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OPEN MEETING

MEMORANDUM

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TO: THE COMMISSION

FROM: Utilities Division

DATE: September 27, 2000

RE: IN THE MATTER OF THE COMMISSION'S OWN MOTION TO ESTABLISH THE COMMISSION WATER TASK FORCE (DOCKET NO. W-00000C-98-0153)

On April 24, 1998, in Decision No. 60829, the Arizona Corporation Commission (Commission) established the Commission Water Task Force (Task Force). The Task Force consists of representatives of regulatory agencies, the water providers, and water consumers. On September 22, 1998, the Task Force held its first meeting. The Task Force meetings were all noticed Open Meetings.

On October 28, 1999, the Task Force completed its Report for the Commission (Report). The Report contains recommendations to the Commission on several issues facing Arizona's water industry. On many issues the Task Force achieved consensus. On other issues, the Report contains different recommendations from the various Task Force members.

On January 5, 2000, the Task Force Report was docketed and distributed to every Arizona water company regulated by the Commission. A deadline of March 15, 2000, was set for comments on the Report to be filed. Only two water companies and the Central Arizona Project (CAP) submitted comments. Arizona Water Company generally supports the Staff's proposals, but does express some reservations. Lakewood Water Company, a small water company in Amado, indicates that they are currently struggling with the financial requirements to fund necessary capital improvements. The capital costs to make improvements would double the rates for the company's customers, many of whom are low-income. The company expresses interest in the possibility of consolidation with other water utilities. The CAP generally supports Staff's proposals, but they do express some reservations.

The Task Force was divided into three subcommittees: the Regulatory Reform Subcommittee, the Conservation Subcommittee, and the Water Supply Subcommittee. The Regulatory Reform Subcommittee achieved consensus on five goals:

- Reduce the number of small, non-viable water systems through new rules and procedures.
- Strengthen the financial capacity of the water utility industry.
- Provide greater emphasis on simplifying, shortening, and reducing the cost of the ratemaking process.

- Improve consumer education.

- Increase interagency coordination.

The Conservation Subcommittee focused on developing policies the Commission could use to encourage water conservation. The Water Supply Subcommittee focused on issues relevant to renewable and surface water supply, such as the Central Arizona Project.

Regulatory Reform Subcommittee

On Pages 3 through 25 of the Report, the Regulatory Reform Subcommittee's recommendations and discussions are summarized.

On Pages 4 through 7 of the Report, Staff's proposal on placing more stringent requirements on approval of CC&Ns for new water companies is discussed.

Commission Staff recommended the following Commission policy changes concerning the establishment of new water companies:

1. The application for a new CC&N must show that an existing water company cannot or will not serve the area being applied for. This showing must be made by submitting service rejection letters from all the "A" size water companies in the state (there are 3) and at least five of the "B" size companies (there are 20). The five B size companies contacted should include the B size companies that are geographically closest to the applicant. The application must also be accompanied by service rejection letters from all the existing water companies within five miles of the area being requested. In addition, the rejection letters must be accompanied by the corresponding request for service that was made to each of the existing water companies by the applicant.

2. The rates should be set such that the company should at least break even no later than its third year of operation. The calculations would be based on the company's reasonable estimates of customer growth. The company should also be required to come in for a rate case three years after serving their first permanent customer.

3. Because Staff believes that it is not in the public interest, no new CC&N would be issued to any company that was affiliated with any other company or person that was not in total or substantial compliance with Commission and ADEQ requirements. This restriction should apply to CC&N extensions and transfers as well.

4. Staff recommends establishing a set of standard service charges for new CC&Ns.

5. Staff will work with the ADWR to establish tiered rate structures for new CC&Ns.

Staff recommends that the Commission endorse Staff's recommendations. Further, Staff requests that the Commission order Staff to develop (through meetings with members of the industry, RUCO, and other interested parties) a detailed statement of policy on water CC&Ns by March 31, 2001. The detailed statement of policy should conform to the general principals of Staff's recommendation contained in the Report and the above discussion. Staff members who are responsible for processing new water CC&N requests should be responsible for conducting these meetings and developing the detailed statement of policy.

On Pages 8 through 11 of the Report, several proposals for providing incentives for consolidation in the water industry are discussed. Staff recommends that an acquisition adjustment or a rate of return premium (but not both) be allowed under certain conditions. These conditions are:

- The acquisition is in the public interest;
- The acquisition will not negatively affect the viability of the acquirer;
- The acquired system's customers will receive improved service in a reasonable timeframe;
- The purchase price is fair and reasonable (even though that price may be more than the original cost less depreciation book value) and conducted through an arms' length negotiation;
- The recovery period for the acquisition adjustment should be for a specific minimum time (e.g., twenty years); and
- The acquired company is a class D or E.

