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BEFORE THE ARIZONA CORPORATION C

COMMISSIONERS

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STAFF'S INITIAL CLOSING
BRIEF

IN THE MATTER OF THE APPLICATION OF
H2O, INC. FOR A DETERMINATION OF THE
CURRENT FAIR VALUE OF ITS UTILITY
PROPERTY AND FOR AN INCREASE IN ITS
WATER RATES AND CHARGES FOR
UTILITY SERVICES.

I. BACKGROUND

H2O, Inc. ("H2O" or "Company") is a for-profit public service corporation that provides water utility service in the area of Queen Creek. Current rates for the Company were approved by the Arizona Corporation Commission ("Commission") in Decision No. 58641 (May 27, 1994). The Company's service territory has experienced high growth and H2O presently serves approximately 6,300 customers throughout its service territory which includes portions of Maricopa and Pinal Counties.

The Company has been approved for various hook-up fees that have assisted the Company with building facilities to serve its growing customer base. Decision No. 56486 (May 17, 1989) approved the Company to collect a Facilities Construction Advance ("FCA") that was limited to 280 residential units and \$120,000. The FCA approved in Decision No. 56486 was later superseded by an Off-Site Capacity Reservation Charge ("CRC") that was approved in Decision No. 63259 (December 14, 2000). The CRC no longer placed restrictions on the number of customers that was part of the FCA. The CRC was designed to collect the cost of a complete stand-alone off-site water plant including the cost of upgrading transmission mains for the area served by a typical water plant. Decision No. 63259 at 2.

As of the test year end date, December 31, 2006, H2O had collected between its various hook-up fees an approximate total contributions in aid of construction ("CIAC") of \$9,309,115. After removal of accumulated amortization of \$683,565, the Company had an approximate net CIAC of

1 \$8,625,550. In addition, the Company had acquired approximately \$3,065,859 in advances in aid of
2 construction ("AIAC").

3 On January 16, 2007, H2O, Inc. ("H2O" or "Company") filed an application to add larger
4 meter sizes to its existing tariffs. Decision No. 69413 (April 16, 2007) denied the request and
5 directed the Company to file a rate case by September 28, 2007 using a test year ending December
6 31, 2006 or later. H2O subsequently filed the above captioned rate case that was docketed on
7 October 1, 2007.

8 **II. RATE BASE**

9 In its original application, the Company proposed using an original cost rate base ("OCRB")
10 of \$1,408,584 as its fair value rate base ("FVRB"). Exhibit A-1, Schedule B-1 Revised. The
11 Company calculated its FVRB starting with \$12,987,344 of gross utility plant in service and removed
12 \$1,180,340 in accumulated depreciation for a net plant in service of \$11,807,004. The Company then
13 removed \$6,449,776 of CIAC and \$3,031,454 in AIAC and \$1,600,755 in customer meter deposits
14 while adding \$683,565 in accumulated amortization of CIAC to reach its revised initial rate base
15 amount. The Company included only the CIAC and AIAC it had received which had funded plant in
16 service. Exhibit A-3 at 6-7. In rebuttal, the Company revised its FVRB to \$1,995,695.

17 As of the filing of its Surrebuttal, Commission Utilities Division Staff ("Staff") determined
18 that the Company had a rate base of negative \$500,901. Exhibit S-2, Schedule BCA-1. Staff reached
19 this conclusion by including all CIAC and AIAC received by the Company irrespective of whether it
20 was tied to plant in service. At the time of hearing, Staff adjusted its rate base determination by
21 adopting a Company proposed adjustment to net deferred income tax debit from a 34.90 percent
22 income tax rate to 38.60 percent. This had the effect of increasing the Company's rate base to a still
23 negative \$363,842. Exhibit S-4, Schedules BCA-1, BCA-3.

24 The appropriateness of including all collected CIAC and AIAC or just that portion associated
25 with plant in service is the principal basis for the difference in Staff and the Company's rate base
26 amounts and is the primary nexus for most issues in contention between the parties. As Staff
27 explained, the Company excluded from rate base \$498,743 of CIAC that was expended for
28 construction work in progress ("CWIP") and \$2,360,596 of unexpended CIAC and \$34,405 in

1 unexpended AIAC. Exhibit S-2 at 8:12-14. The Company subsequently recognized \$198,372 of
2 unexpended CIAC associated with “fill-in” lots. Exhibit A-3 at 7:18-8:3, Schedule B-2 page 5. The
3 Company’s final proposed unexpended CIAC was thus \$2,162,224.

