ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
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IN THE MATTER OF THE APPLICATION OF UTILITY SOURCE, L.L.C. FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PROPERTY AND FOR AN INCREASE IN ITS WATER AND WASTEWATER RATES AND CHARGES FOR UTILITY SERVICES.

DOCKET NO. WS-04235A-06-0303

STAFF'S CLOSING BRIEF

I. INTRODUCTION

This case proceeds from an unusual starting posture. Utility Source LLC ("Utility Source" or the "Company") began as a home owners association that provided water and wastewater service to a community in the vicinity of Flagstaff, Arizona.[1] The Company began charging rates and installing facilities needed for the provision of a public service without first having obtained a Certificate of Convenience and Necessity ("CC & N") from the Arizona Corporation Commission ("Commission").[2] According to Company owner Mr. Lonnie McCleve, it was not until the Company had begun providing services that it became aware that it was subject to Commission regulation of rates and services.[3] To that point, the Company had been charging rates pegged to the prevailing rates in the City of Flagstaff for the same services.[4]

In 2004, Utility Source made an application to the Commission to obtain a CC & N to serve the area it had already begun serving. This application was approved by Decision No. 67446 in early 2005. Decision No. 67446 considered the rates the Company was charging with those that Commission Utilities Division Staff ("Staff") had designed based on an ordinary initial CC & N analysis. The increase from the rates Utility Source was charging to those that Staff's analysis suggested were appropriate for an initial CC & N was deemed "unconscionable" by the

[1] Exhibit S-1 (Direct Testimony of Jian Liu) Attached Engineering Report at 1.
[2] *See In the Matter of Utility Source, LLC* Docket No. WS-04235A-04-0073, Decision No. 67446 (Jan. 4, 2005)
[3] Tr. Vol. I at 33-34.
[4] *Id.* at 32

Commission and so the Company was directed to continue charging the same artificially low rates pending a full rate application based on year 2005 numbers.[5]

In compliance with Decision No. 67446, Utility Source filed an application for an increase in its rates for the water and wastewater services it provides on May 1, 2006. In its initial application, the Company requested an approximate average 230% increase in rates for its residential water service and 160% increase for its wastewater services.[6] The present shift from the artificially low rates the Company had been charging to what cost of service principles suggest are appropriate gives rise to the major issue presented by this case, rate shock. The Company also made the unusual proposal to essentially double the customer base by including the revenues from an additional 350 future customers in anticipation of rate impact issues.[7]

Staff accepted the offer of the additional revenues but this gave rise to further issues relating to how to reconcile the Commission's obligation to determine just and reasonable rates with the unusual nature of rate base treatment in the context of present and future customers. To deal with this issue, Staff pursued the extraordinary course of suggesting three alternative ways to resolve the interplay between pro forma future customers, rate of return, and the appropriate inclusions in rate base.[8] Staff based its recommendation of the first alternative on the additional issues of rate shock and the Company's low initial rates.

The position Staff recommends accepts the inclusion of the revenue generated by 350 pro forma future customers as well as Deep Well #4 which is not presently used and useful but will be necessary to serve those 350 future customers. Testimony provided at hearing revised the estimate of anticipated future customers to approximately 276, although all parties continue to use 350 as the basis for the future customers contemplated by this offer.[9] However, in light of the over-arching issue of rate shock and gradualism, Staff proposes an adjustment to the fair value rate of return for the Company's water division, effectively reducing it to 6.23% in addition to inclusion of the revenues from the 350 future customers. This reduction applies solely to the water division,

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[5] Decision No. 67446 at 16.
[6] *See, e.g.*, Exhibit A-1 (Bourassa Direct) Schedules A-1 (Water) and A-1 (Sewer)
[7] Exhibit A-1 (Bourassa Direct (Water)) at 11:23-25
[8] Exhibit S-2 (Michlik Surrebuttal (Water)) at 11-12.
[9] Exhibit A-5 (Bourassa Rejoinder (Water)) at 12:11-14, (Bourassa Rejoinder (Wastewater)) at 6:8-11.

whereas the wastewater division would continue to have an 8.9% fair value rate of return applied to its rate base. This course has given rise to yet another contentious issue between the parties relating to the appropriateness of such an adjustment.

At hearing, Administrative Law Judge ("ALJ") Teena Wolfe directed Staff to further prepare schedules relating to a fourth scenario to resolve the issues related to the future customers and rate base. The Company responded formally to this scenario by filing comments in the docket and has expressed concern that electing this alternative bears a number of additional issues related to confiscation of Company assets.[10] Staff did not propose this alternative and continues to offer its first alternative as its recommendation. Further, Staff notes there are significant problems with the ALJ proposed alternative. However, Staff will respond more fully in the hypothetical to the issues presented by the ALJ proposed fourth scenario later.

Although the principal issues here are fallouts of the larger issue of rate shock and gradualism, other disputed issues persist between the Company and Staff in this case. The parties do not agree on the appropriate return on equity. Staff proposes a return on equity of 8.9% based on its cost of capital analysis, whereas the Company reached a 10.5% ROE recommendation. Further, unresolved issues remain related to rate design and revenue requirement as well, though for the most part these are consequences of the positions taken by the parties with respect to fair value rate of return applied to rate base.

II. COST OF CAPITAL

Staff recommends a capital structure of 100% equity and 0% debt.[11] The Company and Staff agree on capital structure. Staff's final recommended ROE is 8.9%.[12] The Company's recommended ROE is 10.5%.[13]

Staff's ROE recommendations employ market-based financial models that have been consistently accepted by this Commission. These methods utilized both historical and forecasted economic information. A typical investor can reasonably be expected to consider all of the inputs

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[10] Company Filed Comments On, And Objections To, Late Filed ALJ Scenario #4.
[11] Exhibit S-1 (Irvine Direct) at 6.
[12] Exhibit S-2 (Irvine Surrebuttal) at 2.
[13] Exhibit A-1 (Bourassa Direct (Cost of Capital)) at 2. Note that the overall rate of return ("ROR") is the same as the respective ROE for Staff and the Company because of the capital structure.

Staff used in determining the expected rate of return.[14] The models are also widely accepted in the financial industry and by most state commissions in setting just and reasonable rates of return.

