STATE OF SOUTH CAROLINA
In the Supreme Court

APPEAL FROM THE PUBLIC SERVICE COMMISSION

Appellate Case No. 2016-000652

Daufuskie Island Utility Company, Inc.,

Appellant,

v.

South Carolina Office of Regulatory Staff,
Haig Point Club and Community Association, Inc.,
Melrose Property Owner's Association, Inc.,
Bloody Point Property Owner's Association, and
Beach Field Properties, LLC,

Respondents.

REPLY BRIEF OF APPELLANT

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SUMMARY

Issued in violation of S.C. Code Ann. § 58-5-240(H), Public Service Commission Orders 2015-846 and 2016-50 are not supported by reliable, probative, and substantial evidence on the whole record. These Orders' conclusions as to property taxes, management fees, rate case expenses, bad debts, and rate base are without factual foundation and must be reversed.

Instead of including the known costs of operation submitted by DIUC, the Orders on appeal improperly adopt adjustments that eliminate the Appellant's ability to pay its taxes and to earn a reasonable rate of return. When the Orders reduce actual expenses (i.e., disallow recovery of expenses through downward adjustments) then calculate an operating margin, the actual expenses must still be paid by the utility. Therefore, the Orders' stated return on equity and operating margin are fictional. A projected rate of return and operating margin are not reliable unless the actual expenses of the entity are used in the calculations.

Under the rates allowed by these Orders DIUC will not only fall far short of the stated return on equity and operating margin set forth in the Orders, but it will also be unable to collect revenue sufficient to meet its debt service obligations or to make its required tax payments. If allowed to stand, these Orders imperil the financial stability of the utility to operate and serve its customers, while depriving the owner of any return at all on its investment.

Pursuant to S.C. Code Ann. § 1-23-380, this Court should reverse and vacate the Orders, and remand this matter for the recalculation of rates in accordance with an accurate determination of the plant in service and expenses for the test year, particularly as to the costs pertaining to property taxes, management fees, rate case expenses, plant in service, and bad debts.

ARGUMENT

I. THE PUBLIC SERVICE COMMISSION ERRED WHEN IT ADMITTED INTO EVIDENCE A PROPOSED SETTLEMENT AGREEMENT THAT INCLUDES ORS AND INTERVENORS BUT EXCLUDES THE APPLICANT AND THE COMMISSION ERRED WHEN IT ENTERED AN ORDER APPROVING THE SETTLEMENT AGREEMENT BINDING THE APPLICANT OVER ITS OBJECTIONS

A. Admission of the Settlement Agreement was an error of law contrary to S. C. Code Ann. Regulation 103-846 and South Carolina Rules of Evidence 401, 402, 403, and 408.

1. ORS fails to provide any exception to the prohibition of Rule 408, SCRE, and the Commission committed legal error in adopting the Settlement Agreement as the basis for its rate determination,

Even though South Carolina Rule of Evidence 408 specifically prohibits parties from admitting into evidence any "conduct or statements made in compromise negotiations," Respondent ORS nonetheless asserts the admission and consideration of the Settlement Agreement between it and the Intervenors were proper on the ground that ORS has a statutory mandate pursuant to S.C. Code Ann. § 58-4-50(A)(9) "to serve as a facilitator or otherwise act directly or indirectly to resolve disputes and issues involving matters within the jurisdiction of the Commission." But, the question is not whether ORS has a responsibility to try to resolve disputes, but whether when it fails to resolve a dispute with the utility, its agreement with a third party is both admissible in the rate proceeding and binding on the utility that did not agree to its terms.

Next, totally contradicting its position that the purported agreement was admissible because of its responsibility to explore consensual resolution of matters pending before the Commission, ORS pivots and argues the semantic distinction that the Settlement Agreement was "not evidence of conduct or statements made in compromise negotiations. Instead, the Settlement Agreement was the product of negotiations." ORS Brief at 30-31. This is a distinction without a difference. It does not matter that the Settlement Agreement was the product of negotiations.

Presumably all settlement agreements result from negotiations.

The amount of effort ORS proclaims it put into trying to obtain a true settlement among all the parties before the hearing is also irrelevant. See ORS Brief at 7, 8, 23, and 29. The amount of time or effort ORS put into trying to negotiate a resolution has no bearing on whether the Settlement Agreement was admissible or whether the Commission committed legal error in relying on it as the basis for its ruling on DIUC's rate application.

The purported settlement was simply not probative of any fact or conclusion that the Commission needed to render its rulings on DIUC's application. Those findings must be based on the evidence, not a hearsay agreement between two of the other parties. The conclusions must be supported by principles of law.

Finally, as discussed at length in DIUC's initial brief, admission of the product of the settlement negotiations between those two parties runs afoul of Rule 408. The Commission should not have admitted the Settlement Agreement. The Orders on appeal clearly demonstrate the prejudice to the Applicant – the Commission adopted every single adjustment and term agreed upon between ORS and the Intervenors in the Settlement Agreement. In so doing, the Commission reneged on its statutory responsibilities as a quasi-judicial body and effectively delegated those responsibilities to ORS and the Intervenors to adjudicate DIUC's application. The Commission's Orders adopting the other parties' Settlement Agreement *in totem* was legally erroneous and, alone, warrants reversal of the Orders on appeal.

2. The Intervenors fail to answer the Appellant's points as to why the Settlement Agreement was improperly admitted and was prejudicial to DIUC.

As explained in Appellant's Initial Brief, the purpose for a hearing on an Application For Rate Increase is for the Commission to determine rates and charges that render a fair rate of return "based exclusively on reliable, probative, and substantial evidence on the whole record." S.C.

