BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF OAK CREEK WATER COMPANY NO. 1 FOR A RATE INCREASE

DOCKET NO. W-01392A-07-0679

STAFF'S CLOSING BRIEF

I. BACKGROUND.

On December 7, 2007, Oak Creek Water Company No. 1 ("Oak Creek" or "Company") filed before the Arizona Corporation Commission ("ACC" or "Commission") the instant application for a rate increase.

On January 29, 2008, Staff filed a letter indicating the application was sufficient and classifying the Company as a Class "C" utility.

On February 28, 2008, the ACC Hearing Division issued a Procedural Order setting this matter for hearing on August 5, 2008.

On August 5, 2008, hearing was conducted in this matter. At the close of evidence, the Hearing Division directed the parties to file closing briefs on or before August 29, 2008.

Staff hereby provides its closing brief.

II. FACTS AND ARGUMENT.

A. Rate Case Expense.

Oak Creek filed the instant rate application on December 7, 2007, using the Small Water Utility Rate Application. However, "since the Company is a Class C utility, it should have filed direct testimony and the Schedules A though H as depicted in Arizona Administrative Code R-14-2-103." *Carlson Direct*, 3: 9-10. Rather than reject the application, Staff processed it "[b]ecause the Company is a non-profit association, the Company's last rate filing was as a Class D utility, and because a rejection of the application might cause undue hardship to the Company." *Id.*, 12-15. However, "one thing that Staff does not do is ever misclassify a utility and call a Class C a Class D

… or anything else. … Therefore, Staff never does recommend that a Class C utility be considered a Class D utility." *Transcript*, 98: 11-24. So, while Oak Creek filed an abbreviated application, on February 28, 2008, the ACC Hearing Division issued a Procedural Order recognizing Oak Creek as a Class C utility and setting forth a procedural schedule that any Class C utility would follow, including the August 5, 2008 hearing.

As the Company acknowledges, "by Staff accepting the short form filing, the Company did save some money because [it] didn't have to prepare direct testimony in the case. So there is some savings. … And neither does the Company disagree with being treated as a Class C and having hearings and doing rebuttal. But the bottom line is that that initial rate case did not contemplate a hearing and rebuttal testimony, or even rejoinder testimony if one were required, or briefs or whatnot." *Tr.* 135: 8-18. As a result, Oak Creek "estimated rate case expense in its direct filing was $10,000." *Bourassa Rebuttal*, 16: 1. In rebuttal, the Company pointed out that "[t]his has been revised to $25,000." *Id.*, 1-2.

At hearing, Administrative Law Judge ("ALJ") Teena Wolfe directed the Company to file, as a late-filed exhibit, the Company's invoices for the professional services provided to date by Mr. Bourassa in preparing the Company's rate application, and for the services provided by the Company's counsel in preparing for the previously-unanticipated hearing. The Company agreed to provide invoices, but as Staff noted, because they would be provided as a late-filed exhibit, the invoices would be "un-audited". Staff would not have a chance to fully examine them or to comment on them on the record. On August 15, 2008, the Company filed its invoices.

As previously stated, Staff believed that the $10,000 rate case expense originally requested seemed reasonable for the amount of work necessary to present the case. Unlike the Company, Staff had assumed that a Class C utility would be presenting its matter at a hearing and took this into consideration, along with the savings the Company had seen in having made the Class D "short form" filing. Having had a chance to review the invoices, Staff's suggests that the latest amounts seem excessive. It is worth noting that the Company's invoices total nearly $30,000, while the Company's total annual test-year revenues total $271,122. If approved, the rate case expenses would amount to more than 10% of Oak Creek's current annual revenue.

Staff does not object to the Company's being allowed to recover the actual costs necessary in the preparation of this rate application, as long as those expenses are reasonably incurred. In this instance, however, Staff does not believe the total amount presented in the invoices represents a reasonable amount for Oak Creek to spend in conjunction with this filing.

Staff continues to support its original position that $10,000 is an appropriate rate case expense.