The Company's recommendations are based on two different constant growth DCF models and one multi-stage DCF model.[15] The Company then selects its recommended ROE within the range of results by comparing them to the risk premium and comparable earnings "approaches" performed by Company witness Mr. Thomas Bourassa.[16]

The risk premium and comparable earnings "approaches" rely extensively on non-market based data and forecasts. Utility Source also requests premiums on the ROE for diversifiable risk to additionally compensate for the Company's small firm size and individual business risk. The Commission has consistently rejected the use of these approaches as well as the extension of premiums for small firm size and individual business risk.

A. The Commission Should Adopt Staff's Recommended ROE of 8.9% Because It Is Based On Proven Financial Models And Balanced And Reasonable Inputs

To determine the required rate of return, Staff used the following financial models: (1) the constant growth discounted cash flow ("DCF") model (7.7%); (2) the multi-stage DCF model (9.1%); and (3) the capital asset pricing model ("CAPM"). Staff used two CAPM estimates, one using an historical market risk premium (11.0%), and one using a current market risk premium (7.8%). Staff first averaged the DCF results (8.4%); then calculated an average for the CAPM results (9.4%); and finally determined the average for both models (8.9%) to obtain the recommended return on equity.[17]

For the constant growth DCF, Staff calculated the growth factor by averaging the results of historical and forecasted earning per share ("EPS"), dividends per share ("DPS"), and sustainable growth.[18] Staff chose a balanced methodology that "gives equal weight to historical and projected EPS, DPS and sustainable growth."[19] Staff witness Mr. Steve Irvine testified that the advantage of

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[14] Exhibit S-2 (Irvine Surrebuttal) at 10.
[15] Exhibit A-1 (Bourassa Direct (Cost of Capital)) at 31:14-17; 32:10-24.
[16] Exhibit A-1 (Irvine Direct) at 19-20
[17] See Exhibit S-2 (Irvine Surrebuttal) Schedule SPI-2.
[18] Exhibit S-1 (Irvine Direct) at 14:18-21, Exhibit S-2 (Irvine Surrebuttal) at 10:15-17.
[19] Exhibit S-2 (Irvine Surrebuttal) at 10:16-17.

Staff's approach is that it produces a balanced outcome whereas the "[e]xclusion of inputs that tend to either increase or decrease results produces a skewed result…"[20]

Mr. Bourassa criticized Staff's choice of inputs because "the constant growth DCF result using projected DPS growth was at or below the cost of debt."[21] As Staff witness Mr. Irvine explained, the Commission has consistently rejected the reasoning Mr. Bourassa offers for excluding DPS growth as an input simply because its inclusion causes the final cost of equity result to decrease.[22] Rather, the "[e]xclusion of inputs that produce results that are … too low or too high based on a comparison to a benchmark of one's liking is inappropriate."[23] Mr. Irvine explained that if the Commission adopted Mr. Bourassa's approach, it should also exclude "the highest growth components to maintain a balanced outcome."[24] Additionally, Mr. Irvine testified that it is unreasonable to assume investors discard any of the information Staff utilized as inputs to its DCF analysis in making their investment decisions.[25]

Mr. Bourassa also criticizes selection of inputs as being laden with subjective judgments that do not pass a "reality check." Yet, Mr. Bourassa further explains that "Staff's approach starts and ends with a <u>mechanical application</u> of their financial models without any checks of reasonableness."[26] The criticism clearly indicates Mr. Bourassa's inappropriate focus on a result driven analysis.

Rather, it is Mr. Bourassa's method that suffers from the inappropriate interjection of professional judgment which disturb the reasonable results derived by "mechanical application" of widely used financial models. Mr. Bourassa's approach relies on utilizing multiple iterations of financial models and then selectively rejecting or accepting inputs as they produce results that bracket the initially desired result. This concerted application of a hit-or-miss approach with a circular input exclusion/inclusion criterion is not consistent with sound ratemaking.

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[20] Exhibit S-2 (Irvine Surrebuttal) at 10:10-11.
[21] Exhibit A-4 (Bourassa Rebuttal (Cost of Capital)) at 7:17-18.
[22] Exhibit S-2 (Irvine Surrebuttal) at 10:22-24 citing Docket No. G-01551A-04-0876, Decision No. 68487.
[23] *Id.* at 10:24 – 11:2.
[24] Exhibit S-2 (Irvine Surrebuttal) at 10:13-15.
[25] *Id.* at 10:11-13.
[26] Exhibit A-4 (Bourassa Rebuttal (Cost of Capital)) at 7:4-6.

Staff chooses its inputs by first identifying available market data. It then analyzes whether investors can be expected to rely on the available data. Staff inputs are pre-selected as specified from a balanced methodology. Staff does not use results to determine inputs. If inputs are selected appropriately, the results speak for themselves.

Finally, Mr. Bourassa criticizes Staff's CAPM results because its current market risk premium ("MRP") is unstable,[27] Staff utalized arithmetic and geometric means,[28] Staff relied on an industry beta as a proxy for the Company's beta,[29] Staff utilized current interest rates rather than forecasted interest rates,[30] and Staff did not include a premium for unique risks.[31] The Commission has repeatedly affirmed Staff's choice of inputs for both its DCF and CAPM models.[32]

Staff believes that the record in this case does not support a conclusion that its current MRP is unstable. The MRP moves with the market which can be volatile. "Changes in Staffs current MRP results are a reflection of changes in the market's current risk premium rather than instability in Staff's method."[33] Market volatility does not make the CAPM model unstable or subject to manipulation. To the extent that market volatility exerts an influence on the market based CAPM model, Staff employs a historical MRP that is averaged with the current MRP which mitigates such a potentiality.[34]

The Company next criticizes Staff's use of both geometric and arithmetic means in the CAPM analysis.[35] The Company's concern, in addition to its objections to the "volatility" of the method is that Staff's current MRP utilizes median values to derive the dividend yield and growth rate for the DCF used in the current MRP.[36] Mr. Bourassa's concern is that Staff utilizes arithmetic

