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BEFORE THE ARIZONA CORPORATION COMMISSION

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WILLIAM A. MUNDELL
Chairman
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Commissioner
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Commissioner

IN THE MATTER OF THE APPLICATION OF BELLA VISTA WATER CO., INC. AN ARIZONA CORPORATION TO DETERMINE THE FAIR VALUE OF ITS PROPERTIES FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES AND TARIFFS DESIGNED TO DEVELOP SUCH RETURN	DOCKET NO. W-02465A-01-0776 **ARIZONA CORPORATION COMMISSION STAFF'S EXCEPTIONS TO THE RECOMMENDED OPINION AND ORDER REGARDING INCLUSION OF POST-TEST YEAR PLANT IN RATE BASE**

Staff of the Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") respectfully submits its exceptions to the Recommended Opinion and Order ("ROO") issued in this case. Staff believes that the evidence on this record justifies exclusion of post-test year plant from rate base. Staff believes that Bella Vista Water Company ("BWVC" or "Company") has failed to show that the addition of post-test year plant results in no impacts on revenues and expenses. The Company has failed to quantify the material derivative impacts of adding post-test year plant to plant in service, and as a result the impacts are not known and measurable. Finally, Staff still believes that, based on the evidence presented, inclusion of post-test year plant violates the matching principle for rate base, revenues, and expenses. For all of the above reasons, Staff does not believe the Company has met its burden justifying inclusion of post-test year plant and would recommend that such be excluded from rate base.

The following highlights the arguments Staff presented in pre-filed testimony, at the hearing, and in its closing brief regarding post-test year plant. In its closing brief, Staff cites to the appropriate portions of the hearing and pre-filed testimony where the issue of post-test year plant was discussed.

THE COMPANY HAS NOT PRESENTED A COMPELLING ARGUMENT JUSTIFYING INCLUSION OF POST-TEST YEAR PLANT

Staff understands the Commission's broad authority and vast latitude to determine fair value,

S:\LEGAL\JGELLMAN\BELLA VISTA\EXCEPTIONS.DOC so long as not arbitrary or unreasonable. Staff also recognizes that the rules allow for pro forma adjustments and that each case must be looked at on its own merits. And Staff also understands the interest of all parties in avoiding an abundance of rate cases. However, the impact of inclusion of post-test year plant in rate base results in an increase in the revenue requirement of approximately $296,082, which will result in higher rates for the rate payer than what the rate payer should have to pay. The resulting rates from the ROO will be the result of a violation of sound rate making principles. Staff's argument here is that given the evidence in this case, this Commission should not allow the inclusion of post-test year plant. Staff agrees with the ROO that post-test year plant can been allowed in cases where no extraordinary circumstances exist; however, if no extraordinary circumstances exist, Staff believes that the Company must show matching of revenues and expenses to rate base via known and measurable quantities. Clearly, in this case, no one is arguing the existence of extraordinary circumstances. While Staff comprehends the need to avoid having the same utility constantly expend time and money for repeated rate cases, Staff believes that this concern cannot outweigh the concern to keep the rate payer from paying any more in rates than he or she should have to pay. Staff presented evidence that explains that to include post-test year plant in this case sacrifices fundamental rate making principles. It is that reason, together with the obligation to ensure that rates are no more than what they have to be, that are the compelling factors outweighing the need to avoid repeated rate cases.

Staff also understands the need to encourage companies to remain as well-managed and well-run as BVWC has been. However, those arguments should not justify the inclusion of post-test year plant in violation of fundamental rate making and accounting principles when rates will be significantly impacted, especially when the Company has discretion over the test-year it chooses. It is the Company's responsibility to select an appropriate test-year when applying to the Commission for an adjustment in rates. The Company should be encouraged to choose a test year that meets its needs while still ensuring adherence to sound rate making principles. Staff's concern is that by allowing a Company to choose a test-year, and include post-test year plant in violation of sound rate making and accounting principles for the sake of avoiding multiple rate cases, sound rate making policy is lost. Similarly, any water company should always provide efficient and reliable service. Staff believes that inclusion of post-test year plant would violate the fundamental accounting principles and is not justified in this case.

STAFF HAS ESTABLISHED A POLICY OF ALLOWING POST-TEST YEAR PLANT IN ACCORDANCE WITH THE ARIZONA ADMINISTRATIVE CODE AND SOUND RATE MAKING PRACTICE.

The historical test year provides the basis for rate-making in Arizona. A. A. C. R14-2-103(A)(3)(p) defines a test year as "the 1-year historical period used in determining rate base, operating income and rate of return. The end of the test year shall be the most recent practical date available prior to filing." This rule is the foundation for rate making in Arizona, as established by the Commission in the Arizona Administrative Code. The rules do allow for pro forma adjustments, which are modifications to test year results to more accurately reflect reality during the periods that rates will be in effect. Pro forma adjustments more accurately reflect reality when revenues, operating expenses and rate base are matched. When appropriate, pro forma adjustments must be in conformance with the matching principle and any pro forma adjustment's impacts on revenues, rate base, and expenses must be known and measurable. The only exception to the above precepts should be when extraordinary circumstances exist. Extraordinary circumstances existed in both the most recent Paradise Valley Water Company and Far West Water Company rate cases. No party contends that this is a case where extraordinary circumstances exist.