B. <u>Rate Base and Accumulated Depreciation.</u>

"In this proceeding, the company is proposing its original cost rate base be treated as its fair value rate base." *Tr.*, 19: 11-13. Staff concurs. "The Company and Staff are in agreement on the adjusted plant-in-service balance of $1,389,738." *Bourassa Rebuttal*, 7: 9-10. There was initially some disagreement between the parties regarding the depreciation of retirements from the computer equipment account. However, Staff has accepted the Company's calculation of that expense. As a result, the parties are now in agreement that the total accumulated depreciation should be $886,569, as reflected on line 3 of Oak Creek's Rebuttal Schedule B-1.

The Company's initial Original Cost Rate Base ("OCRB"), and therefore Fair Value Rate Base ("FVRB"), were $507,283. Upon review of the application, Staff adjusted the Company's cash working capital balance to $0, subtracted amounts for Advances in Aid of Construction ("AIAC"), and subtracted customer meter deposits. Each of these adjustments is outlined on Oak Creek's Rebuttal Schedule B-1. "The advances in aid of construction shown on line 9 and the customer meter deposits on line 14, I believe both Staff and the company are in agreement on those figures." *Tr.* 21: 10-13. "[W]e are also in agreement on the amount of working capital." *Id.*, 21, 15-16. Ultimately, the parties agreed to a total Rate Base of $465,600.

C. <u>Operating Margin and Revenue Requirement.</u>

Despite the agreement regarding total Rate Base, because Oak Creek is a non-profit association, its rates will be set based on an operating margin, as opposed to a return on that Rate Base. The operating margin is typically calculated using a company's expenses as a base and allowing additional income to cover incidental expenses.

Oak Creek reported total operating expenses of $305,261, as shown on line 28 of Rebuttal Schedule C-1. Using that figure as the base, Oak Creek calculated a 10 percent operating margin. Initially, Oak Creek proposed a Revenue Requirement of $343,506, an increase of 27.26 percent over test year revenues. *Bourassa Rebuttal*, 3: 21. However, after "adoption of a number of rate base and operating expense adjustments recommended by Staff" (*Id.*, 7-8.), Oak Creek's rebuttal testimony provided a revised Revenue Requirement of $339,654, an increase of 25.10 percent. *Id.*, at 23. Staff's recommended revenue remains unchanged- $316,618, as shown on line 5 of Staff's Exhibit DWC-5M. Staff's proposed revenue would provide an operating margin of 11 percent and represents an increase of 16.83 percent over test year revenues.

1. Operating Income and Expenses.

Staff has disagreed with a number of Oak Creek's claimed expenses. Some of Staff's adjustments, Oak Creek has adopted. Some of the adjustments remain at issue.

a. <u>Salaries and Wages and Health Insurance.</u>

Oak Creek reported adjusted test year Salaries and Wages of $126,054. The Company modified that figure in its rebuttal filing. "The company is proposing wages and salaries of $139,964." *Tr.*, 22: 18-19.

In its application, Oak Creek reported $11,000 in Adjusted Test Year expenses for Insurance – Health & Life, account 659. However, Oak Creek "does not buy any health insurance. ... [I]t pays its employees an amount specified to be for health insurance." *Tr.*, 101: 9-11. Staff therefore reclassified $9,000 from account 659 to into account 601 - Salaries and Wages, where it belonged. The Company appears to agree with Staffs reclassification, "And to be consistent, ... I also did that." *Tr.*, 25: 10-11.

"Then the other difference is the $2,400, which was not in the company's initial filing but is in this filing because that was approved by the board in early '08." *Tr.*, 25: 24 – 26: 2. The Company's board approved the funding "for health benefits for the office manager of the company." *Tr.*, 25: 15-16. To clarify, the benefits approved in 2008 (one and one-half years after the test year) were provided to "the office manager/bookkeeper hired at the end of August, 2007." *Bourassa Rebuttal*, 10: 6-7. Despite the obvious temporal dislocation from the test year, the Company proposes to have this amount included in this rate application because "the company will incur this level of salaries and wages on a going forward basis." *Tr.*, 27: 1-3. Predictably, the Company also proposes to add salary expense for the office manager/bookkeeper hired at the end of August, 2007 *over and above* those previously estimated in the Company's application, further highlighting the difficulties of estimating expenses not measured within the test year.