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[27] Exhibit A-5 (Bourassa Rejoinder (Cost of Capital)) at 10-11.
[28] Exhibit A-4 (Bourassa Rebuttal (Cost of Capital)) at 23-24.
[29] *Id.* at 22:24-26.
[30] *Id.* at 13:16-21
[31] *Id.* at 17:2-9; Exhibit A-5 (Bourassa Rejoinder (Cost of Capital)) at 13:24 – 14:3.
[32] *See e.g. Re Far West Water and Sewer Company Rates*, Docket No. WS-03478A-05-0801, Decision No. 69335 (Feb. 20, 2007); *Re Black Mountain Sewer Company Rates*, Docket No. SW-0236 1 A-05-0657, Decision No. 69164 (Dec. 5, 2006); *In the Matter of the Application of Southwest Gas*, Docket No. G-01551A-04-0876, Decision No. 68487 (Feb. 23, 2006).
[33] Exhibit S-2 (Irvine Surrebuttal) at 12:5-7.
[34] Exhibit S-1 (Irvine Direct) at 27:22-24.
[35] Exhibit A-4 (Bourassa Rebuttal (Cost of Capital)) at 23:18 – 24:25.
[36] *Id.* at 23:14-15.

averages to determine the growth rate for the historic CAPM.[37] Staff explained that it is reasonable to use both arithmetic and geometric means because it leads to a more balanced approach to the analysis.[38] In its testimony, the Company frequently cites expert Dr. Roger Morin. Dr. Morin explains that, while the choice between arithmetic and geometric means can be confusing, each can be appropriate depending whether the growth being averaged is historic or prospective.[39]

The Company criticizes Staff's use of a sample of proxy companies to estimate Utility Source's expected ROE.[40] The Company claims that there is no evidence that use of the average betas is representative of the industry.[41] The Company used the same sample in its DCF analyses. The sample was chosen by both the Company and Staff because the companies are followed by publications that have necessary inputs for the financial models.[42] It is also noteworthy that very few water utilities are followed by the publications. Nevertheless, Staff's use of the proxy companies to estimate Utility Source's beta is reasonable. According to texts cited by both Mr. Bourassa and Staff, use of an industry beta is an accepted practice among financial analysts specifically because it improves the quality of the beta estimate.[43]

Equally unpersuasive is the Company's criticism of Staff's use of current interest rates in the CAPM formula. Mr. Bourassa states that the Staff recommendation should instead use forecasted interest rates for the 2008 – 2009 period as that is the relevant period when the Commission approved rates will be in effect.[44] As Mr. Irvine explained for Staff, irrespective of timing, it is impossible to predict interest rates.[45] "Analysts who forecast interest rates do not have any more information about the future than what is already reflected in the current rate. Present rates are more appropriate than forecasted rates, as the best indicator of tomorrow's yield is today's yield."[46]

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[37] *Id.* at 23:18-20.
[38] Exhibit S-2 (Irvine Surrebuttal) at 11:14-15.
[39] *See* Dr. Roger Morin, *Regulatory Finance: Utilities' Cost of Capital* (1994) at p. 275-76, 298.
[40] Exhibit A-4 (Bourassa Rebuttal (Cost of Capital)) at 22.
[41] *Id.*
[42] *See e.g.* Exhibit A-1 (Bourassa Direct (Cost of Capital)) at 14:26 – 15:3.
[43] *See e.g.* Richard A. Brealey & Stuart O. C. Myers, *Principles of Corporate Finance* (7th ed. 2003) at 226 ("[E]stimation errors tend to cancel out when estimating betas for portfolios. That is why financial managers often turn to industry betas.").
[44] Exhibit A-4 (Bourassa Rebuttal (Cost of Capital)) at 13:16-21.
[45] Exhibit S-1 (Irvine Direct) at 41:12-13.
[46] Exhibit S-2 (Irvine Surrebuttal) at 9:11-13.

The Company further argues that Staff's estimated beta does not include the following five risk factors: (1) limited revenues and cash flow; (2) firm size; (3) diversification, (4) regulatory risk, and (5) liquidity risk.[47] However, Mr. Bourassa provides no quantification of any of these risk factors in his testimony at any point. With respect to firm size, the Company does provide the example of the California PUC for authority that such a risk should be compensated.[48] However, as the Company notes, the Commission is not bound to follow the path taken by the California PUC. Rather, Mr. Bourassa invites the Commission to make the same subjective adjustment that permeates his cost of equity analysis by according an unspecified premium for a unique and diversifiable risk.

B. The Commission Should Reject The Company's Proposed 10.5% ROE Because It Is Based On Inputs That Artificially Inflate The Rate Of Return And Provide Premiums For Risks An Investor May Eliminate Through Diversification.

Mr. Bourassa testified that his recommended ROE "is based on cost of equity estimates using constant growth and multi-stage growth discounted cash flow ("DCF") and is *confirmed* by a risk premium analysis, [a comparable earnings analysis], and my review of the economic conditions expected to prevail during the period in which new rates will be in effect."[49] Mr. Bourassa testifies that his DCF results must be confirmed to comply with the *Bluefield Water Works*[50] and *Hope Natural Gas*[51] decisions.[52] The Company also argues that Utility Source's small size and individual business risk should increase its ROE.[53]

The Company's constant and multi-stage DCF results are higher than Staff's DCF results. Based on the analysis Mr. Bourassa performed, the midpoints of his three DCF models range from 9.4% to 10.9%.[54] The Company's results could be even lower. Mr. Bourassa's sole DCF model using EPS excluded one of his sample companies. Additionally, had the Company made the

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[47] Exhibit A-4 (Bourassa Rebuttal (Cost of Capital)) at 17:2-9.
[48] Exhibit A-4 (Bourassa Rebuttal (Cost of Capital)) at 17-18.
[49] Exhibit A-1 (Bourassa Direct (Cost of Capital)) at 2:16-21.
[50] *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923).
[51] *Federal Power Commission v. Hope Natural Gas*, 320 U.S. 591 (1944).
[52] Exhibit A-1 (Bourassa Direct (Cost of Capital)) at 12:18 – 13:23.
[53] *Id.* at 15:14-22.
[54] Exhibit A-5 (Bourassa Rejoinder (Cost of Capital)) at 2:3-5; Exhibit A-5 Rejoinder Schedule D-4.0.

appropriate inclusion of dividend growth information by considering DPS in its DCF studies, the rates would have been lower still.

