rebuttal Testimony of Jackie Davis, Exhibit No. \_\_\_ (JD-41T), pp. 11-12 (August 20, 2014).

allocator.<sup>10</sup> The Company never put forward an actual square footage allocation, and the Initial Order rightly concluded that the proposal, or lack thereof, was unsupported and unreasonable.<sup>11</sup> Staff also noted that allocating by square footage was impossible in this case because WCI and its affiliates all share the same employees, physical space, and equipment.<sup>12</sup>

### 3. Allocating Direct Costs to Subsidize Non-Regulated Operations

11 The Company's last proposal violates basic accounting principles. The Company argued to reduce its affiliates' allocation of expense for shared facilities because of approximately \$59,000 the affiliates incurred for expenses in their own, exclusive-use facilities.<sup>13</sup> WCI's is asking the Commission to allocate shared costs using non-shared costs. More simply, WCI is asking regulated ratepayers to pay costs that WCI did not cause. Such a proposal is inconsistent and a clear request for subsidy from regulated operations to non-regulated operations.

12 As Staff pointed out numerous times, the Commission, along with virtually every text on regulatory ratemaking, has stated that direct costs should be directly assigned.<sup>14</sup> Where costs cannot be directly assigned, the remaining common, indirect costs should be allocated to reasonably reflect cost causation.<sup>15</sup> Even the Company's expert witness acknowledged in oral testimony that only indirect costs are allocated.<sup>16</sup> WCI's proposal to

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<sup>10</sup> See Rebuttal Testimony of Layne Demas, Exhibit No. \_\_\_ (LD-1T), at pp. 7-8 (Aug. 20, 2014) and Davis, JD-41T, pp. 11-13.

<sup>11</sup> Initial Order, pp. 12-13 ¶33 ("The other alternatives proposed by WCI also lack substantive justification").

<sup>12</sup> Initial Brief on Behalf of Commission Staff, p. 9 at footnote 31 (Nov. 7, 2014).

<sup>13</sup> Demas, LD-2T, p. 2:22-24, (Nov. 7, 2014) and Cross-examination of Layne Demas, TR. 51 lines 5:22.

<sup>14</sup> Cheesman, MC-1T at 15:18-20; Initial Brief on Behalf of Commission Staff, p. 6 ¶¶12-13 and accompanying footnotes. See also Redirect of Melissa Cheesman, TR. 301:14-20 (explaining that the allocator applied only to shared facilities).

<sup>15</sup> See, e.g. *supra* note 14.

<sup>16</sup> See Demas, TR. 60 line 17 ("Indirect cost is allocated cost.")

offset common, indirect costs with direct costs plainly contradicts the longstanding regulatory principle. Therefore, the Initial Order correctly concluded that the Company's last proposal goes against basic ratemaking concepts and is thus unreasonable.

#### **4. WCI did not put forward any supported alternative**

13 At the evidentiary hearing, Staff counsel asked the Company's expert witness whether WCI had put forward and adequately supported an alternative allocation methodology.<sup>17</sup> The Company's own expert witness responded that he was unaware of any alternative proposal from the Company. Staff, on the other hand, thoroughly explained its recommendation and provided the relevant supporting rationale and regulatory bases.<sup>18</sup> Therefore, the Initial Order's findings and conclusions that largely support Staff's proposal for Shared Utilities Expense are fair, just, reasonable, and sufficient.

### **III. AFFILIATE LAND RENTS**

#### **A. Initial Order Findings**

14 The Initial Order adopted Staff's recommendations for each of the inputs in the affiliate lease calculation (i.e. capital structure, return on equity, cost of debt, and allocation of depreciation and average net investment). Again, the common theme is that WCI's proposals are either unsubstantiated or contradict basic regulatory accounting principles. The Initial Order's conclusions are both correct and fully supported by the evidentiary record.

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<sup>17</sup> Demas, TR. 49:17-20.

Q. Now, in your opinion, has the Company put forward an alternative allocation methodology and adequately supported it on this record?

A. Not that I'm aware of.

<sup>18</sup> Cheesman, MC-1T, pp. 15-17 generally and 16:13-17:6 specifically (July 18, 2014); Testimony of Melissa Cheesman in Support of Proposed Partial Settlement Agreement, Section V.C., p. 21, lines 10 through 22 (Oct. 13, 2014); Cheesman, TR. 299:20 – 303:2.

