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BEFORE THE ARIZONA CORPORATION COMM.

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WILLIAM A. MUNDELL  
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Commissioner  
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Commissioner

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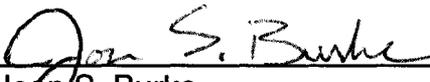
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IN THE MATTER OF THE APPLICATION OF ) DOCKET NO. W-01445A-04-0650  
ARIZONA WATER COMPANY, AN )  
ARIZONA CORPORATION, FOR ) NOTICE OF FILING TESTIMONY  
ADJUSTMENTS TO ITS RATES AND ) OF EDWARD F. HARVEY  
CHARGES FOR UTILITY SERVICE )  
FURNISHED BY ITS WESTERN GROUP )  
AND FOR CERTAIN RELATED )  
APPROVALS )

The City of Casa Grande hereby gives notice that the Direct Testimony of  
Edward F. Harvey is attached and has been filed this same date.

Dated this 20<sup>th</sup> day of April, 2005.

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**BEFORE THE ARIZONA CORPORATION COMMISSION**

**JEFF HATCH-MILLER**

Chairman

**WILLIAM A. MUNDELL**

Commissioner

**MARC SPITZER**

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Commissioner

IN THE MATTER OF THE APPLICATION ) DOCKET NO. W-01445A-04-0650  
OF ARIZONA WATER COMPANY, AN )  
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FURNISHED BY ITS WESTERN GROUP )  
AND FOR CERTAIN RELATED )  
APPROVALS )  
\_\_\_\_\_ )

**DIRECT TESTIMONY**

**OF**

**EDWARD F. HARVEY**

**ON BEHALF**

**OF**

**THE CITY OF CASA GRANDE**

**APRIL 20, 2005**

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1       **I. INTRODUCTION AND QUALIFICATIONS**

2  
3       **Q. PLEASE STATE YOUR NAME AND ADDRESS**

4       A. My name is Edward F. Harvey. My business address is 600 South  
5       Cherry Street, Suite 220, Denver, Colorado 80246.

6  
7       **Q. WHAT IS YOUR OCCUPATION AND WITH WHOM ARE YOU EMPLOYED?**

8       A. I am an economist and the principal of Harvey Economics, a Denver-based  
9       economic research and consulting firm.

10  
11       **Q. WHAT IS YOUR PROFESSIONAL BACKGROUND AND TRAINING?**

12       A. I have been an applied resource economist for thirty-two years. I was employed at  
13       BBC Research and Consulting from 1973 through 2001, where I established the  
14       natural resource economics practice and served as the firm's Managing Director  
15       from 1989 onward. I received a Bachelor of Arts in economics from the University of  
16       Denver and a Master of Science in business administration with an emphasis in  
17       economics from that same institution in 1973.

18  
19       **Q. WHAT SORT OF WORK DO YOU DO?**

20       A. I perform economic, demographic, financial and market analyses related to water  
21       and other natural resources. Our clients, most of whom are in the western United  
22       States, are usually resource providers, state agencies and private developers.  
23       Typical assignments would include rate studies, valuation of resources, financial  
24       feasibility studies, conservation and other resource planning and economic impact  
25       analyses.

26  
27       **Q. WHAT OTHER QUALIFICATIONS DO YOU OFFER SPECIFIC TO THIS CASE?**

28       A. I have performed consulting services for the Salt River Project, the City of Tucson,  
29       the Town of Carefree, Central Arizona Groundwater Replenishment District, the  
30       Town of Show Low and the Upper San Pedro Partnership. For the City of Casa  
31       Grande, I helped establish a value for a small water system purchase and I have  
32       consulted with the City on various water related financial matters since 2001.

1 **Q. HAVE YOU TESTIFIED BEFORE THIS COMMISSION OR ANY OTHER**  
2 **ADMINISTRATIVE OR JUDICIAL BODY?**

3 A. I have not testified before the Arizona Corporation Commission. I have testified  
4 before state trial courts in Arizona, Colorado, Wyoming and Montana, and the United  
5 States District Court for the District of Wyoming. I have also testified before  
6 administrative bodies, including the Kentucky Public Service Commission Siting  
7 Board, the Wyoming Water Development Commission, the Wyoming Industrial Siting  
8 Board, the Colorado Water Conservation Board, the Nebraska Water Resources  
9 Board and other state and local organizations. I have testified as an expert witness  
10 on water related economic and financial matters.  
11