Code Ann. § 58-5-240. South Carolina Code of Regulations 103-846 further states "irrelevant, immaterial, or unduly repetition evidence shall be excluded. The rules of evidence as applied in civil cases in the Court of Common Pleas shall be followed." 10 S.C. Code Ann. Regs. 103-846.

The Intervenors' Brief first asserts that the Settlement Agreement was admitted merely for the purpose of demonstrating that the parties to the Settlement Agreement (again, the Intervenors and ORS but **not** the Applicant) cooperated "in good faith with one another." Intervenors' Brief at 9-10. If that was ORS's stated intent in putting it into the record, then, of course, the Settlement Agreement should not have been admitted. Whether the parties acted in good faith with one another in settlement discussions before the hearing was not relevant or material to any fact or legal issue to be determined by the Commission. .

Additionally, once the inadmissible Settlement Agreement was admitted into the record, the Commission committed legal error in not holding ORS and the Intervenors to its terms with respect to the conduct of the hearing. The Settlement Agreement states that ORS and the Intervenors "agree that no other evidence will be offered in the proceeding by the Parties other than the stipulated testimony and exhibits and this Settlement Agreement unless the additional evidence is in support of the Settlement Agreement or to respond to Commission questions." (Hearing Ex. 3 at 3). Nevertheless, over the Appellant's objection, the Commission did allow the Intervenors to present testimony totally contrary to the Settlement Agreement. (Tr. 301-305)

The Brief of the Intervenors admits at one point the Settlement Agreement was inadmissible by acknowledging it was not probative of any fact: "The Settlement Agreement was not offered to *prove* anything." Intervenors' Brief at 12. "'Relevant evidence' means evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." Rule 401,

SCRE.

The Intervenors argue that DIUC failed to show sufficient prejudice from the admission of the Settlement Agreement. (Intervenors Brief at 7-8). Nothing could be more prejudicial than the Commission's adoption *in totem* of its adjustments, operating margin, and rate of return as the Order of the Commission without making its separate findings supported by the evidence. The Orders on appeal are themselves the proof of prejudice to the Applicant. See Utils. Servs. of S.C. v. S.C. Office of Regulatory Staff, 392 S.C. 96, 115, 708 S.E.2d 755, 765 (2011) (The "fundamental role of the PSC" in ratemaking decisions is to "consider all evidence before it and it does not serve as a 'rubber stamp' for ORS's recommendations.").

II. THE COMMISSION ERRED IN REFUSING TO CONSIDER THE ENTIRE PETITION FOR RECONSIDERATION, INCLUDING THE INEVITABLE LOAN DEFAULT THAT DIUC WILL FACE IF THE INSUFFICIENT RATES ESTABLISHED BY ORDER 2015-846 ARE NOT MODIFIED.

A. The Brief of ORS fails to answer the Appellant's points as to why the Commission's refusal to consider the complete Petition for Reconsideration, including the inevitable loan default the DIUC will face under the rates established by the Commission, constitutes an error of law requiring reversal and remand.

On December 21, 2015, DIUC filed a Petition for Reconsideration and/or Rehearing that included a schedule "demonstrating the impact of the Commission's Order on DIUC's operations" based on the projected revenues from the approved rates and charges. (Pet. Recon. at 3 citing *Attachment A* thereto) The schedule (*Attachment A* to the Petition) demonstrates that the revenue increase allowed by the Commission's Order will result in a negative cash flow, i.e. the utility will actually lose money under the Commission's Order. (*Attachment A* to Pet. Recon.) *Attachment A* simply shows the $1,536,375 of combined water and sewer revenues allowed by the Order and then subtracts the true costs of operation that were part of the record. In denying the Petition for Reconsideration, the Commission incorrectly ruled that the information in the record regarding the

SunTrust loan was insufficient to allow it to consider the inevitability of default. (Order 2016-50 at 21)

Appellant's Brief enumerates the clear and specific proof in the record supporting the default that the Commission neglected to consider in asserting there was no proof to this effect. See Appellant's Brief at Section II, at 23-27; Tr. at 186, 254, 255, 257; and Hearing Ex. 7, Report on Capital Improvements (mentioning SunTrust at least 10 times). The Commission erred in holding there was no proof of the imminent default and in failing to consider the dire effects of its adoption *in toto* of the ORS's adjustments in the purported Settlement Agreement.

ORS continues to assert that somehow the issue of default was not in the record but does not dispute, because it cannot, the references in the record identified by Appellant's Brief that forecast this default. ORS merely complains that "[i]f the loan conditions were so tenuous, it would follow that DIUC would have included the conditions in its justification for rate increase." In fact, there was considerable testimony from John Guastella as to DIUC's critical need to obtain sufficient revenues for DIUC to be able to avoid a default on its overdue loans with SunTrust and to refinance those loans.

ORS acknowledges this proof in the record by DIUC but downplays it as "puffery." ORS Brief at p. 33. This proof was not puffery but a reality check based on DIUC's clear and present expenses and its demonstrated cash needs. ORS seems to believe its massive adjustments to DIUC's known and measurable expenses somehow reduces those expenses. DIUC's creditors have not agreed to ORS's adjustments and intend to collect their bills as rendered. There is no reliable, probative evidence in the record that DIUC's creditors will reduce the amounts owed to them or that DIUC can refinance and avoid default under its bank loan without the requested rate increase.

Although the potential of default under the loan was surely in the record, the exact impact upon DIUC of the Commission Order No. 2015-846 could not be discussed in the hearing because Order 2015-846 Approving the ORS-Intervenors' Agreement had not yet been entered. What was in evidence at the hearing was testimony of the dire consequences on DIUC if the Commission adopted the adjustments and other terms of ORS's purported Settlement Agreement, which was ultimately what the Commission did.