## B. Background

15 WCI leases all of its facilities from Heirborne Investments I LLC (“HBI”) and Heirborne Investments II (“HBII”) (collectively “landlords”). WCI shares 100% common ownership with HBI and HBII. Consequently, WCI’s rent payments to HBI and HBII are affiliate transactions. The Parties agreed to an affiliate lease calculation/methodology previously endorsed by the Commission.<sup>19</sup> The Commission’s previously-accepted calculation relies on capital structure, cost of debt, cost of equity, and allocation of depreciation and average net investment. Staff and WCI disagree as to the appropriate values for all of these terms.

## C. Staff’s Response to WCI’s List in the Petition for Administrative Review

16 WCI’s petition for review includes a list of arguments against the Staff recommendations and the Initial Order’s findings related to affiliate land rents.<sup>20</sup> Each of the Company’s listed positions demonstrates a misunderstanding of regulatory accounting and financial concepts. Staff provides the following list of responses in order:

- WCI begins by arguing that there is no evidence in this case of manipulating equity and debt ratios. First, the Company does not dispute that its proposed arrangement incents and allows for such manipulation. The economic incentive alone is sufficient for the Commission to disallow the Company’s proposal. In any event, as Staff explained, its concerns are not hypothetical. Although all of the affiliate entities’ assets secure HBI’s and HBII’s debts,<sup>21</sup>

<sup>19</sup> See Partial Settlement Agreement, ¶8. The Parties’ agreed methodology derives from *WUTC v. Bremerton-Kitsap Airporter*, Docket TC-001846, Fifth Supplemental Order, Appendix C (August 2, 2002).

<sup>20</sup> WCI Petition for Administrative Review, pp. 14-15 ¶24.

<sup>21</sup> Rebuttal Testimony of Joe Willis, Exhibit No. \_\_ (JW-7), p. 2 (August 20, 2014); Cheesman, MC-1T, p. 20 footnote 19; Cheesman, Exhibit No. \_\_ (MC-3), pp. 1-4 (July 18, 2014).

WCI argues in this proceeding that the vast majority of HBI and HBII debt is associated only with non-regulated operations.<sup>22</sup> WCI and its affiliates have thus already implemented a series of financial transactions to selectively apportion debt to non-regulated operations and equity to regulated operations.<sup>23</sup> Whether intentional or not, the Company's proposal incents manipulation of asset-specific debt ratios through affiliate transactions with no corresponding change in risk profile or benefits to ratepayers.

- The Company next attempts to distinguish cross-collateralization from mortgaging real property. This argument is a fiction. The Company acknowledged and Staff explained that the landlords pledged all of their assets, including all real estate, to guarantee debt financing.<sup>24</sup> The landlords then use rental transactions from the tenant, i.e. WCI, to repay the same debt financing.<sup>25</sup> Staff explained that the transaction is economically identical to a mortgage.<sup>26</sup> The Company's attempt to distinguish the two types of transactions relies purely on semantics and ignores the basic economic reality that all of the buildings are encumbered with a pro rata share of all of the ownership entities' debts.
- WCI then points to Lurito-Gallagher as not sanctioning consolidation of assets of sister companies. This argument confuses financial concepts. The

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<sup>22</sup> See Davis, JD-1T, p. 4: 22-25 and p. 9:21 – 10:3 (April 3, 2014); see also Davis, JD-41T, pp. 14-16, and JD-43T (Aug. 20, 2014) (proposed land rents calculation); Willis, JW-7T (Aug. 20, 2014), p. 2 (“each of the entities . . . are guarantors”). See also Cheesman, MC-1T, p. 20, lines 3-4

<sup>23</sup> See Cheesman, MC-13T, p. 5:13-16 (Feb. 2, 2015); Demas, LD-1T, p. 4 (Aug. 20, 2014) (claiming that the landlords' debts are associated only with non-regulated operations)

<sup>24</sup> Willis, JW-7, p. 2. See also Cheesman, MC-1T, p. 20 footnote 19; Cheesman, MC-3, pp. 1-4 (July 18, 2014).