The Company witness Mr. Bourassa excluded Middlesex because "by excluding Middlesex's projected EPS growth estimate, I remain consistent with my approach to have at least two independent sources."[55] The Company's devotion to the infallibility of analyst published growth estimates on the premise that multiple sources sanitizes them is unreasonable. As Mr. Irvine testified the sole reliance on analyst produced growth figures is unreasonable:

> Investors have at their disposal both analysts' forecasts and historic growth data. While analysts may have considered historical measures of growth, it is reasonable to assume that investors rely to some extent on past growth as well. This calls for consideration of both analysts' forecasts as well as past growth.[56]

Additionally, analyst forecasts are known to be overly optimistic and suggest rates that are consistently too high.[57] The deficiency correlates with all analyst produced growth estimates and Mr. Bourassa's remedy of taking his source data from several journals that are all vulnerable to the identical flaw compounds, rather than mitigates the problem.

As Mr. Irvine explained, the way to eliminate this source of error common to all forecasted data is to use more balanced inputs alongside them. Staff's methodology considers historic data as well as forecasts of EPS growth. Likewise Staff uses historic and forecasted DPS growth because it is consistent with the DCF method whereas the Company considers but does not employ DPS growth at all. The Commission has specifically rejected the Company's choice of inputs and accepted Staff's choices.[58]

The Company, however, rejects the inclusion of DPS information because it produces a result that is too low by its reckoning. According to Mr. Bourassa, the Company did not utilize historical dividend growth in its DCF analysis because doing so would produce an indicated ROE that is below the cost of debt.[59] Further, the Company did not use forecasted DPS because its reliance on analyst forecasts limited it to only one source for forecasted DPS information.[60]

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55 Exhibit A-5 (Bourassa Rejoinder (Cost of Capital)) at 7:25 – 8:1.
56 Exhibit S-1 (Irvine Direct) at 34:20-23
57 *Id.* at 36:23 – 38:3.
58 *See* Fn 32 *Supra.*
59 Exhibit A-4 (Bourassa Rebuttal (Cost of Capital)) at 7:17-21; Exhibit A-5 (Bourassa Rejoinder (Cost of Capital)) at 20:15-16.

In addition to Mr. Irvine's explanation why exclusive reliance on analyst forecasted information is inappropriate, he testified that Mr. Bourassa's exclusion of DPS because it produces lower results is unrealistic. As Mr. Irvine stated, "the omission of such data results in exclusion of publicly accessible data which the investment community may consider in forming its growth expectations."[61] It is thus reasonable that investors will consider such information in making their investment decisions.[62]

Mr. Bourassa uses his risk premium approach, comparable earnings approach, and the Company's small size to select his final recommended ROE. His DCF results ranged from 9.4% to 10.9% while his risk premium approach generated a range from 10.2% to 11.1% and the comparable earnings approach garnered results from 8.0% to 11.3%.[63] He selected a ROE higher than the average of his three DCF analyses based on corroboration with the even higher range produced by the highly subjective bond-yield plus risk premium approach.[64] The Commission has consistently rejected all of these approaches to inflate ROE.[65]

The Company attempts to characterize their risk premium approach as a market based analysis by providing a bond risk premium analysis.[66] Although the method utilizes market data, it is inherently *not* market-based. As explained by Staff, the Company's risk premium analysis computed the actual and authorized returns over a ten year period for a group of Utility Source proxies which he then added to the ten-year interest rates over that period.[67] Despite the availability of these interest rates on the market, the method is not market based, however, and is in fact yet another result driven approach susceptible to inappropriate reliance on subjective judgment based adjustments:

> Some analysts use a subjective, ad hoc procedure to estimate a firm's cost of common equity: They simply add a judgmental risk premium … to the interest rate on the firm's own long-term debt. It is logical to think that firms with risky, low-rated, and consequently high-interest-rate debt will also have risky, high-cost equity,

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[60] Exhibit A-4 (Bourassa Rebuttal (Cost of Capital)) at 7:22-24
[61] Exhibit S-1 (Irvine Direct) at 39:5-6.
[62] Exhibit S-2 (Irvine Surrebuttal) at 10:11-13.
[63] Exhibit A-5 (Bourassa Rejoinder (Cost of Capital)) at 2:3-14; Exhibit A-5 Rejoinder Schedule D-4.0.
[64] Exhibit A-1 (Bourassa Direct (Cost of Capital)) at 3:7-13.
[65] *See e.g.* Fn 32 *Supra*
[66] Exhibit A-1 (Bourassa Direct (Cost of Capita)) at 29-30.
[67] Exhibit S-1 (Irvine Direct) at 40:12-16.

and the procedure of basing the cost of equity on a readily observable debt cost utilizes this logic.[68]

Likewise, with respect to the Company's comparable earnings approach, Staff testified that it is unreasonable in that it does not recognize that "the returns authorized for the sample utilities in prior rate cases cannot be compared directly to the market expectations that exist presently."[69] As all parties have noted, authorized ROE's may be inconsistent with a utility's COE in, for instance, cases where the ROE was set by a settlement agreement.[70] ROE's determined by settlement could actually be higher than the COE as consideration for some other concession.[71] Consequently, "actual returns should not be equated with COE."[72] In addition to these conceptual defects of the comparable earnings approach, the Commission has in several recent decisions recognized that Staff's methods of determining ROE do not violate the principles of either *Bluefield* or *Hope*.[73]

III. RATE DESIGN

Staff and the Company both propose using inverted tier rate designs for residential and commercial customers. The Company also proposes to use an inverted tier design for the irrigation customers, yet provides no rationale for doing so.[74]

While Staff's and the Company's rate designs are both premised on increasing block tiers in an effort to promote the efficient use of water resources, there are differences in where both party's have set the respective break points for the tiers. The Company's rate design includes more gallons in the starting block.[75] This can have the effect of delaying the point at which a customer will experience increasing rate impact from increased usage and thereby obscure the price signal the inverted rate is intended to send.[76] The outcome of the proposal is that such a design has the potential to detract from the purposes of the inverted rate design and should thus not be accepted.