Staff does not recommend allowing for acquisition adjustments unless all of the above conditions are met. Staff believes that the burden should be on the company to prove that an acquisition adjustment or a rate of return premium is in the public interest. The public interest determination should account for the capital investments needed for the customers to receive improved service and the costs savings the company is likely to realize through economies of scale. Other methods of encouraging consolidation include allowing for rate of return premiums and deferral accounting orders. Staff recommends that the Commission endorse Staff's recommendation. Further, Staff requests that the Commission order Staff to develop, through meetings with members of the industry, RUCO, and other interested parties, a detailed statement of policy on acquisition adjustments and rate of return premiums by March 31, 2001. The detailed statement of policy should conform to the general principals of Staff's recommendation contained above and in the Report. Staff members who are responsible for recommending approval or denial of acquisition adjustment requests should be responsible for conducting these meetings and developing the detailed statement of policy.

Other incentives for consolidation could be provided by the State Legislature. Tax breaks or credits could be provided to companies that choose to acquire small and/or financially non-viable water companies. Staff requests that the Commission direct its Legislative Liaison to start a concerted lobbying effort to encourage the consolidation of small water companies.

The establishment of a fund similar to the Universal Service Fund used for telecommunications firms, is another option for improving the financial capacity of small water companies. A fund that all water companies pay into and that financially strapped companies could draw out of for infrastructure investments could be established. For fairness purposes, municipal water companies would need to be included as contributors/beneficiaries of the fund. This would require legislation as well as changes to the Commission rules. Staff proposes this fund as an approach the Commission may want to consider in the future.

Issues involving property taxes are discussed on Pages 12 and 13 of the Report. Staff recommends that the Commission's Legislative Liaison be directed to undertake a concerted lobbying effort to have property taxes on water companies eliminated and replaced with a percentage of revenue tax. Staff also recommends that the Accounting and Rates (A&R) section of the Utilities Division sponsor, for any interested party, a seminar on the ratemaking implications of property taxes, focusing on the problems the industry outlines in the Report.

On Pages 14 and 15 of the Report, the Future Test Year issue is discussed. Staff believes that there is no need to change the present method used by the Commission. At present, the Commission employs an historical test year but does allow for pro forma additions for known and measurable costs. It is Staff's opinion that this is a very good combination of both historical and future test years. Presently, this is done on a case-by-case basis. Staff believes that this method could be improved, therefore, Staff recommends that the Commission order Staff to develop a policy with specific requirements for expense changes, revenue changes, and plant additions that occur after the test year. Such items would include, but are not limited to:

1. Method of matching new expenses with new revenues.

2. Revenue neutral plant, i.e., plant to serve existing, not future, customers.

3. Revenue neutral plant will be installed within a specific timeframe, preferably one year.

4. Revenue neutral plant is necessary to provide proper and adequate service to existing customers.

On Pages 15 and 16 of the Report, Staff's recommended Generic Hook-up Fee policy is outlined. Both the industry and RUCO support Staff's recommendation in principal. Staff believes that implementing this recommendation will require a rulemaking proceeding. Staff requests that the Commission order a rule making proceeding be opened to implement a Generic Hook-up Fee policy along the lines of Staff's proposal.

On Pages 16 through 19 of the Report, proposals for plant replacement fund mechanisms are discussed. Staff recommends that the Commission adopt a policy similar to the Pennsylvania Public Utilities Commission's Distribution Service Investment Charge (DSIC). Staff requests that the Commission order a rule making proceeding be opened to implement rules for a DSIC program in Arizona.

On Pages 19 and 20 of the Report, problems associated with past high depreciation rates are discussed. The industry offered proposals on how to rectify these problems; however, Staff and RUCO found those approaches to be inappropriate. Staff believes that its proposed Rate of Return policy (discussed below) will solve the problems associated with past excessive depreciation rates. All parties agreed that the Commission should no longer approve excessive depreciation rates for small water companies.