<sup>25</sup> See Cheesman, TR. 305 lines 10:19.

<sup>26</sup> Cheesman, TR. 305 lines 13:19.



computation for affiliate lease transactions between WCI and its landlords is distinct from the Lurito-Gallagher regression used to calculate solid waste revenue requirements. They are two different formulas used in two different circumstances. The Lurito-Gallagher formula is not used to calculate affiliate land rents. The Company's argument on this point is thus irrelevant.

- The Company next argues against any analogies to regulated utility rate cases for cost of debt and cost of equity for solid waste companies. First, the landlords are not solid waste companies. More important, Staff's positions rely on overarching, basic financial concepts such as balance sheets, financial reporting, discounted cash flow valuations, and public security filings. These concepts are widely understood across all industries, including solid waste and real estate companies.
- WCI goes on to claim that Staff's DCF analysis relied on an inappropriate sample group and that the Initial Order should not have adopted a dynamic cost of capital approach for landlords of solid waste companies. First, it is important to note that the Company did not provide any alternative sample group<sup>27</sup> and readily stated that its proposed ROE was not supported by any form of quantitative analysis.<sup>28</sup> Staff, on the other hand, explained the basis for its sample group and documented its analysis.<sup>29</sup> Second, the Company's argument that fundamental financial concepts such as ROE should somehow cease to exist within the confines of WCI's affiliate transactions with its

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<sup>27</sup> Cheesman, TR. 307:16-20.

<sup>28</sup> Demas, LD-1T, p. 6:15-17 (Aug. 20, 2014).

<sup>29</sup> *E.g.*, Cheesman, MC-1T, p. 21:12-17 (July 18, 2014); Initial Brief on Behalf of Staff, pp. 18-19 ¶43; Cheesman, TR. 203-215.

landlords is not supported in any academic literature or legal precedent.

- The Company then notes that Dr. Lurito specifically rejected analogies of comparative risk factors between garbage companies and public utility companies. Again, HBI and HBII are not garbage companies, they are real estate ventures. Staff's analysis for equity returns appropriately focused on real estate companies. It is also important to note that Dr. Lurito's testimony took place more than two decades ago in an unrelated proceeding.<sup>30</sup> Such testimony is not relevant to current cost of capital discussions.
- WCI next points to the lack of precedent for Title 81 cases to update return for affiliate rent transactions. The Company presumably refers to Staff's recommended return on equity for HBI and HBII. Again, as Staff explained numerous times, basic financial theory states the return on equity fluctuates over time.<sup>31</sup> WCI is effectively asking the Commission to pretend the cost of capital is static and guarantee its affiliated landlords an unsupported return.
- The Company goes onto argue that a 15% return on equity for affiliate rent transactions had somehow been permanently ratified by the Commission in prior cases. This is simply inaccurate. The case the Company cites took place nearly 15 years ago and does not guarantee or even speak to the permanence of a 15% ROE.<sup>32</sup> There have not been any fully-litigated solid

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<sup>30</sup> Dr. Lurito's testimony took place in approximately 1990 and focused on the continued use of the Lurito-Gallagher regression in solid waste ratemaking and an additional 75 basis points to be added to the ROE. *WUTC v. Sno-King Garbage Co.*, Dockets TG-900657/TG-900658 (consolidated), Fourth Supplemental Order (Final) (December 10, 1991). See also Demas, LD-1T, p. 6:16-18 (Aug. 20, 2014) and Initial Brief on Behalf of Staff, p. 19 ¶44.

<sup>31</sup> Cheesman, MC-1T, p. 22:16-18 (July 18, 2014) ("the cost of equity has a temporal component . . ."); Initial Brief on Behalf of Staff, p. 18 ¶43; Cheesman, TR. 306:13-22.