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[68] Brigham, Eugene F. and Ehrhardt, Michael C. *Financial Management Theory, and Practice* 11th Edition. 2005. Thomson South-Western. United States. p. 319.
[69] Exhibit S-2 (Irvine Surrebuttal) at 8:9-10.
[70] *Id.* at 8:10-12; Exhibit A-4 at 9.
[71] Exhibit S-2 (Irvine Surrebuttal) at 8:17-20.
[72] Exhibit S-2 (Irvine Surrebuttal) at 9:3.
[73] *Re Black Mountain Sewer Company*, Decision No. 69164; *In the Matter of the Application of Southwest Gas*, Decision No. 68487.
[74] Exhibit S-2 (Michlik Surrebuttal (Water)) at 13:11-21.
[75] Tr. Vol. I at 140:16-20.
[76] Tr. Vol. I at 141:4-16.

In addition, without any rationale supporting the switch to an inverted tier rate design for irrigation customers, Staff continues to recommend that the Commission reject the Company's proposal to make such a change.

IV. RATE BASE

In its initial application, the Company indicated it had water utility plant valued at approximately $3,079,513 and wastewater plant valued at approximately $1,401,953.[77] Because of difficulty in verification, Staff recommended disallowing a number of the items which the Company accepted in the process of prefiling testimony.[78] However, Staff initially proposed disallowing the Company's Deep Well #4 as well on the basis that it was not used and useful.[79] In response, the Company withdrew the extension of pro forma revenue from 350 future customers for the water division. The Company explained that because the well is necessary to serving those 350 customers, if it is disallowed, then so too should be the revenue from the customers who would be utilizing it.[80]

Staff acknowledged the rationale and therefore adopted the position that the well should be included.[81] The recommendation correlates to Staff's First and Second proposed alternative scenarios and is consistent with the principle that plant included in rate base be used and useful because the well will become necessary to serve the 350 additional customers when they come.[82] Staff further recommends inclusion of this asset so as to not forego the opportunity to alleviate the rate impact so dramatically by the inclusion of the future customers' revenue.

The other issues relating to rate base largely deal with whether and how to include Deep Well #4 in rate base. Staff has proposed an alternative resolution in addition to its recommended scenario where this asset would be disallowed as well as foregoing the revenues of the 350 future customers. This resolution will be dealt with in greater detail below but Staff does not recommend it because the consequent loss of the future customers' revenue gives rise to a drastic increase in rates to the existing customers. Further, ALJ Scenario #4 likewise deals with the inclusion of this

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[77] Exhibit A-1 (Bourassa Direct) Schedule A-1 (Water), (Bourassa Direct) Schedule A-1 (Sewer).
[78] Exhibit A-4 (Bourassa Rebuttal (Water)) at 4-5, Exhibit A-5 (Bourassa Rejoinder (Wastewater)) at 8-9.
[79] Exhibit S-1 (Michlik Direct (Water)) at 7.
[80] Exhibit A-4 (Bourassa Rebuttal (Water)) at 4-5.
[81] Exhibit S-2 (Michlik Surrebuttal (Water)) at 4-6.
[82] *Id.* at 6.

sole asset by proposing that it be treated as a contribution in aid of construction. Because of problems associated with this option that will be discussed below, Staff does not recommend this option either although it would give rise to the lowest rate increase of any of the proposals.

Aside from this issue, there were no rate base issues. The Company proposed that the original cost rate base be used as the fair value rate base for the purposes of this application, which Staff agrees is appropriate. Likewise, the Company, with the exception of unique circumstance surrounding Deep Well #4, accepted all of the Staff proposed disallowances from rate base due to lack of substantiation as used and useful.[83]

V. REVENUE REQUIREMENT

A. Staff's Recommendation to Adjust the Revenue Requirement for the Water Division is Reasonable – with respect to issues of gradualism.

All parties agree there is a significant issue in this case due to the rate increase and its rate shock implications. The Company has taken the extraordinary position of proposing to include revenues from 350 additional future customers. This effectively doubles the customer base for Utility Source, thereby spreading the impact of a rate increase. Even with such a measure, the Company proposes a very sudden and steep increase in rates. The last position taken by the Company proposed an approximate 179% increase to the water division's revenue requirement[84] and 122% increase to the wastewater division.[85]

In Decision No. 67446, there was an opportunity for the Commission to consider a comparable increase in rates based on Staff's cost based rate analysis. There Staff's proposal amounted to approximately a 189% increase, which the Commission responded was so precipitous that the increase would be "unconscionable."[86] In comparison to the last time such an increase was contemplated, now the Company proposes an increase almost equally high that, even with the addition of future revenues, enters well into the range of increases that would surely be "unconscionable."

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[83] Exhibit A-4 (Bourassa Rebuttal (Water)) at 4-5, Exhibit A-5 (Bourassa Rejoinder (Wastewater)) at 8-9.
[84] Exhibit A-5 (Bourassa Rejoinder (Water)) at 1:18-20.
[85] Exhibit A-5 (Bourassa Rejoinder (Wastewater)) at 1:18-20.
[86] Decision No. 67446 at 16.

As the testimony indicated, Utility Source has at present approximately 300 customers who live in houses ranging in value from $200,000 to $600,000.[87] Owner Mr. McCleve described the distribution as being in the range of affordable to slightly unaffordable housing with the majority in the affordable range.[88] This increase will also be across the board and impacting all customer classes owing to the artificially low nature of the rates the Company charged before obtaining a CC & N.

In light of the prior indication that such a large increase borders on the "unconscionable," Staff proposed rates targeted around a fixed increase in the rates. Most significant, and a source of contention with the Company, is that Staff recommends setting a rate of return of 6.23% for the water division, because in Staff's view that rate of return is appropriate when all relevant factors presented in this case are considered by the Commission. The resulting rate increase is approximately 110% for both the water and wastewater divisions' customers, and Staff believes these rates are within the range of what is just and reasonable under the circumstances of this case.[89] This adjustment, if accepted, will be effective for only so long as the Company chooses not to return for a rate increase and thus provides for a more gradual increase to full cost of service premised rates for the consumer.[90] Staff did not recommend making any adjustment to the rate of return applied to the wastewater division and it remains 8.9%.