Staff has adhered to a longstanding policy regarding post-test year plant, yet has looked at this case on its own individual merits. The historical test year with allowance for pro forma adjustments when appropriate or in extraordinary circumstances is Staff's policy. This policy was emphasized in Decision No. 62649, where the Commission stated:

> It is unreasonable for the Commission to order the Company to make such an investment that triples its rate base and to approve financing, but reject the request for rates that would support the investment and provide a fair and reasonable return. By establishing permanent rates based on this application, we do not intend to create a precedent permitting companies to disregard the requirement of A.A.C. R14-2-103(B) to file applications based on a historical test year, or indicating that we will approve post-test year adjustments in any other context.

<u>See</u> Commission Decision 62649, p. 5, lines 7 – 13.

The administrative code and prior Commission decisions establishes the clear policy that

Staff should abide by. Staff has done so in this case. Based on its analysis Staff did not feel inclusion of post-test year plant was warranted in this case.

THE INCLUSION OF POST-TEST YEAR PLANT IN THIS CASE IS NOT AN APPROPRIATE PRO FORMA ADJUSTMENT BECAUSE THE IMPACTS OF THE ADJUSTMENT ARE NOT KNOWN AND MEASURABLE.

In this case, BVWC sought to include $1,797,279 of post-test year plant into rate base. However, the impact of the post-test year plant additions on revenues and expenses was not determined. The Company argued that the improvements were not intended to increase revenues and that expenses would either stay the same or increase. However, the Company failed to demonstrate the actual impacts of inclusion of post-test year plant on revenues and expenses[1]. In other words, those impacts are not quantifiable and are not known and measurable. Consequently, the Company has failed to meet its burden to show that no mismatch exists if post-test year plant is included in rate base.

Staff believes inclusion of $1,797,729 of post-test year plant in rate base is not an appropriate pro forma adjustment to make in this case because the evidence shows a mismatch between rate base, revenues and operating expenses is created. By contrast, Staff did recommend approval of the salary for an employee recruited in 2001 because the cost was known and measurable and did not create a mismatch between revenues, operating expenses and rate base. Furthermore, the impact of that expense (i.e. the salary for the additional employee) was known and measurable. In this proceeding, no evidence was presented quantifying the impact of post-test year plant on revenues and expenses. If post-test year plant were to be included, then the appropriate matching adjustments would need to be made to items such as accumulated depreciation, which do not appear to have been made in the ROO[2]. This only worsens the dilemma.

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[1] Staff's closing brief extensively cites portions of the transcript and pre-filed testimony, which shows that the Company's evidence has been refuted and that its burden to justify inclusion of post-test year plant has not been met. <u>See</u> Staff's Closing Brief at 4-8.

[2] The relationship between advancing the utility's plant beyond the test year (i.e. including post-test year plant) and not advancing can best be analogized to an interest bearing bank account. The bank pays a depositor on the deposit at the end of the day. The ending balance is calculated by adding deposits and subtracting withdrawals from the beginning balance. For example, if a customer with a $25,000 beginning balance makes a $5,000 deposit and a $10,000 withdrawal, the ending balance on which interest is earned is $20,000. If the bank recognized only deposits, but not withdrawals, the depositor would earn interest on $30,000 (although only $20,000 was in the account). Both deposits and withdrawals must be measured and recognized at the same point in time for the calculation to be meaningful. Similarly, all components of rate base must be measured at the same point in time. Otherwise, a utility's earnings are based on a rate base that is not equal to investor's capital commitment on any particular date. Plant additions are best equated to bank

Since construction of most of the $1,797,729 post-test year plant commenced after the end of the test year, the plant simply was not used and useful at any point during the test year. Under these circumstances, the plant could not be classified as construction work in progress ("CWIP"); CWIP is not normally allowed in rate base in Arizona anyway. As stated above, the Company presented no financial data to support its claim that the inclusion of post-test year plant in rate base would have no material impact on revenues or operating expenses. For those reasons, Staff respectfully disagrees with the conclusion in the ROO that the Company has met its burden justifying inclusion of post-test year plant.

CONCLUSION

In conclusion, Staff would respectfully recommend that post-test year plant in the amount of $1,797,297 be disallowed and the proposed rates be reduced accordingly for the reasons stated above. BVWC has failed to meet its burden justifying inclusion of that plant, and it should be excluded.

RESPECTFULLY SUBMITTED this 25th day of October, 2002.

Jason D. Gellman
Attorney, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
(602) 542-3402

The original and fifteen (15) copies
of the foregoing was filed this
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Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

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case deposits by utility investors and recoveries of accumulated depreciation are like bank cash withdrawals by utility investors. In this case, the inclusion of post-test year plant results in a mismatch because accumulated depreciation is measured from a different date.

Lyn Farmer, Chief Hearing Officer
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Christopher Kempley, Chief Counsel
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85008

Ernest Johnson, Director
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

William P. Sullivan, Esq.
Martinez & Curtis, P.C.
2712 North 7th Street
Phoenix, Arizona 85006-1090

Daniel W. Pozefsky, Esq.
Residential Utility Consumer Office
1110 West Washington Street, Suite 220
Phoenix, Arizona 85007

Viola R. Kizis