<sup>32</sup> *WUTC v. Bremerton-Kitsap Airporter, Inc.*, Docket TC-001846, Fifth Supplemental Order (Final) (Aug. 2, 2002).

rate cases in that time. Most important, the Commission, and every legitimate financial text, recognizes that equity returns fluctuate over time and capital market conditions.<sup>33</sup> The Commission is not inflexibly bound by decades-old cases and circumstances, and regulatory ratemaking clearly sides with financial theory in recognizing changing ROEs.<sup>34</sup>

- WCI then argues against Staff's three factor allocation for depreciation and net investments. Conspicuously absent is the Company's acknowledgement that it did not put forward any legitimate and supported allocator in this proceeding.<sup>35</sup> Staff's allocator is documented, transparent, and reasonably estimates cost causation.<sup>36</sup> The Initial Order correctly recognized that's Staff's allocation methodology was the only legitimate and supported recommendation in this proceeding.
- The Company next takes issue with the concept of declining returns on depreciating assets. Staff testified that the nominal amount of returns does decrease over the life of an asset because customers should not pay for depreciated assets forever.<sup>37</sup> The Commission does not allow companies to

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<sup>33</sup> *E.g.*, CHARLES F. PHILLIPS JR., *THE REGULATION OF PUBLIC UTILITIES*, p. 380 (1993); *WUTC v. Pacific Power & Light Co.*, Docket UE-130043, Order 05 (Final Order), p. 8 ¶24 (Dec. 4, 2014). For long-term analyses of the fluctuating costs of capital throughout human history, *see generally* WILLIAM J. BERNSTEIN, *BIRTH OF PLENTY: HOW THE PROSPERITY OF THE MODERN WORLD WAS CREATED* (2004) *and* WILLIAM J. BERNSTEIN, *A SPLENDID EXCHANGE: HOW TRADE SHAPED THE WORLD* (2009).

<sup>34</sup> *See* LEONARD SAUL GOODMAN, *THE PROCESS OF RATEMAKING, VOLUME I*, pp. 606 (1988) (describing "Cost of Equity. General Principles")

<sup>35</sup> *Supra* note 17 (citing Demas, TR. 49:17-20 for the proposition that the Company did not put forward any supported allocation methodology).

<sup>36</sup> Cheesman, MC-1T, pp. 15-17 generally and 16:13-17:6 specifically (July 18, 2014); Cheesman in Support of Partial Settlement Agreement, Section V.C., p. 21, lines 10 through 22 (Oct. 13, 2014); Cheesman, TR. 299:20-303:2.

<sup>37</sup> Cheesman, MC-1T, p. 20:11-18 (July 18, 2014) ("The very nature of cost plus a return has a declining cost recovery when assets are fully depreciated and no new improvements are placed into service. If this was not the case, ratepayers would have to pay for a fully depreciated asset forever.")

collect returns on fully depreciated assets forever, and it should not allow a Company to achieve such treatment through affiliate transactions.<sup>38</sup> WCI's argument to use affiliate transactions to engineer permanent recovery of depreciated assets reflects a misunderstanding of regulatory accounting.

- Lastly, WCI makes a general accusation that Staff is mistreating the Company and intentionally seeking the lowest possible returns. WCI also argues that Staff's approach is unprecedented. Absent the Company's continuing and unsubstantiated accusations, there is absolutely no evidence in this proceeding that Staff mistreated or otherwise intentionally targeted WCI. Further, the affiliate rent calculation methodology chosen by Staff is the exact methodology endorsed by the Commission more than a decade ago.<sup>39</sup> As for the specific inputs, Staff has provided extensive testimony documenting the reasons and regulatory bases for its recommendations.<sup>40</sup>

#### **D. Summary of Staff Positions and Support for the Initial Orders findings for each of the inputs in Affiliate Land Rents<sup>41</sup>**

##### **1. Capital Structure**

17 The Parties' dispute over capital structure is the most significant accounting dispute in this case. The underlying facts, positions of the parties, and the accompanying evidentiary record are fairly straightforward. WCI argues for a building-specific capital structure, while

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<sup>38</sup> *Id.*

<sup>39</sup> *WUTC v. Bremerton-Kitsap Airporter, Inc.*, Docket TC-001846, Fifth Supplemental Order (Final) Appendix C (Aug. 2, 2002).

<sup>40</sup> Cheesman, MC-1T, pp. 18-22 (July 18, 2014); Initial Brief on Behalf of Staff pp. 11-21; Cheesman, MC-13T pp. 4-6 and p. 14 (February 2, 2015); Cheesman, TR. 303:3 – 308:4; Reply Brief on Behalf of Staff p. 6 ¶12 through p. 11 ¶23 (Mar. 27, 2015).