As a consequence of Staff's recommendation, the rate increase for the water division customers will remain at approximately the same level as for the wastewater division. As several cases recognize, the cost of capital is only one among several appropriate considerations in reaching a rate of return on rate base, and determining the just and reasonable rate that a utility may charge. Further, the Commission has issued orders in the past on the basis of concerns of gradualism which the Commission used as a factor in determining a rate of return.[91]

B. Gradualism Is an Issue Irrespective of Discrimination.

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[87] Tr. Vol. I. at 25:17-21.
[88] Tr. Vol. I. at 54:2-18.
[89] Exhibit S-2 (Michlik Surrebuttal (Water)) at 8-9.
[90] Tr. Vol. II at 233:13 – 234:3.
[91] *See e.g. Re Far West Sewer Company*, Decision No. 69335 (granting an effluent rate but in the interest of gradualism declining to adopt either Staff's or utility's proposed imputed revenues from effluent sales); *Re Southwest Gas Corporation*, Decision No. 68487 (noting although rates are designed to move to cost-based principles, gradualism and other factors may alter the balance).

The Company may argue that the concept of gradualism is strictly applicable only to the elimination of discrimination between customer classes and is thus no basis for the additional adjustment made to the water division rate of return. At hearing the Company repeatedly asked of Staff witness Mr. Jeffrey Michlik what discrimination exists between customers of the water and wastewater divisions.[92] Gradualism does not apply solely to the elimination of disparities between classes of customers. There is not an issue here about cross class disparities, however. As their own witness testified, strict cost of service principles do not apply because, this is a case involving an inverted tier rate design.[93] Likewise, there has been no testimony to the effect that there are inequities between customer classes. The line of questioning the Company undertook with Staff witness Michlik regarding the comparison of the wastewater division to the water division suggests they may be confusing customers of different services with customers of different classes using the same service. Only in the latter case is discrimination a relevant consideration under a gradualism analysis.

In the present case, gradualism is an issue because of the across the board increase all customers face.[94] For the water division, Staff is proposing an approximate 110% increase to the Company's requested 179% increase. Staff recommends a 106.71% increase for the wastewater division to the Company's proposal of 122.61%.[95] As a response, Staff has recommended an adjustment to the revenue requirement aimed at keeping the increases on both sides to relatively equal percentages as well as keeping the increase in monthly minimums at the approximate $18.50 that emulates the result produced under Staff's initial position and has been de facto revived by the ALJ Scenario #4.

C. The Staff Recommended Adjustments to Revenue Requirement Are Reasonable and Do Not Prevent the Company From Receiving a Fair Value Rate of Return on Its Fair Value Rate Base.

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[92] *See* Tr. Vol. II. at 263-266.
[93] Tr. Vol. I. at 137:3-6.
[94] *See e.g. Re Southwest Gas Corporation*, Decision No. 68487 at 37 explaining that although rates are designed to move toward a cost-basis, concepts of gradualism among other principles render unacceptable a rate design that increases rates in excess of 100 percent for a substantial number of customers.
[95] Exhibit A-5 (Bourassa Rejoinder (Water)) at 3:21-22; Exhibit A-5 (Bourassa Rejoinder (Wastewater)) at 2:19-20.

The Company may also contend that the legal basis for making any adjustment to the rate of return implied by the cost of capital analysis is barred by Arizona case law and the Arizona Constitution.[96] They may argue that the recent decision in the appeal of the Chaparral City Water Company rate case, Docket W-02113A-04-0616, Decision No. 68176, dictates that the Commission must directly apply the formulaically produced weighted average cost of capital, which in this case is identical to the return on equity, to the fair value rate base. Otherwise, they will likely contend that adoption of the Staff recommendation inevitably prevents the Company from receiving a just and reasonable return on the fair value of its invested plant.

The outcome of the Chaparral City appeal in no way precludes the Commission from considering all factors it deems relevant in rate setting and making reasonable adjustments necessary to protect the public interest. In that case, the major issue in contention was whether a fair value rate of return that backed into the rate of return implied by a direct application of the weighted average cost of capital to the OCRB was unlawful. While the court determined in a memorandum decision that the method of "backing-in" employed by Staff was inappropriate, the court was very clear that there is no prohibition against the Commission making reasonable adjustments to the fair value rate of return applied to the FVRB. Likewise, the Commission is not bound to develop a cost of capital analysis and apply it directly to a utility's FVRB.[97] "If the Commission determines that the cost of capital analysis is not the appropriate methodology to determine the rate of return to be applied to the FVRB, the Commission has the discretion to determine the appropriate methodology."[98] Cases from other jurisdictions that also must determine rates of return based on the fair value of a utility's assets are in accord with this conclusion. For example, the Indiana court of appeals noted,

> While the cost of capital, including equity capital, to [the utility] is an important element properly to be considered in the determination in a fair rate of return on the fair value of ... rate base, we recognize, as we have many times previously in other cases, that *cost of capital is*

[96] *See e.g. Simms v. Round Valley Light & Power Co., 80 Ariz. 145, 294 P.2d 378 (1956)*; Arizona Constitution art. XV Sections 3, 14.
[97] *Chaparral City Water Company v. Arizona Corporation Commission*, Arizona Court of Appeals (Division 1) 1 CA-CC 05-0002 (*unpublished*) at 13 ¶ 17.
[98] *Id.*

not necessarily synonymous with, equivalent to, or the sole measure of a fair rate of return[99]

Clearly there is no bar preventing the Commission from considering relevant factors it deems necessary in its rate setting and making appropriate adjustments to the rate of return applied to the FVRB even if they are outside the parameters of what a strict cost of capital analysis would prescribe.