12 **II. PURPOSE AND SCOPE OF TESTIMONY**

13  
14 **Q. CAN YOU DESCRIBE THE SCOPE OF YOUR TESTIMONY IN THIS**  
15 **PROCEEDING?**

16 A. I have been retained by the City of Casa Grande to review and comment upon the  
17 Arizona Water Company (the "Company") filing for a water rate increase for its  
18 Western Group as set forth in its September 8, 2004 submittal under Docket No. W-  
19 01445A-04-0650. In my direct testimony, I will comment upon or critique different  
20 elements of the Company's rate filing, focusing upon assumptions and rate making  
21 procedures that the Company has put forward in its direct case.  
22

23 **III. CRITIQUE OF THE COMPANY'S RATE FILING**

24  
25 **Q. WHAT NEW PERSPECTIVE CAN YOU AS A WITNESS FOR THE CITY OF CASA**  
26 **GRANDE BRING TO THIS RATE PROCEEDING?**

27 A. Certainly, the Company has produced extensive testimony and information in  
28 support of its application for a rate increase. The ACC staff and RUCO will  
29 presumably scrutinize the Company's application and provide their own alternative  
30 analyses for the Commission and others to consider. However, it is the cities and the  
31 citizens themselves who will ultimately have to live with the water rate increases, the  
32 water resource management, and operating philosophies of the Company. As of the  
33 test year 2003, the residents and businesses located within the City of Casa Grande  
34 accounted for almost two-thirds of the Western Group customers, three-quarters of

1 the original cost rate base, and almost 81 percent of the adjusted operating revenue  
2 of the Western Group. About \$2.3 million of the \$3.1 million in additional water  
3 system revenues sought by the Company, and which are the subject of this  
4 proceeding, would be paid by City of Casa Grande residents and businesses.

5  
6 **Q. CAN YOU SITE A SPECIFIC INSTANCE WHERE THE INTERESTS OF CITY OF**  
7 **CASA GRANDE CUSTOMERS ARE NOT ADEQUATELY ADDRESSED IN THIS**  
8 **RATE PROCEEDING?**

9 A. The first and simplest instance relates to the cost recovery plan for Central Arizona  
10 Project (CAP) M&I deferred capital payments. Based upon the presumption that CAP  
11 water is primarily intended to serve future customers, the incremental costs of CAP  
12 deferred M&I capital charges should be paid by those future customers. It is not fair  
13 that existing customers should subsidize future customers by paying for water costs  
14 that are not properly attributed to them.

15  
16 There are several means of accomplishing this cost recovery in the context of this  
17 rate proceeding. The first alternative would be the cost recovery of CAP deferred  
18 capital costs through a surcharge to new customers' bills as those customers are  
19 added to the Casa Grande system, following the 2003 test year. Should this  
20 alternative be adopted, as it was in the Eastern Group rate case, the deferral amount  
21 might need to be amortized over a longer period than the ten years adopted in the  
22 Eastern Group case, perhaps 20 years. Should a 20 year period be used, the  
23 appropriate basis for amortizing the deferred M&I costs would be the projected  
24 number of Casa Grande customers through the year 2025, after Casa Grande's CAP  
25 allocation is consumed.

26  
27 Another means for recovering CAP deferred capital costs would be to establish a  
28 water resource fee as a one-time, up-front capital cost to all new customers. I  
29 understand that this approach might be outside the purview of the ACC in this  
30 proceeding, but it is an approach the Company might consider taking.  
31 Either approach would help protect existing customers, since payment of CAP capital  
32 costs by existing customers would violate the principal that growth should pay its  
33 own way in Casa Grande. The City of Casa Grande imposes impact fees, for

1 example, on new developments within the City. Treatment of new customers should  
2 be consistent.

3  
4 **Q. ARE THERE OTHER EXAMPLES WHERE YOU BELIEVE THE INTERESTS OF**  
5 **CASA GRANDE CUSTOMERS ARE BEING IGNORED?**

6 A. Yes. I believe the Company should be committed to providing the City of Casa  
7 Grande and other customers in this case, the lowest cost, high quality water over the  
8 long term for the customers in its service area. This commitment should be  
9 demonstrated in this rate proceeding as an indispensable foundation to the charges  
10 the customers will face in the future. For example, the deployment of CAP water  
11 versus groundwater over time, the tactical plan and technical approach for removing  
12 arsenic, and the Company's decision to lease or purchase the arsenic treatment  
13 facilities are all essential precursors, in my mind, which lead to the rate increase  
14 proposals that are the subject of this proceeding. How the Company approaches  
15 each of those issues in the test year, today, and in the future will go a long way  
16 toward establishing the cost of water which the citizens of Casa Grande and others  
17 in the Western Group face.