<sup>41</sup> This section gives an overview of the basic premises supporting Staff's positions on each of the four inputs in the affiliate lease calculation (Capital structure, return on equity, cost of debt, and allocation of depreciation and average net investment) and the Initial Order's findings related to affiliate land rents. Portions of this section do admittedly, and unavoidably, repeat the previous section responding to WCI's arguments.

Staff advocates use of each of the landlords' actual, company-wide capital structures. WCI also notes its objection to calculating affiliate land rents on the basis of non-regulated affiliates; that is, the Company believes its landlords' capital structures are inappropriate because those companies are not directly regulated. The Company's positions demonstrate a fundamental misunderstanding of regulatory accounting and financial concepts.

**a. Actual sources of financing**

18 Staff explained that HBI's and HBII's balance sheets document those entities' sources of financing.<sup>42</sup> Staff calculates a return on the basis of those actual sources of financing and associated costs.<sup>43</sup> There is thus nothing hypothetical about Staff's proposal. The Company proposes a building- or asset-specific capital structure. In substance, WCI argues that its landlords should be able to apportion debt and equity among assets at their discretion. Staff testified that the term capital structure refers to an entity's debt and equity positions on its balance sheet.<sup>44</sup> The Company's proposal to deviate from the standard accounting definition is thus a hypothetical capital structure that invites cross-subsidies. The Initial Order appropriately rejected the Company's position for hypothetical, and easily manipulated, asset-based capital structures.

**b. Cross Subsidies**

19 The Company's proposal allows for and incents cross-subsidies. Staff's expert explained that cash flows from the regulated company through a real estate holding company to repay loans that other affiliates used to finance regulated and non-regulated

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<sup>42</sup> Cheesman, TR. 303 line 4 through 304 line 8.

<sup>43</sup> Cheesman, MC-1T, p. 18 lines 17:21 and p. 20 lines 1:3 (July 18, 2014)

<sup>44</sup> Cheesman, TR. 303:7 – 304:8.

operations.<sup>45</sup> WCI also guarantees those loans, which are HBI and HBII debts.<sup>46</sup> The regulated company, WCI, thus subsidizes the cost of debt to the holding companies through an express guarantee and then pays for that same debt through affiliate rent transactions. Even though those transactions are largely debt-financed, the Company argues that its landlords should be able to apportion debt and equity percentages among the buildings and other assets. The Company then argues that the landlords' equity should be apportioned to facilities leased to regulated operations and debt should be apportioned to those facilities associated with the owners' non-regulated business ventures. In substance, WCI is asking the Commission to approve equity-priced payments for debt financing, with the difference going to its shareholders' outside business ventures. Staff pointed out that such an arrangement results in regulated ratepayers subsidizing non-regulated operations.<sup>47</sup> Regulated ratepayers should not subsidize shareholders' non-regulated business ventures.

### **c. Encumbrances**

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WCI argues that its landlords' buildings are not encumbered with debt. Staff explained that the Company's position is based on a false distinction.<sup>48</sup> Staff demonstrated numerous times that the landlords' creditors hold claims against all of the landlords' assets, not just those that are rented to non-regulated businesses.<sup>49</sup> The buildings leased to WCI are thus encumbered for all practical purposes. There is simply no economic difference

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<sup>45</sup> See Cheesman, Exhibit MC-3, July 18, 2014, at pp. 3-4. See also Demas, LD-1T, p. 4 lines 23:25 (describing landlords HBI and HBII as "entities that carry a large amount of debt for projects and investments that have no bearing on the actual properties being leased to WCI.")

<sup>46</sup> Willis, Exhibit JW-7 (letter from WCI counsel explaining that lenders hold claims against WCI's assets, including its cash flows); Willis, TR. 82:18 through 83:1.

<sup>47</sup> Cheesman, MC-1T, p. 22:7:11 (July 18, 2014); Cheesman, MC-13T, p. 5:13-16 (Feb. 2, 2015).

<sup>48</sup> Cheesman, TR. 305 lines 13:19.