Staff's recommended adjustment to the fair value rate of return is reasonable. The adjusted rate of return is applied to the FVRB which in this case is also the OCRB. Additionally, Staff provided reasonable justifications why a return should not be earned on Deep Well #4. As Staff witness Mr. Michlik explained, "allowing the Company to receive a larger increase on the water division than is recommended by Staff would not only allow it to benefit from its violations, but would also penalize its captive customers."[100] Thus, to the extent that Staff recommends acknowledging Deep Well #4 as part of Utility Source's fair value rate base and also recommends applying a rate of return adjusted downward, there is no inconsistency with the duty to provide just and reasonable rates on the fair value of the Company's plant.

Indeed, the Company acknowledged that it would be appropriate under the circumstances of Staff's third scenario to simply exclude the Deep Well #4 from rate base entirely as it is not presently used and useful.[101] There can be no question that this plant asset is not presently a part of Utility Source's fair value rate base. It is solely because it *will* become necessary at such time as the 350 anticipated future customers come onto the system that Deep Well #4 will satisfy the used and useful aspect of the fair value evaluation. It is therefore not just and reasonable that customers who are not served by the well to be paying rates on its fair value.

Likewise, there is no strict requirement that the Commission cannot use methods other than a cost of capital analysis to arrive at an appropriate rate of return for a utility.[102] As Staff witness Mr. Michlik explained, under the Staff proposal, the Company will be earning not only a positive income, but will have a substantial operating margin to cover unanticipated expenses. Under the

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[99] *Office of the Utility Consumer Counselor v. Public Service Company of Indiana*, 449 N.E.2d 604, 608 (Ind.App., 1983).
[100] Exhibit S-2 (Michlik Surrebuttal (Water)) at 9:3-5.
[101] Exhibit A-4 (Bourassa Rebuttal (Water)) at 4-5.
[102] Tr. Vol. II at 291:17 – 292:8.

Staff recommendation, Utility Source's water division will have an operating margin of 47% and a wastewater operating margin of 41%.[103] In ordinary circumstances, these operating margins would be considered high.[104] In any event, under the Staff recommendation, the Company will be receiving both a positive cash flow and a profit.

However, the Company argues that Staff's analyses of operating margins for the Company are invalid. The basis of this contention appears to be that, because the 350 future customers do not presently exist, the revenue that they will produce cannot be counted for purposes of considering the Company's operating margin.[105] Confusingly, the Company insists that this is not a retraction of the offer to include the revenues from 350 future customers for the purposes of this rate case that Staff accepted in its recommendation.[106] Indeed, it admits that all of the Company's calculations performed regarding rate of return using the assumed revenues of the future customers have actually made use of those revenues as well.[107] However, Company witness Mr. Bourassa was unclear as to whether the Company's position was merely a clarification of the circumstances actually surrounding this application or if the Company believes that the revenues they offered to include should be selectively ignored for the purposes of presenting testimony relating to operating margins.

Staff does not dispute that the actual revenues the Company receives, assuming the inclusion of the 350 future customers, will not be in fact as high as if those customers really existed. This is not surprising because that is a natural outcome of using assumed revenue to distribute the rate impact of the rate increase. The operative notion behind using this revenue is that it will inflate the Company's income with assumed revenues and thereby forego having to obtain the amount from existing customers.

This outcome would not be inconsistent with prior Commission decisions either. In CC & N grant cases, rates must be determined for utilities where they do not obtain profitability at the outset of the rate's effective period. As was noted in the testimony under the ordinary CC & N evaluation

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[103] Exhibit S-2 (Michlik Surrebuttal (Water)) at 10:3-4.
[104] Tr. Vol. II at 242:13-15.
[105] Exhibit A-5 (Bourassa Rejoinder (Water)) at 13:5-7.
[106] Tr. Vol. I at 142:10-15.
[107] Tr. Vol. I at 144:23 – 145:6; 146:1-5.

process, the Staff calculated rates for a start-up utility would typically forecast out to five years.[108] Ordinarily it would not be until several years into collecting rates that Staff would expect the utility to become profitable. Assuming the Company had undergone an ordinary CC & N process, it would still not be at the point where it would be reasonable to anticipate that it had attained profitable operations.[109] In rate cases as well, the Commission has approved of rate increases limiting returns on the basis of gradualism to the point that they were actually negative although there was a positive cash flow.[110]

However, even by the Company's schedules which pro forma only 300 future customers at a rate of 50 to 100 new customers added per year, using Staff's recommendation, at the end of three years, before reaching the end of the five year period where a CC & N's initial rate would be benchmarked, the Company is turning a positive cash flow and is profitable with an operating margin of 39.27%.[111] Indeed, by Mr. Bourassa's numbers, the water division will be turning a profit several years before reaching the pro forma five year basis for CC & N rates.[112] For the wastewater division, for which Staff is not proposing any adjustment to rate of return, there is a starting operating margin of –14.34%.[113] Even so, at the end of the Company's three year projection, the operating margin rises to a positive 15.67%.[114]

Thus, the Company is still going to be at the approximate position that it should be had it obtained its CC & N in the proper legal and procedural manner. To give credence to the Company's position that it must as a matter of law receive a profitable rate at the immediate outset[115] would, "allow it to benefit from its violations." This outcome would be unjust and unreasonable to the existing customers of Utility Source as well as inconsistent with implementing the offer of future revenues that the Company proposed. Further the operating margin analysis demonstrates that the Company will be at the relative position it should be had its CC & N process been more typical. As

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[108] Tr. Vol. II at 243:18-22.
[109] *Id.* at 243:23-25.
[110] *See e.g. Re Bradshaw Water Company Rates* Docket No. W-02476A-97-0634, Decision No. 60708 approving a Staff rate recommendation that left the utility with a negative return on FVRB but with a positive cash flow on the basis of gradualism.
[111] Exhibit A-5 (Bourassa Rejoinder (Water)) attached Rejoinder Exhibit 1 page 3.
[112] *Id.*
[113] Exhibit A-5 (Bourassa Rejoinder (Water)) attached Rejoinder Exhibit 1 page 7.
[114] *Id.*
[115] Tr. Vol. I at 143:20-22.

the Company insists that it has not retracted the extension of the future customers' revenues, Staff's operating margin analysis remains sound.