DIUC notes that S.C. Code Ann. § 58-5-330 instructs the Commission, when addressing a Petition for Reconsideration and/or Rehearing, to consider all facts, "including those arising since the making of the order or decision" that is being challenged. Clearly what DIUC sought in one of its grounds for rehearing was consideration of the effects of the Order, a valid basis for reconsideration under the controlling statute.

Once Order 2015-846 was issued, DIUC filed a Motion for Reconsideration to demonstrate, in part, the financial hardship the Order would create. The Commission committed legal error in rejecting this ground for reconsideration on the basis there was no proof in the record that the adjustments and rates approved by the Commission would put DIUC in default on its SunTrust loans and deprive DIUC of its ability to refinance them. Pursuant to S.C. Code Ann. § 1-23-380, the decision to ignore the complete Petition and *Attachment A* constitutes an error of law requiring remand.

B. The Brief of Intervenors fails to answer the Appellant's points as to why the Commission's refusal to consider the complete Petition for Reconsideration, including the inevitable loan default the DIUC will face under the rates established by the Commission, constitutes an error of law requiring reversal and remand.

Intervenors likewise attempt to defend the Commission's refusal to consider the issue of loan default by citing Spreeuw v. Barker, 385 S.C. 45, 68-69, 682 S.E. 2d 843, 855 (2009). However, the referenced quotation from the Spreeuw case addressed the trial court's use of the

"term 'lease payments' in lieu of the term 'automobile expenses,'" finding the interchanging of terms was without consequence. Spreeuw v. Barker, 385 S.C. 45, 68-69, 682 S.E. 2d 843, 855 (2009). Spreeuw in no way is analogous to this case where the Commission incorrectly ruled there was no evidence of the dire effects of the approved rates and charges on KIU, including DIUC's inevitable loan default.

In Order 2016-50 the Commission refers to the looming default as "speculative" and cites Kiawah Prop. Owners Grp. v. PSC, 357 S.C. 232, 593 S.E.2d 148 (2004). Intervenors likewise rely on Kiawah Prop. Owners Grp.; however, in Kiawah Prop. Owners Grp. the landowners contended certain loan agreements were "commercially unreasonable and *may* affect Utility's customers in the future." Kiawah Prop. Owners Grp., 357 S.C. at 242-43, 593 S.E.2d at 154 (emphasis added). This Court ruled that the landowners' unsupported concern was insufficient to raise a justiciable controversy. In the present case, however, DIUC fully supported its concern by putting in evidence that the initial due date on SunTrust loan had passed, that the amount of expenses for property taxes were unavoidable, and that amount of the other DIUC expenses were also accurate.

Specifically as to the looming default on the bank loans, the Appellant has more than sufficiently demonstrated the supporting proof in the record and that the Commission erred as a matter of law by stating there was no such proof. (See DIUC Testimony, Tr. at 186 (The proposed Settlement Agreement "will not give us enough money to pay our debt service on our existing loan. We will be in default ...."); Tr. at 254 ("The bank is looking at our operations now, and they are seeing us with a shortfall in meeting their coverage requirements."); Tr. at 255 ("[W]e're not going to be able to make our debt service payments of principal and interest. It would put us right into bankruptcy. We need to have a real decision based on our real costs."))

Intervenors also complain they did not have the opportunity to "test . . . the inputs and assumptions" in *Attachment A* to the Petition for Reconsideration. Not so. *Attachment A* merely reflects the $1,536,375 of combined water and sewer revenues allowed by the Order then subtracts the actual cost of operations submitted by DIUC in this case. The actual operating expenses of $1,355,363 listed in the Attachment are those reflected in the testimony, filings, and DIUC's Proposed Order, all of which are in the record of this case. These are the same inputs from DIUC's application and prefiled testimony. These are the same inputs that the ORS and Intervenors witnesses reviewed prior to issuing their opposing testimony. There are no surprises here.

Attachment A to the Petition for Reconsideration merely shows the negative Net Cash Flow of (-$4024) that directly results from the approved rates and charges applied to the expenses already in the record. Even though the complete SunTrust loan documents were not submitted to the Commission, the financial effect on DIUC from the approved rates and charges does not depend on the terms of those loan documents. The necessary information is in the record.

The Commission committed legal error in determining there was no proof in the record of the imminent default on the SunTrust loans. The Court should remand the matter to the Commission for consideration of the entire Petition, including *Attachment A* and its analysis of the impact of Order 2015-846 upon DIUC's operations and ability to meet it contractual and taxation obligations.

III. THE COMMISSION ERRED IN ITS FINDINGS, INFERENCES, CONCLUSIONS, AND DECISIONS IN ORDERS 2015-846 AND 2016-50 WHICH REJECTED THE APPLICANT'S ANALYSIS OF PROPERTY TAXES, MANAGEMENT FEES, RATE CASE EXPENSES, PLANT IN SERVICE, AND BAD DEBTS. S. C. CODE ANN. § 1-23-380 REQUIRES THIS COURT TO REVERSE THE ORDERS.

As explained in Appellant's Initial Brief, critical findings in the Commission's Orders are not based upon reliable, probative, and substantial evidence on the whole record, as required by

S.C. Code Ann. § 58-5-240. In particular, the Commission's unsupported adjustments to expenses and plant artificially reduce substantial expenses and ignore significant plant in service resulting in rates that in fact do not yield the rate of return or operating margin stated in the Orders and do not produce revenues "sufficient to assure confidence in the financial soundness of the utility and . . . to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties," as is required by the United States Constitution. Bluefield Waterworks and Improvement Company v. West Virginia Pub. Serv. Comm'n, 262 U.S. 679, 692-693 (1923).