<sup>49</sup> Willis, Exhibit JW-7 (letter from WCI counsel explaining that lenders hold claims against all assets of HBI and HBII as well as the assets of all other affiliates); see also Cheesman, Exhibit MC-3.

between pledging assets to obtain debt financing and mortgaging those assets directly to obtain debt financing.<sup>50</sup> The difference is particularly fictional where the Company is using income from the pledged assets to repay the debt.

**d. Using affiliate landlords to calculate rents**

21           The concept of cost-plus-return is inherently linked to the entity that incurs the cost and is entitled to the return. In land rent transactions, the appropriate party is, of course, the landlord. The landlord owns the building and presumably incurs the costs associated with maintaining the asset. Therefore, it is appropriate to calculate rents in this case based on the financial structure of the landlords, HBI and HBII.<sup>51</sup> WCI's arguments to calculate cost-plus-return rates on the basis of a tenant instead of the landlord demonstrate a misunderstanding of cost-plus-return pricing and regulatory accounting.

**e. General bases for Staff's recommendation on capital structure**

22           Although RCW 81.16.030 is aimed at removing cross-subsidies and the Commission has long taken the position that regulated entities should not subsidize non-regulated businesses, WCI argues that the Commission should ignore its landlords' financing arrangements, cross-subsidies, and the various affiliate companies' economic obligations to creditors. Given Staff's detailed testimony, the statutory regime, and a few fundamental regulatory principles, the Initial Order reasonably and fairly adopted Staff's recommended capital structure for calculating affiliate lease payments.

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<sup>50</sup> Cheesman, TR. 305 lines 13:19.

<sup>51</sup> It is also well within the Commission's statutory authority because it is an affiliate transaction. RCW 81.16.030.

## 2. Return on Equity

23 WCI argues that its landlords are entitled to a flat 15 percent return on equity. The  
Company acknowledges that there is no quantitative basis for its proposal.<sup>52</sup>

24 Staff argues that the return on equity is a dynamic number that changes from time  
period to time period.<sup>53</sup> Staff's proposal is supported by a discounted cash flow ("DCF")  
calculation using a sample group of real estate investment companies with similar capital  
structures to HBI and HBII.<sup>54</sup> Staff obtained financial data from the Securities and  
Exchange Commission's database and the ValueLine Investment Survey database.<sup>55</sup> Staff  
explained that both of these sources are credible, primary sources within the financial  
community.<sup>56</sup>

25 The Company again failed to put forward any support for its recommendation. Staff,  
on the other hand, conducted a thorough, transparent analysis that is documented and  
explained multiple times in the record. The Initial Order's conclusion to follow Staff's  
recommendation is thus reasonable and fully supported.

## 3. Cost of Debt

26 Cost of debt is also a straightforward dispute. The Company advocates for an asset-  
specific cost of debt.<sup>57</sup> That is, WCI argues that its landlords should be allowed to allocate  
specific debt obligations to specific assets. Staff recommends using the cost of debt readily  
observable on the landlords' financial statements.<sup>58</sup> The actual, company-wide costs of debt

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<sup>52</sup> Demas, LD-1T, p. 6:15-16 (August 20, 2014); Initial Brief on Behalf of Staff, p. 19 ¶44 (Nov. 7, 2014).

<sup>53</sup> Cheesman, MC-1T, p. 22:16-18 (July 18, 2014).

<sup>54</sup> Cheesman, MC-1T, p. 21:12-17 (July 18, 2014); Cheesman, TR. 307:1-10.

<sup>55</sup> Cheesman, MC-1T, p. 21 at footnote 21 (July 18, 2014).

<sup>56</sup> Cheesman, TR. 307:11-15.

<sup>57</sup> Davis, JD-41T, p. 21 (August 20, 2014).

<sup>58</sup> Cheesman, MC-1T, p. 21:5-9 (July 18, 2014). Staff also agreed to amortize the loan origination fees over the life of the loan and add those to the cost of debt figures. Cheesman, MC-13T, p. 5:7-8 and footnote 7 (Feb.



are transparent, measurable, and easily verified. And, as Staff testified, use of the landlords' company-wide debt costs avoids cross-subsidies and recognizes the underlying economic reality that creditors hold equal claims against all of the landlords' assets.<sup>59</sup>

27 Staff's proposal is reasonable and the Staff analyst explained and documented her rationale numerous times. The Initial Order's conclusion is thus fair and reasonable.