4 Inclusion of all CIAC is appropriate and consistent with Commission methodology. Exhibit
5 S-2 at 8:23. “Recognizing all CIAC and related accumulated amortizations is appropriate because the
6 Company has the use of these funds regardless of whether it has expended the funds for plant.” *Id.* at
7 8:23-25. Likewise, inclusion of all AIAC is proper for the same reason. “As discussed previously
8 regarding CIAC, recognizing all AIAC is appropriate because the Company has the use of these
9 funds regardless of whether it has expended the funds for plant.” *Id.* at 9:20-22.

10 Staff’s removal of all CIAC and AIAC is appropriate because funds that are not provided by
11 the Company should be applied as a subtraction from rate base. As Mr. Aladi explained,

12 [t]ypically, funds received as CIAC or AIAC are used to build plant which may
13 ultimately be in rate base. Plant that is used and useful for the provision of utility
14 service is a component of rate base. CIAC and AIAC are also components of rate
15 base. As components of rate base, plant differs from CIAC and AIAC in that plant
16 increases rate base and CIAC and AIAC decrease rate base. Plant that is under
17 construction (“CWIP”) is normally not a component of the rate base calculation. Thus
funds received as CIAC or AIAC that are funding CWIP are included in the rate base
calculation while the CWIP is not included in the rate base calculation. As a result,
the plant included in the rate base calculation may not equal CIAC and AIAC funds
received.

18 Exhibit S-3 at 4:22-5:4. The complicating factor that the Company actually has a level of
19 unexpended CIAC and AIAC that would offset rate base into negative numbers does not compel
20 deviation from the ordinary treatment of CIAC and AIAC with respect to reducing rate base.

21 Rather, the Company’s position would not recognize the origin of the funds. “CIAC and
22 AIAC represent funds or plant provided to the Company by parties other than investors.” *Id.* at 4:21-
23 22. Moreover, not applying all CIAC and AIAC to rate base would be “a departure from traditional
24 rate-making practices.” *Id.* at 5. The importance of maintaining the traditional treatment of CIAC
25 and AIAC is that the “Company has use of the funds advanced or contributed by others, regardless of
26 how the funds are used; investors commit less funds for utility purposes. Accordingly, the
27 Company’s rate base should be reduced by the CIAC and AIAC regardless of how it is used.” *Id.* at
28 5:16-19.

1 The surplus of advanced and contributed funds is a reflection of the extraordinary growth that
2 H2O has benefitted from without having to supply its own investment in order to serve. The
3 problematic outcome of the situation is that H2O will have challenges maintaining and replacing
4 plant funded by contributions given the disproportionate extent to which its growth has depended on
5 contributed capital. For purposes of the immediate case, however, Staff believes that it is reasonable
6 to employ the traditional treatment of contributions and advances, regardless of whether they have
7 been expended and properly reflect them in rate base. As such, Staff recommends a \$34,405
8 adjustment to increase AIAC and a \$2,859,339 adjustment to properly reflect CIAC. Exhibit S-4,
9 Schedule BCA-3.

10 **III. TERMINATION OF THE HOOK UP FEE**

11 Regardless of the ultimate determination on whether inclusion of only those contributions and
12 advances associated with plant in service is appropriate, Staff believes that the accumulation of such
13 an extensive supply of contributed funds is cause for substantial concern. As indicated by Staff, the
14 Company has not been building its equity in its total capital structure to a like extent as CIAC and
15 AIAC have increased. As of the end of the December 31, 2006 test year, H2O had a total
16 capitalization of \$13.16 million. Tr. at 78. Of that amount, only an approximate \$820,000 was either
17 debt or equity. *Id.* at 77. However, approximately \$12.34 million is customer supplied funds made
18 up of nearly \$9.27 million in CIAC and \$3.07 million in advances. *Id.* at 77-78. As a percentage of
19 total capitalization, contributions and advances constitute nearly 94% of H2O's total capital.