18  
19 **Q. SPECIFICALLY, WHAT ARE YOU SUGGESTING?**

20 A. At least for the City of Casa Grande, the Company should explain the strategy for  
21 using CAP water in the future and demonstrate why it is the lowest cost long-term  
22 strategy. Can CAP water, for example, be deployed in Casa Grande more quickly,  
23 avoiding a \$12 million cost for arsenic abatement? A water resource plan is an  
24 essential foundation for the establishment of water rates because it establishes key  
25 assumptions leading to costs. I believe that a water resource plan demonstrating the  
26 lowest cost, long-term approach merits consideration in this proceeding.

27  
28 **Q. HAVE YOU REVIEWED THE ARSENIC COST RECOVERY MECHANISM**  
29 **DECISION IN THE NORTHERN GROUP CASE, AND DO YOU HAVE ANY**  
30 **OPINIONS ABOUT ITS APPLICABILITY TO THE CITY OF CASA GRANDE OR**  
31 **OTHER WESTERN GROUP CUSTOMERS?**

32 A. Yes, I have reviewed the opinion and order regarding the arsenic cost recovery  
33 mechanism ("ACRM") in the earlier case. Unlike CAP water, which was obtained to  
34 serve future customers, the arsenic removal requirement benefits existing as well as

1 new customers, and, therefore, it is appropriate that an arsenic cost recovery  
2 mechanism be devised for all customers.

3  
4 I have several concerns about the pursuit of grants and low interest loans or other  
5 public support for the arsenic treatment facilities. If the Company is able to reap any  
6 savings from grants, low interest loans, or a reduced cost repurchase of a  
7 demonstration facility in Sedona for instance, all of the customers served by the  
8 Company should participate in those savings. If the Company, for example, happens  
9 to pursue arsenic treatment for the Northern Group before the Western Group, it  
10 might get assistance there that would not be further extended to other Arizona Water  
11 Company systems. It is only fair to all of the Company customers that any savings  
12 be shared among those facing arsenic treatment costs.

13  
14 Secondly, it is disappointing that a loan from the Water Infrastructure Finance  
15 Authority ("WIFA") could not be obtained. Is it possible that such low interest  
16 financing could be obtained if municipalities played a larger role?

17  
18 I believe a much greater effort should be made to obtain low interest loans or grants  
19 and that any savings should be shared among the water systems which fall under  
20 the ACRM on a percent of total investment basis. The capital expenditure for arsenic  
21 treatment for the City of Casa Grande is a very substantial number, on the order of  
22 \$12 million, and the City should have much more involvement in how this need is  
23 met on a cost effective basis, with the tactical plan sanctioned by this Commission.

24  
25 **Q. DOES IT CONCERN YOU THAT THE COMPANY DOES NOT KNOW YET**  
26 **WHETHER IT INTENDS TO LEASE OR OWN THE ARSENIC TREATMENT**  
27 **PLANTS?**

28 **A.** Yes, it does. The ACRM, and therefore the position of the customers, remains in flux  
29 somewhat until the lease-versus-own decision is made. At a minimum, I believe the  
30 Company should be required to demonstrate that the decision of leasing versus  
31 owning the arsenic treatment plants will be made in the best long-term interest or  
32 lowest long-term cost for the customer.

33

1       **Q.     NOW LET US TURN TO THE RATE OF RETURN PROPOSED BY THE**  
2       **COMPANY. FIRST OF ALL, DID YOU DEVELOP YOUR OWN FINANCIAL**  
3       **MODELS FOR THIS CASE, SUCH AS DISCOUNTED CASH FLOW, AND IF YOU**  
4       **DID NOT, WHY NOT?**

5       A.    No, I did not prepare my own models for this direct testimony. I confined my direct  
6       testimony to an evaluation of the Company's proposed rate of return and its  
7       underlying and supporting information. I did not prepare my own models because I  
8       did not have sufficient data, nor any data in electronic form, in which to produce such  
9       a model. Further, I believe ACC Staff and RUCO will prepare such alternative  
10      models for me to review, so the effort to prepare yet another set of models might be  
11      unnecessary.

12  
13      **Q.     WHAT IS YOUR OPINION ABOUT THE COMPANY'S CAPITALIZATION**  
14      **STRUCTURE AS PRESENTED FOR THE TEST YEAR?**

15      A.    I believe the Company needs to make a showing of why this capitalization structure  
16      is the most advantageous from the standpoint of the customer as well as for the  
17      Company. Short-term debt, a relatively low-cost source of funds, was \$1.25 million  
18      in 2002 for the Western Group, but is not evident for the 2003 test year, which is the  
19      subject of this proceeding. On the other hand, common equity, the highest cost  
20      source of funds from the customers' standpoint, has increased almost 20 percent  
21      from 2001 to 2003.