#### **4. Allocation of Depreciation and Average Net Investment**

28 Staff allocates depreciation and average net investment using its three-factor allocator.<sup>60</sup> Staff testified to the rationale behinds its allocator multiple times in oral and written testimony.<sup>61</sup> Most important, the Commission should recognize that Staff has put forward a reasonable analytical methodology while the Company has proposed "1-divided by-3."<sup>62</sup> WCI has not offered any analysis, documentation, or even an explanatory narrative of its proposal.<sup>63</sup> Staff was the only party providing analysis on this issue, and Staff's proposal was the only supported recommendation in the record of this proceeding. Therefore, the Initial Order correctly and reasonably adopted Staff's proposal.

#### **5. Staff's positions are not new**

29 Staff's testimony documents the regulatory basis for each of its recommendations.<sup>64</sup> Nearly all of Staff's positions, including ideas of allocating only indirect costs, cost-plus-return, disallowing cross subsidies, and closely reviewing affiliate lease transactions and

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2, 2015).

<sup>59</sup> See Cheesman, MC-1T, p. 22:12-14 (July 18, 2014); Cheesman, MC-13T, p. 5:13-16 (Feb. 2, 2015); Initial Brief on Behalf of Staff, pp. 17-18 ¶41 (Nov. 7, 2014).

<sup>60</sup> Cheesman, MC-1T, p. 20:6-9 (July 18, 2014); Cheesman, MC-13T, p. 5:9-10 (Feb. 2, 2015) (recommending use of the updated three factor allocator).

<sup>61</sup> See Initial Brief on Behalf of Staff, pp. 2-3 ¶¶4,5, p. 5 ¶10, and pp. 6-8 ¶¶12:16; Cheesman, MC-1T, pp. 16:13 - 17:6 (citing to Exhibit MC-7); Cheesman, TR. 300 lines 7:16.

<sup>62</sup> See Cheesman, TR. 299:20 – 302:19.

<sup>63</sup> Cheesman, TR. 299:20 – 300:3.

<sup>64</sup> See generally, e.g., Cheesman, MC-1T (July 18, 2014) (where each recommendation includes a response to the question "What is the regulatory basis for your recommendation?").

non-regulated operations, are not new. Indeed, many of these regulatory concepts go back several decades, and the Commission's statutory authority to disallow unreasonable affiliate transactions dates to 1933.<sup>65</sup> The Uniform System of Accounts, which documents general accounting standards for regulated solid waste companies and includes a section on affiliate transactions was initially published in the 1960s and has remained completely unchanged for over 20 years.<sup>66</sup>

#### IV. GENERAL RATE CASE COSTS

##### A. Initial Order Findings

30 The Initial Order found the Company's rate case costs exorbitant. The ALJ subsequently adopted Staff's proposal to allow the Company to recoup in rates 100% of costs in the informal auditing process and then 50% of costs associated with the adjudicative proceedings in TG-131794 and TG-140560. The Initial Order appropriately cites to the Company's conduct during the rate proceeding and Commission's obligation to balance shareholder and ratepayer interests in allowing only prudently incurred costs.

##### B. Background

31 It is important to note that WCI's petition for review changes the Company's position on rate case costs.<sup>67</sup> The Company now seeks 100% of costs associated with the informal process in TG-131794, 50% of costs associated with the formal adjudicated process in TG-131794, and 100% of costs associated with TG-140560. Therefore, the Company's

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<sup>65</sup> RCW 81.16.030.

<sup>66</sup> Uniform System of Accounts for Class A and B Solid Waste Collection Companies ("USOA"), Prescribed by the Washington Utilities and Transportation Commission, p. 14 (Revised ed. Jan. 1992)

<sup>67</sup> Prior to filing its petition, the Company's litigation position was recovery of 100% of all rate case costs. WCI's Initial Brief, p. 8 ¶15 (Nov. 7, 2014).

petition appears to contest only the Initial Order's determination to reduced recovery of rate case costs associated with TG-140560.