In responding to the Appellant's Initial Brief and its examination of the specific adjustments erroneously adopted by the Commission in its Orders, ORS asks this Court to reject the Appellant's statement of South Carolina law and the burden shifting analysis explained in Utils. Servs. of S.C. v. S.C. Office of Regulatory Staff, 392 S.C. 96, 109 708 S.E. 2d 755, 762 (2011). Making this argument, ORS asserts:

> [T]he Utility's expenses are presumed to be reasonable and incurred in good faith. This presumption does not shift the burden of persuasion but shifts the burden of production on to the Commission or other contesting party to demonstrate a tenable basis for raising the specter of imprudence.

ORS Brief at 13 quoting Utils. Servs. of S.C. V. S.C. Office of Regulatory Staff, 392 S.C. 96, 109-110, 708 S.E. 2d 755, 762-63 (2011). This is an accurate quotation from the case. However, ORS goes on to attempt to modify the appropriate legal test of Utils. Servs. of S.C. by stating: "A presumption of reasonableness therefore only applies to utility expenses until they are challenged by the Commission or another party." Id. at 13. That is not an accurate statement of law.

According to the plain language of Utils. Servs. of S.C., once a challenge to the presumed reasonableness of a utility expense is made, then that challenge "shifts the burden of production

on to the Commission or other contesting party to demonstrate a tenable basis for raising the specter of imprudence." Utils. Servs. of S.C. v. S.C. Office of Regulatory Staff, 392 S.C. 96, 109-110, 708 S.E. 2d 755, 762-63 (2011). That means if ORS or the Intervenors allege a challenge to any expense asserted by DIUC, the presumption of reasonableness and good faith of the expense remains; however, the *burden of production* then shifts to the challenger which may advance its position **if** it can "demonstrate a tenable basis for raising the specter of imprudence" of the expense. (Emphasis added.)

ORS skirts this requirement by simply proclaiming that it met its burden "through its direct testimony." ORS Brief at 13. However, ORS's glib response does not satisfy its legal requirement to demonstrate **at the very least** a credible basis for believing a submitted expense is somehow improper or unsupported (i.e., a tenable basis for raising the specter of imprudence) ORS fails to cite a single example of information in the record that demonstrates "a tenable basis for raising the specter of imprudence" justifying the reduction of DIUC's submitted expenses which are presumed reasonable and to have been incurred in good faith.

As explained in DIUC's initial brief and touched on again below, the Commission erred in reducing DIUC's requested amounts for its Utility Property Taxes, Management Fees, Rate Case Expenses, inclusion of Elevated Water Tank and facilities in DIUC's Water Plant, DIUC's Proposed Plant in Service, and DIUC's explanation of Bad Debts. Here, neither ORS nor Intervenors satisfied the required burden of production for the specifically identified adjustments adopted by the Commission in approving the purported Settlement Agreement.

A. The actual, known and measurable amount for DIUC's Utility Property Taxes is $258,227.40 annually.

In the almost 30 years since 1985 when the water and sewer utilities on Daufuskie Island were created, the South Carolina Department of Revenue never once made a "Utility Property

Tax" assessment -- until 2012, and then it did so in arrears for three years all at once. As a result, Beaufort County then sent tax bills to DIUC for all three years -- 2010, 2011 and 2012. (Tr. at 78, 96-98). In response, John Guastella on behalf of DIUC's manager, Guastella Associates ("GA"), personally undertook to negotiate a way for DIUC to pay these taxes without penalty or interest. DIUC and Beaufort County entered into an agreement to cover payment of DIUC's 2012, 2013, 2014, and 2015 Utility Property Taxes. Because of the circumstances, the 2010 and 2011 Utility Property Taxes were forgiven.

Pursuant to the binding contract between DIUC and Beaufort County, DIUC must pay $526,843.20 at the rate of $65,856 per year for eight years to cover the 2012, 2013, 2014, and 2015 Utility Property Taxes. (Walls Ex. A, Hearing Ex. 5). The full cost of that annual expense is set by contract, and is known and unavoidable. Yet, in adopting ORS's "settlement," the Commission disallowed roughly half of it.

During those eight years (and in the future) DIUC must also accrue funds to pay its ongoing annual Utility Property Taxes.[1] In order to meet its past and future tax obligations, DIUC must be able to charge: (1) rates sufficient to recover the monthly payments totaling $65,856 per year for eight years; and (2) rates sufficient to address DIUC's ongoing annual accrual of $192,372 for the 2016 and later years' Utility Property Taxes. (Tr. at 168-170).

Instead of the contractually obligated $65,856 per year for eight years to cover the 2012, 2013, 2014, and 2015 Utility Property Taxes, ORS recommended and the Commission ordered only $30,612 per year. (Order 2015-846 at p. 23). **The Commission's Orders create an annual shortfall of $35,244 each year for the next eight years for a total shortfall of $281,952**. The

[1] For example, pursuant to the Department of Revenue Formula the 2016 Utility Property Taxes are expected to be $192,302, which must be paid in January 2017. (Tr. at 212)

Commission's adoption of ORS's adjustment is not supported by substantial evidence and is contrary to the unrebutted exhibits and unrebutted testimony including that of the Beaufort County Treasurer that there will be no abatement.

Further compounding its errors, instead of allowing DIUC to accumulate funds to pay the calculated $192,372 ongoing annual Utility Property Taxes that will be due annually for years 2016 and later, ORS recommended and the Commission ordered only $140,881 per year for annual Utility Property Taxes. (Order 2015-846 at p. 23). **The Commission's Orders create an annual shortfall of $51,491 for ongoing Utility Property Taxes**.