The "annualized wages for the office manager/bookkeeper is higher in the Company's rebuttal filing than in the Company's direct filing by approximately $2,000." *Bourassa Rebuttal*, 11, 10-12. In explanation, "[t]he initial estimate was based on the actual hourly wage and an *estimate* of the number of work hours per week and annualized to a full year. In the rebuttal filing, the annual *estimate* is based on the 4 months of wages paid *in 2007* annualized to a full 12 months." *Bourassa Rebuttal*, 11: 14-17. (emphasis added) Leaving aside the continuing problem with approximating expenses outside of the test year, despite the fact that the Company admits that its original estimate has proven incorrect, the Company insists that the newer expense figure is more accurate estimate, while at the same time insisting that these estimations represent *known and measurable* adjustments to the test year. They do not.

Staff has opposed inclusion of the additional expenses. Staff believes inclusion of these expenses is inappropriate because the fact that one estimate proposes to supersede the previous estimate illustrates that the amounts being requested are estimates, and by definition are neither known nor measurable. The test year used to calculate rate base and revenue requirements was 2006. Staff opposes these far post-test-year adjustments.

As an additional concern, although the Company has offered to provide minutes showing that the board did, in fact, approve the funding at issue, the Company has never provided documentation to show that the increase was actually *implemented.* And even if the Company did provide such documentation, at this point in the case there will be no more testimony taken, and therefore no opportunity for Staff to scrutinize and examine any documents, or to make appropriate objections, all of which further serves to highlight the many problems with post-test-year adjustments.

. . .

. . .

Staff has accurately calculated the Company's expenses on a going-forward basis. No adjustment is necessary. Of course, Staff takes no position regarding the inclusion of these expense increases in the Company's next rate filing.

b. Fuel Expenses.

[B]ecause the cost of gasoline to fuel its vehicles has risen significantly since 2006, the Company proposed to annualize the gallons of gasoline purchased during 2006 to reflect the current price of gasoline." *Bourassa Rebuttal*, 15: 8-10. While it is completely understandable that the Company would want to include allowances for the significant increase in the price of fuel, the methodology applied lacks foundation. As a result, the Company's proposed adjustments are not sufficiently grounded in reality to warrant the proposed increase in fuel expense.

The Company's calculation used "the historical spending on gas prices and calculated what the actual expenses were for that ... and then ... imputed $4 gas to those exact same figures." *Tr.*, 61: 11-15. The obvious problem with this methodology is has been demonstrated nationwide. As fuel costs increase, drivers often modify their driving habits to conserve fuel. The Company's projection of $4 gas onto previous usage figures assumes that no matter how high gas prices rose, the Company would not have altered its driving behaviors at all. As recent history shows, this is simply not the case. And while we know that consumers will alter their patterns of consumption in the face of escalating costs, in this case, we do not no how they will modify their behaviors or to what extent. Absent this kind of information, the Company's proposal, while well-meaning, is nothing more than speculation. Speculation, by definition, is not known and measurable. *Any* change made based upon the data provided by the Company would simply be a guess. There should be no change to the Company's fuel expense level.

c. Repairs and Maintenance.

Once again, the Company has proposed an adjustment intended to "update" past expenditures to reflect costs going forward. And again, the calculation used is fundamentally flawed, rendering the results unusable.

"Staff recommends that repairs and maintenance be normalized to the average of the six years of expenditures from 2002 to 2007. The result of that average is $14,280, an $11,418 reduction from the Company's proposed amount." *Carlson Direct*, 11: 6-9. The averaging of past expenses over a period of years is a standard practice in rate case proceedings.

The Company argued that Staff should not have used six full years of known results to reach an average. "[T]he use of six historical years reaches too far into the past and may not reflect more current conditions. While the Company's repairs and maintenance expense has fluctuated over the past few years, the general trend is upward." *Bourassa Rebuttal*, 13, 1-4. "So a three-year average is, in my opinion, a better average." *Tr.*, 56, 20-21.

From a purely mathematical perspective, it is clear that averaging six years of data provides more "stability" in result than an average using only three years. So the Company's argument is not that Staff's figure is inappropriate from that perspective.