22  
23      The capitalization structure of the Company is obviously within the Company's  
24      control and more evidence is needed about how and why the Company arrived at  
25      this particular capitalization structure. Capitalization structure or breakdown goes a  
26      long way towards establishing the rate of return that might be approved by the  
27      Commission in this case. The Company's 2003 test year capitalization structure  
28      appears to offer the opportunity for a relatively high rate of return, which would  
29      produce large water rate increases for customers. Has a good-faith effort been  
30      expended, for instance, to refinance long-term debt or to reduce borrowing costs?

31  
32      **Q.     HAVE YOU REVIEWED THE COMPANY'S TESTIMONY AND EXHIBITS WITH**  
33      **RESPECT TO THE RETURN ON EQUITY ASSUMPTION?**

34      A.    Yes, I have.

1       **Q.     CAN YOU DESCRIBE ANY ISSUES YOU HAVE WITH THE USE OF**  
2       **FORECASTING IN THE COMPANY'S CALCULATED RETURN ON EQUITY**  
3       **(ROE)?**

4       A.     Yes, I believe the Company's witness has over-relied upon projected stock market  
5       conditions, prices, merger and acquisition prospects influencing stock price, interest  
6       rate projections and other future considerations that are too speculative for a rate  
7       making decision by this Commission. It is common knowledge that stock prices are  
8       influenced day-to-day by many considerations and interest rate projections are highly  
9       speculative. The Company could be unfairly penalized or unjustly rewarded if the  
10      Commission were to rely upon such prospective and speculative forecasts. Further,  
11      such reliance upon prospective, speculative assumptions will lead inevitably to a  
12      battle of investment market prognosticators, a slippery slope without a definitive  
13      answer. I would suggest that the Commission adopt return on equity calculations  
14      which consider a minimum of forecasted information in arriving at a justifiable  
15      calculation. The Company's use of projected financial data is a step toward  
16      prospective rate setting. I believe the ACC's traditional process, based upon a  
17      demonstrative showing of historical costs and inadequate returns, is best since it  
18      allows all of the facts to be fully examined by the parties.

19  
20      **Q.     IF THE COMMISSION WERE TO AGREE WITH YOU AND AVOID AN OVER-**  
21      **RELIANCE ON FINANCIAL MARKET FORECASTS, WHAT ARE THE**  
22      **IMPLICATIONS FOR THIS PROCEEDING?**

23      A.     This would suggest the adoption of an approach for calculating return on equity more  
24      similar to the Staff approach in the Northern and Eastern cases, as opposed to the  
25      Company's approach proposed in this Western Group case. A reliance on historical  
26      financial data will typically support the lower end of the ROE estimates produced by  
27      discounted cash flow models, regardless of whether they are generated by the  
28      Company or Commission Staff. It will also produce lower estimates from the risk  
29      premium approach by avoiding interest rate forecasts.

30  
31      **Q.     DO YOU HAVE AN OPINION ABOUT THE RISK PREMIUM METHODS FOR**  
32      **ESTIMATING ROE?**

33      A.     Yes, conceptually the discounted cash flow models and the risk premium method  
34      can be useful approaches to estimating ROE, as long as historical data are used. In

1 the risk premium technique, I believe the reliance on historical 10-year Treasury  
2 returns is the correct risk-free benchmark.

3  
4 The shortcoming to the risk premium calculations is the reliance on the return on  
5 equity experience of other water utilities. The myriad of factors that determine an  
6 acceptable return on equity for one water utility are unlikely to be repeated for others.  
7 The customer base is different, the regulatory environment is different, the water  
8 resource availability and water quality issues also differ. For example, a California  
9 water utility represents a very different equity investment opportunity than the  
10 Arizona Water Company. Debt structures alone will change the attractiveness of one  
11 water utility as an investment. The usefulness of comparables must be tempered or  
12 each utility in the sample needs to be adjusted for more direct comparability.  
13

14 **Q. IT SEEMS THAT YOU HAVE CRITICISMS FOR EACH COMPONENT OF THE**  
15 **RATE OF RETURN DERIVATION PROCESS. WHAT DO YOU RECOMMEND**  
16 **THAT THE COMMISSION DO UNDER THESE CIRCUMSTANCES?**