20 The problem with so little investor supplied funds in the Company's capitalization is manifest
21 and troubling. As a for-profit public service corporation, the Company obtains a fair value rate of
22 return on the fair value of its investor purchased plant. Earning a return on and of its investment
23 provides the Company's investors with a means to not only repay the original investment but
24 accumulate funds that can be invested into additional plant in the future. The surfeit of customer
25 supplied capital, which is applied as a negative to rate base, proportionally reduces the ability of
26 returns on investor owned plant to build up a store of capital that investors can apply toward future
27 investment.

28 ...

1 Staff's employment of an operating margin, as opposed to a cost of capital methodology, to
2 determine a rate of return is a reflection of the effect this phenomenon has had on H2O. After
3 removing all advances, contributions and customer deposits from total plant in service, the Company
4 would have a negative rate base. Exhibit S-4, BCA-1, BCA-3. Using a 10 percent operating margin
5 for a \$321,871 operating income, Staff's recommendation provides nearly 2.5 percent of the total
6 capitalization annually. Even under the Company's methodology for determining a rate of return, the
7 Company will have an operating income of only \$228,614 from which it must then pay interest
8 expense. Clearly, regardless of the methodology, or which position is taken on the appropriate
9 treatment of total CIAC in rate base, the Company is not building up the investment it has an
10 opportunity to earn an income on.

11 The Company may argue that the solution to this issue is to accept the Company's position on
12 inclusion of CIAC in rate base and then to increase the approved return on equity. That would not
13 present a meaningful solution to the issue, however. First, even under the approach proposed by the
14 Company, it is over earning and is due for a rate decrease under present rates despite the contention
15 that the present rates are too low to earn a sufficient amount to build up the equity in the Company's
16 rate base. *See e.g.* Exhibit A-3, Schedule A-1 indicating that a 3.97% decrease in revenue is
17 appropriate. Second, the Company acknowledges that, even assuming the Company ceased to
18 experience customer growth that it will eventually have need to replace existing plant as ordinary
19 wear necessitates eventual plant replacement.

20 For example, the Company acknowledges that in the event that the CRC is terminated, that
21 the flow of contributed funds will taper. Tr. at 49:9-14. The Company likewise agrees that there is a
22 long term risk to the effect that,

23 [t]he fact that the company has a significant portion of CIAC in its rate base and is not
24 earning, not recovering either depreciation or return on it, will or could increase the
25 company's risk in the future, because eventually that plant when it wears out has to be
26 replaced. So at that point in time you have to raise capital to replace that plant. And it
won't come through a hookup fee, because the developer is long gone. The growth is
already there.

27 Tr. at 50:17-25. Company witness Mr. Tom Bourassa further elaborated on the long term difficulties
28 produced by these circumstances as the following colloquy demonstrates.

1 Q. And I think you alluded to this earlier. The danger is if a company relies too heavily
2 for its backbone plant on purely contributed capital, the danger is that in the long-term
3 the company being so heavily relying on that source of revenue for the backbone plant
4 cannot replace the plant down the road as necessary and would not have the ability to
5 earn a return of and on that capital that was given to the company for that backbone
6 plant, correct?

7 A. Yeah. Other than I think you used the term revenue, CIAC as revenue, I would agree
8 with you.

9 Tr. at 53:21- 54:5

10 Q. And so isn't the goal to achieve some balance in the company's capital structure such
11 that there is sufficient rate base on a going forward basis that will enable the company
12 to earn a return on and of plant so that it's positioned in the long-term to have the
13 revenue stream necessary to continue to serve customers as needed by making repairs
14 and/or improvements to plant that becomes depreciated or obsolete?

15 A. I think, yes, companies should have or try to achieve some balance in their
16 capitalization because of those factors that you just mentioned.

17 Q. And despite wanting to have that balance, isn't there a concern that if the Commission
18 does not adopt Staff's recommendation to discontinue the hookup fees, that this
19 company could be setting -- the Commission could be setting the company up to fail in
20 the long term because it would not have the ability to, on a going-forward basis, earn a
21 return on and of the capital investment because it's relying too heavily on contributed
22 plant?