So, under the Commission's allowed rate increase, **DIUC will be short a total of $86,735 for its 2016 tax obligations and it will be short a similar amount every year thereafter**.

DIUC is not alone in recognizing the problem the Orders create. As Beaufort County Treasurer Walls testified:

> If the rates are not sufficient to allow DIUC to collect enough money prior to January 15th of a given year to pay the tax bill due on that date, then DIUC will not be able to pay its taxes. Of particular concern to me is the payment that will be due January 15, 2017, and whether DIUC will be allowed to charge rates sufficient to collect the funds necessary to make that payment in 2017.

(Tr. at 84)

Although the Commission specifically acknowledged that the contract between DIUC and Beaufort County requires the payment of the taxes as submitted by DIUC, the Order embraces a completely hypothetical circumstance to justify its significantly reduced allowance. (Order 2015-846 at 23). ORS speculated that DIUC's Agreement with Beaufort County "could be amended in the future," in the face of the testimony of the Beaufort County Treasurer Maria Walls that the agreement could not be amended again in the future. (See ORS Brief at 27; Appellant's Brief at 31 and Tr. at 95) Relying on this completely impossible assumption, the Commission ruled, "the

Company's settlement agreement with Beaufort County has already been amended once, and could be amended in the future."[2] (Order 2015-846 at 23) The Commission's willingness to embrace this "hypothetical" amendment to deny DIUC its ability to pay taxes (despite the testimony that there will absolutely be no such amendment in the future) completely contradicts the record and DIUC's known and measurable costs.

The failure to include the known and measurable expenses of DIUC's Utility Property Taxes is a clear error of law based upon an inconsistent logic and is contrary to the reliable, probative, and substantial evidence and should be reversed.

B. **The requested management fees of $174,364 should be allowed.**

Because DIUC and Guastella Associates ("GA") are not affiliated, DIUC's expenditures for management fees are presumed reasonable and incurred in good faith. See Utils. Servs. of S.C. v. S.C. Office of Regulatory Staff, 392 S.C. 96, 109, 708 S.E.2d 755, 762 (2011) and Appellant's Brief at 36-38. Even if GA were an affiliate of DIUC, which it is not, the record demonstrates the significant management efforts of GA on behalf of DIUC and the increase in services since 2012 that justify the requested Management Fees.

The record establishes that GA provided to DIUC a level of expert engineering, accounting, administrative, rate setting and valuation expertise that is rarely, if ever, available on a day-to-day basis to a small water and wastewater utility like DIUC. (Tr. at 213) Furthermore, GA successfully maintained the ongoing operation of DIUC despite cash shortfalls and even foregoing its own payments. (Tr. at 214) As detailed in the Report on Capital Improvements,

[2] Despite this ruling against DIUC based upon a hypothetical opportunity to amend a contract, the Commission in this proceeding refused to consider DIUC's *Attachment A* regarding the default imminent from the rates allowed by Order 2015-846 because it was "a future contingent or hypothetical event." (See Order 2016-50 at 6.)

GA's management successfully overcame an unprecedented number of significant challenges that DIUC faced with respect to revenues, financing, replacement of major facilities, unanticipated tax increases, and acquisition of a neighboring bankrupt utility – all to the benefit of DIUC's customers. (Hearing Ex. 7, Guastella Rebuttal Ex. B; see also Appellants Brief at 38-42 for further detailing of these efforts by GA) Clearly the reliable, probative, and substantial evidence on the whole demonstrates GA's management services significantly increased since the last rate case in 2012.

Even assuming ORS raised a proper challenge to these charges which are, again, presumed to be reasonable and incurred in good faith, it did not produce sufficient proof of any tenable basis for raising the specter of imprudence regarding the management fees due to GA. In its initial Brief, ORS only repeats its refrain from the hearing, "We think management services have a value. We think ratepayers should pay it. But ORS doesn't think the ratepayers should pay the premium." (ORS Brief at 16 quoting Tr. at 56) Rather than conducting its own analysis of the ample record demonstrating the significant and substantially increased in efforts by GA for DIUC since 2012, the Commission ruled "ORS found no apparent increases in the amount of management services provided by GA since the last rate proceeding ... and this Commission adopted the ORS finding." (Order 2016-50 at 14)

As explained in Appellant's Brief, the Commission's Order failed to demonstrate it properly considered the record, including the schedule provided by DIUC that compares the costs per customer of DIUC with the costs of other municipal water and sewer utilities in South Carolina. (Hearing Ex. 8) As explained in that schedule, after adjusting for taxes and cost of capital in order to compare the cost of operations on an equal basis, DIUC's cost per customer is lower than four of the eight utilities, even though the cost per customer should be considerably higher because

DIUC has a much lower number of customers. (Hearing Ex. 8) Also, DIUC is on an island accessible only by boat, which drastically increases costs of doing any kind of business on the Island. (Tr. at 216) The Commission's Order includes no mention of this evidence, let alone proper consideration of the same.

The Commission also erred in its conclusion that GA and DIUC are affiliated entities. The distinction is important because payments to affiliated entities are not entitled to the same presumptions as those to non-affiliates under Utils. Servs. of S.C. The record demonstrates that the finding of affiliation was not supported.