On Pages 20 and 21 of the Report, the pass-through mechanism approved by the legislature in SB 1252 (now A.R.S. § 40-370) is discussed. The industry representatives on the Task Force felt that the Commission's policy on A.R.S. § 40-370 needed to be clarified because, at the time the Report was written, only one company had applied for authority to adjust rates under the provisions of this mechanism. Since then the Commission has approved two such applications (they both have been appealed). The two approved applications were for Arizona Water Company's Monitoring Assistance Program (Decision No. 62141) and Rio Verde Utilities, Inc.'s CAP cost increase (Decision No. 62037). Those two decisions indicate that the Commission's policy on A.R.S. § 40-370 applications is to support appropriate pass-throughs, which should mitigate the industries concerns.

On Pages 21 and 22 of the Report, Staff's proposed Rate of Return policy is outlined. Staff believes that implementing this policy will solve the problems associated with high depreciation rates and lead to other improvements. This policy would make filing rate cases much less burdensome for small water companies. Staff's proposed policy allows companies that are filing rate applications to choose between 1) a generic rate of return (for C, D, and E companies only); 2) setting rates based on an operating margin basis (i.e., no rate of return consideration); or 3) an individual rate of return (i.e., traditional rate making). In addition to the recommendations in the Report, Staff is recommending that the choice of the generic rate of return be limited to C, D, and E companies. Also, Staff recommends that the generic rate of return should be a minimum rate of return; thus, points can be added to it to account for special expenses such as WIFA loan payments. Staff requests that the Commission order a rule making proceeding be opened to implement Staff's proposed Rate of Return policy. Staff is aware that the recent Court of Appeals Opinion may impact the Commission's ability to implement Staff's proposed rate of return policy. Staff believes that the issues raised by the Court of Appeals Opinion are best dealt with during the rulemaking proceedings.

On Pages 22 and 23 of the Report, the electronic filing of annual Reports, rate cases, and other filings with the Commission is discussed. Staff, the industry, and RUCO all agreed that allowing for electronic filing would be beneficial. Staff has already initiated the first steps of this process by making the Short Rate Case Form available on the Commission's web site. Staff is committed to making all of its forms available electronically. In order to institute full electronic filing, the Hearing Division will need to be involved. Staff is committed to working with the Hearing Division to develop a process that will allow for full electronic filing.

During the Task Force's discussions of electronic filing, the industry also expressed concern about the volume and extent of the Commission's filing requirements. Staff acknowledges that certain filing requirements may be out-dated. Staff is currently reviewing all forms and filing requirements. However, such a review is a major undertaking and may take some time to complete.

On Page 23 of the Report, Staff's Main Extension Agreement (MXA) proposal is outlined. Staff's proposal is to have standard MXA provisions included in each water companies tariffs, instead of the current process of approving MXAs on an individual case basis. Both the industry and RUCO supported Staff on this issue. <u>Staff requests that the Commission order a rule making proceeding be opened to implement Staff's proposed MXA policy.</u>

On Pages 23 and 24 of the Report, several suggestions concerning consumer education are discussed. Staff is currently working on educational programs for all industries the Commission regulates. Implementing any educational program may require additional funds from the Legislature. Staff is also evaluating the expansion of its well-regarded Small Water Assistance Team (SWAT) program (which deals with educating water company owners/operators) to include education for water consumers.

On Pages 24 and 25 of the Report, Staff's Phased Rate Increase policy is discussed. Staff believes that in certain limited circumstances it is appropriate to phase rate increases in over time. Staff will develop well-defined guidelines for when and how phased rate increases are appropriate.

On Page 25 of the Report, Staff's recommendation on rates tied to conditions is discussed. <u>Staff recommends that *all* rate increases be conditioned on the company providing acceptable quality service, water quality, and other relevant conditions.</u> Staff has already implemented this policy informally by including specific conditions in recent Recommended Orders. Staff will develop a standard set of conditions that could apply to all water companies. One impediment to this policy being successful is the Commission's lack of enforcement resources. Currently, the Utilities division has *one* compliance officer to handle *all of the utilities* the Commission regulates.

Conservation Subcommittee

On Pages 26 through 29 of the Report, the Conservation Subcommittee's recommendations and discussions are described. On Pages 26 through 28, a perceived problem with the Commission's conservation policy is discussed. The industry and consumer members of the Task Force as well as the ADWR representatives believed that the Commission would not allow companies to include the costs of conservation programs in rates unless the conservation program was mandated by the ADWR. If this were true, it would discourage companies from engaging in conservation programs. However, Staff does not believe that this is true. No member of the Task Force could site any examples of instances where Staff has recommended denial of conservation program costs or where the Commission approved an order that included the denial of conservation programs and their reasonable costs. Staff supports and encourages conservation. Staff believes that recovery of any reasonable costs for conservation programs should be allowed.