### C. Rationale and Support

32 The core rationale behind Staff's recommendation is simply that it is unfair for the Company to ask ratepayers to pay for multiple, fully-litigated rate cases.<sup>68</sup> Staff explained why the Company is responsible for the extraordinary costs associated with TG-140560, pointing to the Company's convoluted filing, refusal to explain its hardcodes, and delay in filing supporting information until rebuttal testimony.<sup>69</sup> The history of a dismissal, an order to compel discovery, not meeting minimum filing requirements, and the significant amount of new information provided on rebuttal testimony were each the fault of the Company and played a central role in delaying WCI's general rate filing.<sup>70</sup> The Company's proposal to recoup 100% of costs associated with TG-140560 from ratepayers is thus unfair and unreasonable.

33 Staff recommended the Commission balance shareholder and ratepayer interests and allow WCI to recoup the cost of one fully litigated case in rates.<sup>71</sup> Staff accomplished its proposal by allowing 50 percent of costs associated with the formal adjudicative processes in both TG-131794 and TG-140560.<sup>72</sup> Staff explained that the Commission has long held the responsibility to balance competing interests in a rate proceeding to achieve a fair result.<sup>73</sup> Staff's recommendation literally balanced interests by allocating 50% of rate case costs to ratepayers and 50% to shareholders.

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<sup>68</sup> Cheesman, MC-1T, p. 47:1-5 (July 18, 2014); Cheesman, MC-13T, p. 12:13-15 (Feb. 2, 2015).

<sup>69</sup> Cheesman, MC-1T, pp. 25-26 ¶¶57-60 (July 18, 2014); Cheesman, MC-13T, pp. 13:7 – 14:8 (Feb. 2, 2015).

<sup>70</sup> See *id.*

<sup>71</sup> Cheesman, MC-1T, p. 47:1-5 (July 18, 2014); Cheesman, MC-13T, p. 12:13-15 (Feb. 2, 2015).

<sup>72</sup> Cheesman, MC-1T, p. 47 lines 1:5 (July 18, 2014); Cheesman, TR. 308 lines 9:18.

<sup>73</sup> Initial Brief on Behalf of Staff, p. 23 ¶54 (citing RCW 81.28.010 and *POWER v. Utilities & Transp. Comm'n.*, 711 P.2d 319, 326 (Wash. 1985)).

## V. INVESTIGATION FEES

34 RCW 81.20.020 authorizes the Commission to impose investigation fees. WCI filed an inadequate case, disputed discovery, and remains responsible for much of the extraordinary time and expense this case has cost the Commission. Regardless of how the Commission interprets its discretion or lack thereof under RCW 81.20.020, the assessment of investigation fees presents an appropriate and commensurate response to allow the Commission to recoup its extraordinary costs in this case.

35 Staff disputes WCI's and WRRRA's arguments claiming a lack of notice and process. Staff's recommendation that the Commission impose investigation fees first appeared in Staff testimony on July 18, 2014.<sup>74</sup> That position was reiterated in settlement throughout the fall of 2014,<sup>75</sup> and in supplemental testimony on February 2, 2015.<sup>76</sup> Therefore, the Company and Intervenor had notice of the recommendation and the Commission's consideration of the issue, were able to brief the issue twice, engaged in settlement talks, had the opportunity to provide responsive testimony on two occasions,<sup>77</sup> and cross-examined Staff's expert at a live evidentiary hearing. Any reasonable interpretation of adequate notice and due process has been met.

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<sup>74</sup> Cheesman, MC-1T, pp. 54:18 – 56:12 (July 18, 2014).

<sup>75</sup> See Partial Settlement Agreement (noting discussions between the parties and listing investigation fees as a remaining contested issue)

<sup>76</sup> Cheesman, MC-13T, p. 7:5-19 (Feb. 2, 2015).

<sup>77</sup> The Company filed its Responsive Testimony on August 20, 2014, and then filed supplemental testimony with its initial briefing on November 7, 2014.

**VI. CONCLUSION**

36 For the foregoing reasons, Staff requests the Commission adopt the entirety of the Initial Order as a Final Order.

DATED this 9<sup>th</sup> day of July 2015.

Respectfully submitted,

ROBERT W. FERGUSON  
Attorney General

A handwritten signature in black ink, appearing to read "B P Shearer", written over a horizontal line.

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