The Company's issue is with the amount provided by using historical data. "Staff did not adjust … for inflation … the historical costs. So he is not averaging current dollars. He is averaging prior year dollars." *Tr.*, 56: 22-24. The Company then argued that a comparison of dollars from previous years to current years is "not comparing apples to apples." *Tr.*, 57: 3-4. The Company's remedy for the perceived inequity was to attempt to "update" the past expenditures to their more recent values.

The Company "developed an annual rate of increase in costs using the Handy-Whitman Index of Public Utility Construction Costs." *Bourassa Rebuttal*, 13, 10-11. The Company placed past repair expenses into various categories as found in the Handy-Whitman Index ("Handy"). He then projected the costs incurred within those categories into the current year using the inflation factors represented in Handy. On that basis, the Company has suggested that an annual amount of $18,721 should be allotted for repairs and maintenance.

The Company's fundamental argument is that if the Commission approves Staff recommended figures, regulatory lag will result in the Company having insufficient funds to cover its repair costs going forward. Oak Creek is not the first utility to be faced with this issue. The typical mechanism, where one is needed, is a pro forma adjustment based on known and measurable changes. The Company's proposal is neither known nor measurable due to the fundamental flaw in its reasoning.

To illustrate: If the Company's past repairs had involved replacement of a transmission main, no one would dispute that three years later, it would be unreasonable to assume the cost of repairing that same main should be a component of the current repair and maintenance budget. But this is almost exactly what the Company has done. Rather than making a direct correlation of individual repairs, the Company has placed numerous repairs into categories and then updated the costs associated with repairs within that category. Each individual category is then "inflated" at its own particular rate. The method is flawed because it is based upon the unfounded assumption that during every year, the Company will continue to experience the same amount of expense within each category in proportion to the Company's total expense. The method is thus unreliable and is certainly not known and measurable.

The Commission should ignore the Company's results and accept Staff's proven average.

D. Rate Design.

The Company and Staff are in agreement regarding the rate design for residential service. The disagreement arises regarding the treatment of non-residential rates. The Company proposes no change to its current three-tier inverted block rate design. Staff believes a two-tier design is appropriate.

The three tiered rate design is the standard residential design. Every home is considered to have a certain level of "non-discretionary" use- the minimum amount needed to sustain living conditions. The first tier of residential rate design is typically 3-4000 gallons and reflects this non-discretionary use. The second tiers reflect the need to conserve water by charging increasing amounts per gallon as consumption increases. The typical non-residential rate structure has just two tiers. There is no assumption that non-residential customers have no way to conserve.

The Company currently has a three-tiered non-residential rate design. The Company has requested that the three-tiered design continue and has proposed a series of rates based thereon.

While it is unclear how the Company's current three-tier design came into being, Staff believes that it is inappropriate and should not be continued and recommends approval of the rate design Staff has proposed in its Direct Testimony.

III. CONCLUSION.

Under the unique conditions this matter has posed, Staff has thoroughly analyzed the Company's application. Staff has arrived at its conclusion based upon standard practices accepted b the Commission. The Company has proposed various "inventive" measures to deal with what it sees as shortcomings in the rate process, but in each case it should be clear that these methods are fundamentally unsound. None of the Company's proposed adjustments are truly known or measurable with the kind of certainty necessary to deviate from the result reached using tried-and-true rate-making principles. The Company's adjustments should not be accepted.

Staff has presented a series of calculation based upon standard ratemaking practice and Staff's proposals should be adopted in this matter.

RESPECTFULLY SUBMITTED this 29th day of August, 2008.

Kevin O. Torrey, SBN # 022300
Attorney, Legal Division
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007
(602) 542-3402

Original and thirteen (13) copies of the foregoing were filed this 29th day of August, 2008 with:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85008

Copy of the foregoing mailed this
29th day of August, 2008 to:

Paul Slevin, Vice President
Oak Creek Water Company No. 1
90 Oak Creek Boulevard
Sedona, Arizona 86336

Richard L. Sallquist
Sallquist, Drummond & O'Connor, P.C.
4500 South Lakeshore Drive, Ste. 339
Tempe, Arizona 85282

Thomas J. Bourassa, CPA
139 West Wood Drive
Phoenix, Arizona 85029