On Pages 28 and 29, Staff's proposal to institute three tiered rates is discussed. Tiered rates are the Commission's only direct means of encouraging conservation. Both the industry and RUCO opposed Staff's proposal. The industry claimed that it is sure to result in companies underearning, while RUCO claimed the policy is sure to result in companies overearning. Staff believes that as with any rate design there is a possibility of either over or underearning. However, with rates designed as proposed by Staff in the Task Force's Report there is almost no chance of underearning while there is a good possibility of overearning. If properly designed though, the tiered rates would result in the non-conserving customers paying extra for large uses of water and reward those customers that used very little water. If customers conserved such that all were falling within the middle tier, the company should earn its allowed rate of return. If the customers continued to use water in the third tier, the water company would probably overearn. The use of the overearnings could be restricted by the Commission in such a manner as to benefit the customers. Staff realizes that this is a new and way of looking at rate design combined with conservation, but Staff also realizes that new ways have to be considered to save what many consider to be this State's most precious resource. Staff recommends that the Commission order Staff to *consider* tiered rate designs for *all* water company rate cases and that the tiers be designed to encourage conservation. Staff recognizes that tiered rates may not be appropriate in all cases and that the decision to use or not use tiered rates must be made on a case by case basis. However, the appropriateness of tiered rates should be considered in every case. Further, Staff requests that the Commission order Staff to develop a detailed statement of policy on tiered rates by March 31, 2001.

Water Supply

On Pages 30 through 33 of the Report, the Water Supply Subcommittee's recommendations and discussions are summarized. The main focus of this subcommittee was the recovery of Central Arizona Project (CAP) water allocation costs (CAP costs). All members of the Subcommittee agreed that the Commission could somehow approve the recovery of CAP costs in a proceeding outside of a rate case. However, the Commission's Legal Division has concluded that considering CAP costs outside of a rate case would run counter to the recent Court of Appeals opinion on fair value. There was disagreement among the Subcommittee members about what the Commission should require before it allows for CAP cost recovery. In the Report, Staff recommended that the Commission allow for CAP cost recovery once the company has submitted a plan that indicates how they will begin to actually use their CAP allocations within five years. Staff chose a five-year time horizon because Staff wished to limit the extent to which current customers are charged for CAP allocations which will only be used to serve future customers.

Since the Report was written, Staff has modified its position. Staff believes that the Commission should be more flexible with the time horizon it allows for CAP water to go unused while allowing cost recovery. Staff believes that the time requirement placed on companies applying for CAP cost recovery should be decided on a case by case basis. Also, to ensure that current customers do not pay an unfair amount relative to future customers, a portion of the CAP cost should be recovered through some type of hook-up fee. The amount of the recovery that is recovered through a hook-up fee should be determined by the company's total demand for water relative to its CAP allocation. For example, if a company's total demand is 200,000 gallons per year and its CAP allocation is 1,000,000 gallons per year, then the company should recovery 20 percent of its CAP cost from current customers and the remaining 80 percent from hook-up fees. The methodology used for CAP cost recovery in the Vail Water Company Rate Case (Decision No. 62450) is an example of the general policy that Staff advocates.

Staff requests that the Commission order Staff to develop, through meetings with members of the industry, RUCO, and other interested parties, a detailed statement of policy on CAP cost recovery by March 31, 2001. The detailed statement of policy should conform to the recovery methodologies used in the Vail Rate Case, Decision No. 62450.

Conclusions

In conclusion, Staff recommends several changes in and clarifications of Commission policy, several changes to the Commission's rules, and that the Commission pursue several Legislative changes. These recommendations are summarized as follows:

Policy Changes

- CC&Ns (new, transfers, and extensions)
- Acquisition Adjustments and Rate of Return Premiums
- Seminar on ratemaking implications of property taxes
- Electronic Filing and review of filing requirements
- Phased Rate Increase
- Rates tied to Conditions
- Tiered Rate Structure
- CAP cost recovery
- Pro forma adjustments

Rulemaking

- Generic Hook Up Fee
- Rate of Return
- Main Extension Agreements
- Plant Replacement Fund

Legislative Changes

- Incentives for consolidation, e.g. tax breaks
- Replace property taxes with a percentage of revenue tax

Staff recommends that the Commission endorse the above policy and Legislative changes. Also, Staff recommends that the Commission open a rulemaking proceeding in order to implement the above changes to the Commission rules.

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