The GA management agreement was entered into before GA began managing DIUC. Neither DIUC nor its owners had any relationship to GA. The agreement's renewal over the years reflects the same provisions as from the outset. The management agreement was and remains arm's length, and all charges have been subject to approval of DIUC's owners and its president, all of whom have never had an affiliation with GA or GA's employees and owners. Neither GA or its owners or employees have any ownership in DIUC or its stockholder or individual owners of its stockholder; it is not a subsidiary of DIUC or its stockholder; GA does not own stock in DIUC or DIUC's stockholder corporation. GA has no authority to perform any service for DIUC unless in accordance with the existing arm's length management agreement; GA has no vote in any decision to sell or otherwise transfer DIUC to a third party.

The reliable, probative, and substantial evidence demonstrates that GA is not an affiliate of DIUC and that there was a substantial increase in efforts and results justifying the presumptively reasonable management fees requested by DIUC.

C. **DIUC should be allowed to recover its Rate Case Expenses of $191,200.**

The Brief of Respondent ORS fails to address the specific points presented by the

Appellant regarding the lack of evidence to support the Commission's Order denying DIUC its reasonable rate case expenses. Instead, ORS merely cites S.C. Code Ann. § 58-4-50 and asserts that it made a recommendation which, although not supported by any facts, should be trusted because "[i]nherent in ORS's recommendation is its expertise and experience." (ORS Brief at 19)

S.C. Code Ann. § 58-4-50(A)(1) requires ORS to "review, investigate, and make *appropriate* recommendations to the commission with respect to the rates charged or proposed to be charged by any public utility." (Emphasis added.) However, in this instance, ORS's recommendation was not supported by the proof and was therefore not *appropriate* as required by law. ORS's witness, Ms. Gearheart, did not provide any analysis that establishes the basis for ORS's arbitrary $75,000 cap on rate case expenses; further, there was no testimony that the work included in DIUC's proposed expense was not performed or was unnecessary. (Tr. at 484-500) The record is insufficient to support the unexplained and arbitrary adjustment generally and in light of the presumed reasonableness of the expense.

ORS points to the testimony of ORS witness Ms. Gearheart who suggested the $75,000 rate case expense because that was the total amount of rate case expense ORS recommended in the last, 2011 rate case. Ms. Gearheart suggested adding to that amount the remaining unamortized balance of $22,500 from the last rate case, or $97,500 amortized over a 5 year period (typically the interval between occurrences), should be applied. (Order 2015-846 at 25 and Order 2016-50 at 20). Significantly, Ms. Gearheart did not provide any factual analysis supporting her opinion that rate case expenses must be capped at $75,000. (Tr. at 484-500).

The Commission also failed to consider the uncontradicted testimony presented by Mr. Guastella fully justifying DIUC's actual paid rate case expense. Mr. Guastella explained the actual rate case expenses were as high as they were because, among other things, rate proceedings for a

small utility, such as DIUC, are essentially as involved as for a large utility; the rate filing on this matter required weeks and weeks of work that were necessary to prepare the application; DIUC was required to respond to over 300 data requests and discovery from ORS; the testimonies and multiple positions of nine witnesses had to be examined and addressed in advance of the hearing; there was attendance at the general public hearing and participation at the evidentiary hearing (Tr. at 181 and 218). Additionally, subsequent to the hearing, there was preparation of a proposed order and after the Commission's decision, there was a need for a petition for reconsideration and ultimately for this appeal.

In an attempt to recreate a proper record for its recommendation and the Order, ORS asserts in its Brief that at the time of its recommendation on rate case expenses it had concluded that GA's relationship with DIUC was not arm's length and that the management agreement allowed GA to be paid separately for rate case work. (ORS Brief at 20) However, that argument was not mentioned by Ms. Gearheart or any other ORS witness as support for this adjustment. Nor did the Commission cite this as the basis for its Orders.

ORS's last argument on this issue is that DIUC failed to overcome the "challenge to the reasonableness of its rates case expenses or to substantiate to the Commission's satisfaction the prudence of over $450,000 in such costs." (Brief of ORS at 21) First, DIUC did not seek recovery of rate case expenses in the amount of $450,000; it did not even seek the actual $380,000 incurred in this case. (Tr. at 181) As in the last rate case, DIUC requested only about half of the actual costs, or $191,200, which is just $10,000 more than the request in the last case and is in line with the $190,905 in rate case expenses the Commission allowed in the recent Kiawah Island Utility Company rate case. (Pet. Recon. at 17 citing PSC Order 2012-98).

The Commission's endorsement of the ORS recommendation for an arbitrary limit to rate

case expenses is contrary to the reliable, probative, and substantial evidence on the whole record.

D. **The Orders erroneously reduced the Plant In Service upon which DIUC is entitled to earn a return and to recover its costs through depreciation expense.**

1. **The elevated water tank and related facilities are part of the DIUC water plant and should be included for calculation of DIUC's Plant In Service.**

While there was a significant amount of testimony and discussion before the Commission regarding DIUC's elevated water tank and facilities, both ORS and ultimately the Commission's Orders rely upon an insufficient basis for excluding the elevated 125,000 gallon water tank and facilities from the DIUC Water Plant in Service. ORS and Intervenors did not present proof nor make any argument that disputes DIUC's proof that the elevated water tank, well, and related facilities continue to be used and useful since their installation. Further, neither ORS nor the Intervenors presented any testimony to contradict DIUC's proof of the costs of these facilities.