23 A. Yes. The company should not rely too heavily on contributed plant.

24 Tr. at 54:10-55:5.

25 Rather than confront the issue by proposing a termination of the CRC, the Company instead
26 attempts to cast the problem in terms of a timing issue. "And so really what we're dealing with in this
27 case is a timing problem. Well, it's a timing issue created by the company's collection policy, which
28 is collect these things up front. That's why we have a huge amount of unexpended CIAC." Tr. at

1 55:9-13; *See also* Tr. at 55:21-56:2. The matter is more substantial than a mere timing issue though.
2 For example, if the alleged timing issue were eliminated by the Commission accepting the
3 Company's proposed treatment of CIAC that is not associated with plant in service, it would not
4 change the fact that the Company's proposed FVRB of \$1,995,695 would represent only 15 percent
5 of the total \$13 million plant in service. The plant in service will eventually need replacement as the
6 Company acknowledges. Tr. at 50. However, the portion of plant that is actually earning a return on
7 which the Company can invest in future replacements is clearly disproportionately low regardless of
8 the timing.

9 The Company acknowledges that in the long term the problem is far more substantial than a
10 mere timing issue. "Over the long term, the company will be required to put in either debt or equity,
11 because the existing hookup fee will not cover all of the backbone facilities." Tr. at 55:13-16.
12 Ultimately, the Company's witness explained that the resolution is essentially what Staff has
13 proposed. "The Commission may determine that based on the circumstances that it would be
14 appropriate to eliminate the hookup fee. That's going to take away a funding source that the company
15 has relied on to build plant." Tr. at 56:15-18. Staff believes that there is presently an appropriate
16 basis for terminating the hook-up fee.

17 As Staff witness Brendan Aladi testified, Staff frequently proposes a capital structure of 40
18 percent equity to 60 percent debt. Tr. at 78. Moreover, Staff also generally supports a percentage of
19 contributions and advances in the total capitalization of no more than 30 percent. *Id.* at 79. By
20 Staff's estimation an appropriate proportion of equity to total capital inclusive of contributions and
21 advances would be approximately 28 percent equity. *Id.* By Staff's calculations, the Company
22 would need to have nearly \$4.89 million in invested equity in order to have an appropriate proportion
23 of investor supplied capital funding the Company's plant. *Id.*

24 Certainly it will take more than simply terminating the hook-up fee to resolve the long term
25 issue of ensuring that H2O has sufficient opportunity to accumulate the funds it will need to build up
26 the equity to total capitalization. However, to improve the Company's long term sustainability the
27 CRC should be terminated to prevent making the task any more daunting than it already is.

28 ...

1 **IV. REVENUE REQUIREMENT AND OPERATING MARGIN**

2 A consequence of reaching the conclusion that the Company has a negative rate base is that a
3 cost of capital approach to determining an appropriate rate of return would produce a negative rate of
4 return. Therefore, Staff employed an operating margin methodology to produce recommended rates
5 that are just and reasonable. Staff proposed a \$321,871 operating margin based on 10 percent of a
6 revenue requirement of \$3,218,705. Tr. at 74.

7 Staff's revenue requirement is substantially similar to the Company's proposed revenue
8 requirement of \$3,244,489. Based on either the Staff's or the Company's revenue requirements, a
9 rate decrease for H2O would be appropriate. Based on Staff's proposed revenue requirement, H2O
10 would experience a 4.73 percent decrease in rates. Tr. at 73:24-74:2; Exhibit S-4, Schedule BCA-1.
11 Using the Company's recommendation there would be a decrease of 3.97 percent. Exhibit A-3 at 3,
12 Schedule A-1.

13 Although Staff's operating margin methodology is due to the position that the Company has a
14 negative rate base, the Company has already noted that the results of the Company's cost of capital
15 methodology produces a very similar result. By the Company's reasoning an 11 percent operating
16 margin would essentially match the revenue reduction proposed by H2O. Tr. at 12:20-22.

17 Because Staff believes that the Company has a negative rate base for which a cost of capital
18 methodology would be inappropriate, Staff maintains that an operating margin is the most reasonable
19 method to develop an operating income under the present circumstances. In that vein, Staff would
20 recommend not adjusting the operating margin to match a cost of capital based result that is clearly
21 inapplicable to a utility that has a negative rate base. Specifically, the difference in revenue
22 requirements between the parties' positions is only approximately \$25,784. However, the Company
23 contends that Staff's position, even though it produces a higher operating income, will jeopardize
24 cash flows to the Company. Exhibit A-3 at 4. H2O asserts that the Staff position will keep the
25 Company from receiving \$73,000 in cash flows. *Id.*

26 To the extent that the Company has identified a difference between the ultimate income
27 statement results between the party positions, these differences are in large part fall outs of the
28 difference in positions on rate base. For example, as the Company notes, many operating expenses,