17 A. Be conservative in the rate of return it awards the Company.  
18

19 **Q. DO YOU SUPPORT THE COMPANY'S ASSERTION THAT ITS RELATIVELY**  
20 **HIGH LEVEL OF UNCERTAINTY MERITS A HIGHER RATE OF RETURN THAN**  
21 **OTHER COMPARABLE WATER UTILITIES?**

22 A. Absolutely not. First of all, the Company's size might be somewhat smaller than  
23 other companies, but it enjoys certain advantages as well. Notably the Company,  
24 and certainly the Western Group, has a growing base of customers, 4.5 percent as  
25 an annual average for Casa Grande from 1990 to 2003. The Company's risk is  
26 diversified by serving eighteen different water systems. Importantly, the Company's  
27 risk as perceived in the marketplace might actually be reduced as a result of this, as  
28 well as the previous Northern and Eastern rate proceedings, because a mechanism  
29 has been established for recovering CAP deferred M&I capital costs and recovering  
30 arsenic capital costs and certain O&M costs. The contention that the ACRM  
31 increases the Company's risks or uncertainties does not appear to make sense  
32 because the Company was instrumental in its creation. Regarding the purchased  
33 power adjustment mechanism and the purchased water adjustment mechanism,  
34 these factors do not appear to have been dominant cost considerations in the past.

1 Both mechanisms together produced only a net adjustment difference of \$176,000  
2 from 1993 to 2003. In sum, the uncertainties facing the Company are not  
3 demonstrably different from others in the industry and the uncertainties facing the  
4 Company will be reduced substantially with this and recent rate case decisions and  
5 orders. Two key sources of uncertainty facing the Company have already been  
6 resolved in the Northern and Eastern rate cases, and it is likely they will also be  
7 resolved in this one. In my opinion, the approved rate of return to come out of this  
8 proceeding should not be increased from the minimum levels estimated using the  
9 discounted cash flow, capital asset pricing, or risk premium method which will be  
10 utilized in this case. If anything, I believe there is a lower overall uncertainty facing  
11 the Company which might warrant a discount on the return on equity.  
12

13 **Q. DO YOU HAVE ANY OPINIONS ABOUT THE COMPANY'S PROPOSED RATE**  
14 **DESIGN?**

15 A. Yes, I do.  
16

17 **Q. DO YOU BELIEVE THAT INVERTED BLOCK RATES CREATE UNDUE REVENUE**  
18 **UNCERTAINTY ON THE PART OF THE COMPANY'S WESTERN GROUP**  
19 **CUSTOMERS?**

20 A. No, I do not. Inverted block rates are quite common throughout the water utility  
21 industry and they are widely accepted as an appropriate water resource  
22 management strategy. There is ample information regarding price elasticity for the  
23 Company to predict any reduction in water usage and associated revenue. In a  
24 location such as the City of Casa Grande, a rate structure other than inverted blocks  
25 would send the wrong message to present and future customers.  
26

27 **Q. WHAT ARE YOUR OPINIONS ABOUT THE PROPOSED WATER RATES BY**  
28 **METER SIZE FOR THE CITY OF CASA GRANDE?**

29 A. The water rates by meter size proposed by the Company make no sense. For an  
30 unexplained and unjustified reason, the Company proposes to increase rates at a  
31 higher percentage for the smaller meter sizes. The Company's Exhibit H-2 suggests  
32 that in Casa Grande, the smallest meter size, 5/8 inch, will experience the highest  
33 percent rate increase, except for the 8 inch meter size. No rationale supports this.  
34 Regarding the proposed minimum charges, the Company's Exhibit H-3 would result

1 in an increase in charges of 25.7 percent for the 5/8 inch meter size, whereas the  
2 minimum charge for a 3 inch meter would increase by 57 percent in Casa Grande.  
3 Again, no rationale is offered to support this.

4  
5 The Company's Exhibit H-4, the percentage changes in water bills, points to a  
6 regressive rate structure and, in fact, these rates offer an incentive not to conserve  
7 water. The Casa Grande customers who consume the least water are subject to the  
8 highest percent increases in their bills. This singles out the smaller lot owners, often  
9 older people on fixed incomes, for the higher rates. In contrast, those who use  
10 excessive amounts of water would face ever smaller increases in their bills.

11  
12 As it stands, the Company's proposed water rate design has no validity. There has  
13 been no cost of service study by meter size or by volume of water sold, not to  
14 mention cost of service by customer type, so there is no basis in the Company's  
15 evidence submitted in this case to support its proposed rate design. A cost of  
16 service study by meter size and by volume of water sold should be offered as  
17 support for a rate design.

18  
19 **Q. DOES THAT CONCLUDE YOUR TESTIMONY?**

20 **A.** Yes, it does.

21