ORS witness Willie Morgan did not dispute that these facilities were a vital part of DIUC's water infrastructure and used by DIUC to provide services. Instead, Mr. Morgan relied upon an internet printout that identifies Mr. Mamdouh Sabry Abdelrahman as the recipient of a tax sale deed to the .337 acre tract of land upon which DIUC operates its storage tank and related water system facilities. (Tr. at 511 and Hearing Ex. 19, WJM-7) In response, DIUC witness John Guastella explained that the property record noted by Mr. Morgan in Exhibit WJM-7 does not include any reference to DIUC's utility facilities. (Tr. at 201-202) Beaufort County Treasurer Maria Walls testified that Beaufort County sold the land to Mr. Sabry but did not sell DIUC's elevated tank, well, pump, pipes and other facilities in the tax sale; Treasurer Walls also testified that SCDOR assesses DIUC for the water tank and facilities and DIUC pays Utility Property Taxes to Beaufort County on them. (Tr. at 201-202 and at 82-83) Finally, at the Commission's request, Beaufort County Assessor Gary N. James submitted a letter stating Beaufort County has valued

the real property at $24,400 and that does not include "a water tank/tower" on the property. (Hearing Ex. 6 at 3)

At the time of the Commission's hearing, DIUC had condemned the land, obtained a ruling from the circuit court rejecting the land owner's challenge to DIUC's right to condemn, and was expecting a decision by the Court of Appeals affirming the circuit court. (Tr. at 194) On June 15, 2016, the South Carolina Court of Appeals issued its opinion affirming the circuit court's ruling in DIUC's favor. See Abdelrahman v. Daufuskie Island Utility, Inc., Unpublished Opinion No. 2016-UP-301 (filed June 15, 2016). On July 1, 2016, the South Carolina Court of Appeals issued its Remittitur to the lower court. Therefore, by operation of law and pursuant to S.C. Code Ann. § 28-2-90,[3] DIUC as condemnor rightfully possesses the land in addition to the various facilities that it has always owned and possessed.

The Commission's finding that adopted ORS's adjustment removing the elevated water storage tank and related facilities from the plant in service was not supported by the reliable, probative, and substantial evidence on the whole record.

2. The Commission erred in adopting the undocumented $1,624,696 reduction to Plant In Service proposed by the Settlement Agreement.

Attempting to support the $1,624,696 downward adjustment that was adopted by the Commission, the ORS brief points to "the list of plant in service categories from DIUC's Application" and cites to Hearing Exhibit 18, ORS Audit Exhibit ICG-5. (ORS Brief at 21) However, that Exhibit is just a schedule of "primary plant accounts" or categories. (See Hearing Ex. 18 at 13)

[3] "A condemnor may take possession of property ... upon deposit with the clerk of court in the county in which the property to be condemned is situated, the amount stated in the Condemnation Notice as just compensation for the property...." S.C. Code Ann. § 28-2-90 (3).

While Hearing Exhibit 18 does show a column of adjustments with dollar amounts for a number of those categories, there is no identification of what the specific adjustments represents. (Id.) For example, there is a $24,605 downward adjustment to the "Pumping" account or category, but there is no explanation in Ms. Gearheart's schedules of whether it is one or more pumps, where said pump(s) are located, whether the pump(s) are in service, or why that adjustment was made. (Id.) There is no factual basis to support the adjustment amount.

ORS then quotes Ms. Gearheart's testimony that plant in service adjustments "were simply carried forward from the last case and we do not retest or retry anything that was approved in the last rate case." ORS Brief at 21. This "carrying forward" is completely unreliable in this instance because neither ORS's previous rate base nor its utility plant in service calculations were actually approved in the last rate case. See PSC Order 2012-515. ORS's proposed rate base in the last rate case was $4,615,755, but the parties agreed to a rate base of $5,000,000, as set forth in the settlement approved by the Commission. Id. The approved settlement in the last case also states with respect to rate base:

> The Parties agree and stipulate that DIUC shall be at allowed to set rates and charges on a rate base of $5,000,000. This stipulated rate base shall not be binding in future proceedings, instead those proceedings will be determined based on the evidence presented in each docket and the applicable law.

PSC Order 2012-51, Attachment at 2.

Clearly, the ORS adjustments in the last rate case were not identified in the approved settlement in that case and therefore there was no basis for "carrying them over" into this case. Because the ORS adjustments were never documented in this case, the adjustments to rate base and plant in service adopted by the Commission's Orders are not supported by the reliable, probative, and substantial evidence on the whole record.

3. It was error for the Commission to rely upon DIUC's Revised Water Annual Reports for 2012 and 2013 to reduce DIUC's Plant In Service for ratemaking purposes.

ORS defends the Commission's improper reliance upon DIUC's Revised Water Annual Reports for 2012 and 2013 to reduce DIUC's plant in service for ratemaking purposes by citing testimony of its witness, Willie Morgan. Mr. Morgan hypothesized that when DIUC revised its annual reports to SCDOR to reflect the agreed upon rate base from the last case, DIUC removed the elevated storage tank. (Tr. at 516-517) In error, Mr. Morgan actually compared the reduction in SCDOR's assessed values of $1,110,715 for 2012 and $893,781 for 2013 with the $863,781 original cost of the elevated storage tank. Compounding his error, Mr. Morgan incorrectly calls this amount the "plant asset value." (Tr. at 516) In other words, Mr. Morgan saw that in the previous matter, Docket No. 2011-229-WS, ORS assigned $863,379 as the value of the elevated storage tank and then he saw a reduction in the DIUC annual reports of $893,781 and concluded that despite the $30,000 difference, these amounts were "close" enough to each other that the two numbers must really refer to the same thing. (Tr. at 516 (Morgan testifying "the adjusted plant-in-service values ... may be related to the elevated storage tank."))

However, the substantial evidence DIUC put into the record completely refutes Mr. Morgan's conjecture about what he thought was going on. In fact, reduction in the SCDOR assessment basis does *not* correspond to the storage tank and facilities at elevated tank site.