D. The Scenarios

Because of the unusual circumstances, Staff is proposing three different alternative means to resolve the delicate balance between the rate of return on rate base, rate base and the inclusion of pro forma changes. In all scenarios, the cost of capital recommendation remains the same although in one of the scenarios, which is actually Staff's recommended position, the rate of return is not identical to the cost of equity.

Staff was also directed by the ALJ to prepare schedules for an additional scenario, discussed as ALJ Scenario #4. Described in hearing, this scenario, which treats the Deep Well #4 as a contribution by the developer, offers the advantage of producing the lowest rates of any of the scenarios presented. However, this scenario also presents additional challenges that likely render it impracticable as a resolution to the issues already existing in this case.

Staff Scenario #1

Under Staff Scenario #1, which is Staff's recommended resolution of the disposition of rate base and rate of return, includes the pro forma revenue, includes Deep Well # 4, and includes the 350 future customers in rate design. This alternative also reduces the rate of return on rate base from 8.9 percent to 6.23 percent.[116] The results are a monthly minimum charge of $18.50 for a 3/4-inch residential customer.[117] The median usage of residential 3/4-inch meter customers is 4,500 gallons per month. The 3/4-inch meter residential customer would experience a $22.07 or 114.83 percent increase in his/her monthly bill from $19.22 to $41.28 under Staffs recommended rates.[118]

Staff Scenario #2.

Under Staff Scenario #2, Staff includes the pro forma revenue, includes Deep Well # 4, and includes the 350 future customers in rate design, and uses an 8.9 percent rate of return on rate base.[119] The results are a monthly minimum charge of $23.00 for a 3/4-inch residential customer.[120]

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[116] *See* Exhibit S-3 Staff Surrebuttal Schedule JMM-W1.
[117] *See* Exhibit S-3 Staff Surrebuttal Schedule JMM-W12.
[118] *See* Exhibit S-3 Staff Surrebuttal Schedule JMM-W13
[119] *See* Exhibit S-3 Staff Surrebuttal Schedule JMM-W14.
[120] *See* Exhibit S-3 Staff Surrebuttal Schedule JMM-W15.

The 3/4-inch meter residential customer would experience a $30.53 or 158.86 percent increase in his/her monthly bill from $19.22 to $49.74 under Staffs recommended rates.[121]

Staff Scenario #3.

Under Staff Scenario #3, which the Company proposes in its rebuttal testimony,[122] Staff eliminates the pro forma revenue, does not include Deep Well # 4, and excludes the 350 future customers in rate design, and uses an 8.9 percent rate of return on rate base.[123] The results are a monthly minimum charge of $34.00 for a 3/4-inch residential customer.[124] The 3/4-inch meter residential customer would experience a $55.80 or 290.37 percent increase in his/her monthly bill from $19.22 to $75.01 under Staff's recommended rates.[125]

ALJ Scenario #4

ALJ Wolfe directed Staff at hearing to prepare an additional fourth scenario. Under this scenario, the revenues from 350 future customers are included and the Deep Well #4 is treated as a Contribution In Aid of Construction ("CIAC"). Practically speaking, this resolution is de facto identical to the position taken by Staff in its prefiled Direct Testimony. This option has the benefit of producing the lowest possible rates to the consumer. However, as the Company noted there are several problems with such a scenario that make it unworkable as proposed. Staff concedes that there likely is merit to some of the problems the Company noted, principally, that it risks being confiscatory and is a permanent resolution of a temporary problem.[126]

Due to the absence of evidence demonstrating an actual contribution, it will be difficult to reach the conclusion that a contribution has been made. Likewise, the evidence adduced at hearing does not immediately recommend any suitable legal vehicle that would effect such a change in the well's character. Consequently, designating Deep Well #4 as CIAC poses a significant potential of being confiscatory if adopted.

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[121] *See* Exhibit S-3 Staff Surrebuttal Schedule JMM-W16.
[122] *See* Exhibit A-4 (Bourassa Water Division Rebuttal) at 4-5 (note that the Company proposes only the resolution of the rate base, pro forma revenues and rate design issues of this scenario, not the actual 8.9% rate of return to be used).
[123] *See* Exhibit S-3 Staff Surrebuttal Schedule JMM-W17.
[124] *See* Exhibit S-3 Staff Surrebuttal Schedule JMM-W18.
[125] *See* Exhibit S-3 Staff Surrebuttal Schedule JMM-W19.
[126] Comments On, And Objections To, Late Filed ALJ Scenario #4 at 3-4.

Staff notes that in the hypothetical, these problems are not insurmountable with some modification of the scenario. Although there was no testimony on the issue, the Deep Well #4 could alternatively be treated as an Advance In Aid of Construction ("AIAC") which would be funded with an appropriate refundable hook up fee charged to the future customers who will need its capacity. This allows the Company to retain ultimate ownership over the asset and recover its cost and thus removes concerns of confiscation. It could also offer the benefit of temporary rate relief offered to present consumers who do not benefit from the existence of the well and recommends itself as a suitably temporary solution to a temporary problem. In addition, it would be consistent with past Commission practice dealing with excess capacity[127] as well as policies favoring making growth pay for growth,[128] albeit after the fact.

However, the precise amount of an appropriate hook up fee and the extent to which Deep Well #4 represents excess capacity to the present customers are evidentiary issues as well as policy issues and there is no evidence on record speaking to any of them. Likewise, as the Company notes, it is under no obligation to include the revenues of 350 future customers, and so, it remains to be seen if the Company would still be willing to include those revenues under this modification of the scenario. It may be appropriate to reopen the evidentiary hearing to deal with these issues and any others that the Company may identify with respect to this alternative.

VI. CONCLUSION

For the above stated reasons, the recommendations made by Staff are reasonable and should be accepted.

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[127] *See, e.g., Re Litchfield Park Service Company*, Docket No. SW-01428A-06-0021, Decision No. 65436 (Directing Staff to consider dealing with the utility's excess capacity by using a hook-up fee for new customers in the utility's next rate case).

[128] *See e.g.* Exhibit A-5 (Bourassa Rejoinder (Water)) at 12:18-25 noting that the current developer over the future customers' lots is already funding some of the on-site infrastructure requirements with advances.

RESPECTFULLY SUBMITTED this 16th day of July, 2007.

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