1 such as accounting for CIAC amortization in depreciation expense, separated the parties' positions on
2 operating expense. As the Company stated, the differing positions on depreciation expense alone
3 accounted for approximately \$195,853 in differences between the operating expenses between
4 parties. *Id.*

5 Consequently, differences in operating expenses are substantially what drive the differences
6 in operating incomes and produce the major distinction between the two positions. The differences in
7 operating expenses in large part trace their roots to the differences in rate base positions, which the
8 Company essentially acknowledges. "The bottom line is the Company believes that its filing
9 represents a more realistic relationship between rate base, revenues and expenses for the test year..."
10 Exhibit A-3 at 4:9-10. As Staff continues to believe that its rate base recommendations are
11 reasonable, as are the resultant operating expense recommendations, Staff urges the adoption of its
12 operating margin proposal as proposed.

13 **V. RATE DESIGN**

14 Staff and the Company both propose relatively similar rate designs. Both parties are
15 proposing inverted tier increasing block rates. Staff's recommendation is somewhat different in that
16 it proposes inverted tier rates for all rate classes, whereas the Company excludes the 2 and 3 inch
17 meter customers from the conservation based rate design. Staff believes that the Commission has
18 demonstrated a consistent policy in favor of approving rate designs that encourage efficient water
19 consumption choices by ratepayers. Exhibit S-22 at 20:10-15. The Company appears to espouse the
20 same interest in conservation yet confusingly does not propose a conservation rate design for all
21 customer classes nor does it explain why it distinguishes the 2 and 3 inch meter sizes. Tr. at 74:23-
22 75:5. Staff recommends conversion of all customer classes to inverted tier rate designs using Staff's
23 proposed rate design.

24 Likewise, Staff and the Company disagree as to the proper allocation of revenue recovery
25 through fixed minimums or through commodity rates. Staff proposes a 38.5 percent of revenue
26 would be recovered from monthly minimums and 61.5 percent should be recovered through the
27 commodity rate. Tr. at 75:15-20. Placing a greater emphasis on the commodity rate will give
28 customers a greater opportunity to control their rates by making efficient water consumption choices

1 and thereby encourage conservation. Tr. at 76:2-6. Staff's recommendation also falls within the
2 typical recommendation that the fixed monthly minimum be in the range of 35 to 40 percent. Exhibit
3 S-2 at 21:8-12; Tr. at 75:21-76:1.

4 However, the Company proposes to allocate 44 percent of its revenue recovery through fixed
5 minimums and 56 percent through the commodity rate. Exhibit A-3 at 14:17-19; Tr. at 32. The
6 Company agrees that there is more price incentive to conserve when there a greater portion of the
7 revenue is recovered through the commodity rate. Tr. at 33-37. A revenue recovery structured so as
8 to stress fixed minimums deemphasizes the variations in commodity usage by consumers. Tr. at 33.
9 Consequently, consumers will have less opportunity to observe tangible economic benefits from
10 reducing usage. *Id.*

11 As it has been a consistent policy of the Commission to use rate design as a means to
12 encourage water conservation, Staff believes that it would be appropriate to employ an allocation of
13 revenue recovery through fixed minimums that sends a stronger conservation signal than that
14 proposed by the Company. Both Staff and the Company agree that a rate design structured to
15 encourage conservation is appropriate. Moreover, the Company acknowledges that a balance
16 between revenue stability, through fixed minimums, and stress on commodity rates is appropriate.
17 "...[I]t's a balancing act. The Company is proposing a conservation-oriented rate design. It is
18 proposing inverted tier rates which will send a price signal to consumers. Again, we have to balance
19 revenue stability with that conservation goal...." Tr. at 38:1-5. Staff believes that its proposed rate
20 design strikes the right balance because it sends an appropriate conservation signal while not
21 jeopardizing revenue stability.

22 VI. CONCLUSION

23 For all the above stated reasons, Staff believes that its recommendations are reasonable and
24 should be adopted.

25 ...

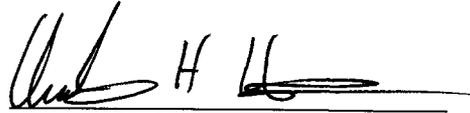
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RESPECTFULLY submitted this 15th day of June, 2009.



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