First, Mr. Morgan's terminology is not correct; the $863,379 is the original cost of the elevated storage tank as shown on the annual reports, not the value, which would be cost less depreciation. (Hearing Ex. 20) Second, the $863,379 is only the original cost of the elevated storage tank; it does not include the original cost of the rest of the facilities (well, pump, piping, etc.); the total cost is $1,303,083.97. (Tr. at 201 and Hearing Ex. 20)

Mr. Morgan's Surrebuttal Exhibit WJM-1, Hearing Exhibit 20, actually demonstrates the opposite of Mr. Morgan's speculation. Hearing Exhibit 20 contains the annual reports for 2012 and 2013 before and after DIUC revised those to reflect the agreed upon $5,000,000 rate base from the last settled rate case. Before revision, the $863,379 original cost of the storage tank appears on line 29, account 330.4 Distribution Reservoirs and Standpipes. The revised annual reports show year-end amounts of $616,522 and $657,413 for the elevated storage tank. It is very clear that if over $600,000 remains in the reports for the elevated storage tank plus hundreds of thousands of dollars for the other facilities, it is not correct that the reduction in SCDOR's assessed value for property tax purposes "corresponds" to only the elevated storage tank. Instead, the reduced tax assessed value by SCDOR is precisely as Mr. Guastella described; all the individual plant facilities were reduced on a proportionate basis to reflect the total rate base of $5.0 million as settled in the last rate case. (See Hearing Ex. 20 (DIUC annual reports stating values adjusted "to reflect the rate base allowed in Docket No. 2011-229-WS"); see also Tr. at 52 (DIUC counsel explaining "There is an adjustment in our SCDOR return proportionately to get our plant-in-service to $5 million, which was the amount we agreed on last time, but it was not done to eliminate the elevated storage tank, as suggested by ORS.")

DIUC's Revised Water Annual Reports for 2012 and 2013 do not support the Orders' reduction to DIUC's Plant In Service for ratemaking purposes.

4. The Commission erred in adopting the Settlement Agreement's proposal for Bad Debts.

The ORS Brief also fails to answer the Appellant's points as to why the Commission erred in adopting the Settlement Agreement's proposal for bad debts. While ORS states in its Brief that the reason DIUC argues for the bad debt adjustment proposed in ORS's pre-filed direct testimony is "because ORS recommended more money for DIUC," that is not the reason stated by Mr.

Guastella in his testimony. (See Tr. at 136-137) Mr. Guastella testified that although the total 2014 actual bad debts were over $100,000, DIUC originally submitted a more conservative amount in the application. (Tr. at 137) Then, subsequent to filing the application, DIUC determined to accept the ORS bad debt allowance because the 2015 actual bad debts were again in excess of $100,000. That amount, then, is a more accurate reflection of the actual debt and DIUC's cost of providing service.

No ORS witness provided any cost justification for the change in ORS's position as to the bad debt other than a capitulation to the request of the Intervenors. There is no proof that the Orders' bad debt allowance of only $30,852 is realistic or anywhere close to the actual amount of over $100,000. The only two matters in the record as to the proper level of bad debts are ORS's original position of $108,349 and DIUC's testimony that the actual bad debts expense for the 2014 test year and the most current 12 month period of 2015 is over $100,000. (Tr. at 136) The Commission's decision to disallow almost $70,000 of the actual bad debt expense suffered by DIUC is not supported by the reliable, probative, and substantial evidence demonstrated on the whole record.

CONCLUSION

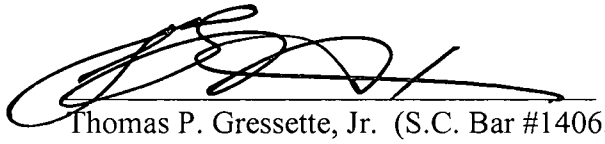
Orders 2015-846 and 2016-50 announce a return on equity and operating margin that are wholly illusory because they are based upon adjustments that do not reflect the real, known expenses of DIUC's operations. Under the rates allowed by these Orders DIUC will not only fall far short of the Orders' stated return on equity and operating margin but it will also be unable to collect revenue sufficient to meet its debt service obligations or its required tax payments.

The Commission's blind adoption of the Settlement Agreement resulted in Orders that are not supported by substantial evidence, in violation of S.C. Code Ann. § 58-5-240(H). Pursuant to

S.C. Code § 1-23-380, this Court should reverse and vacate Orders 2015-846 and 2016-50, and remand this matter to the Commission with instructions to determine DIUC's rates without applying the ORS adjustments to property taxes, management fees, rate case expenses, plant in service, and bad debts.

Respectfully Submitted,

PRATT-THOMAS WALKER, PA



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August 31, 2016
Charleston, South Carolina

STATE OF SOUTH CAROLINA
In the Supreme Court

APPEAL FROM THE PUBLIC SERVICE COMMISSION

Docket No. 2014-346-WS

Daufuskie Island Utility Company, Inc.,

Appellant,

v.

South Carolina Office of Regulatory Staff,
Haig Point Club and Community Association, Inc.,
Melrose Property Owner's Association, Inc.,
Bloody Point Property Owner's Association, and
Beach Field Properties, LLC,

Respondents.

PROOF OF SERVICE

I, Nancy Jane Dennis, an employee of Pratt-Thomas Walker, P.A., hereby certify that I have served this 31st day of August, 2016, a copy of Appellant's **INITIAL REPLY BRIEF** on counsel of record, by placing same in the United States Mail, first class postage prepaid to the following:

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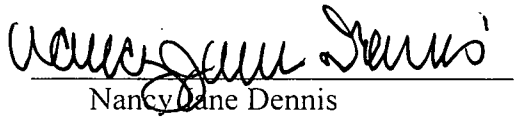

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