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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF LITCHFIELD PARK SERVICE COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANTS AND PROPERTY AND FOR INCREASES IN ITS WASTEWATER RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO. SW-01428A-09-0103
IN THE MATTER OF THE APPLICATION OF LITCHFIELD PARK SERVICE COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANTS AND PROPERTY AND FOR INCREASES IN ITS WATER RATES AND CHARGES FOR UTILITY SERVICES BASED THEREON.	DOCKET NO. W-01427A-09-0104
IN THE MATTER OF THE APPLICATION OF LITCHFIELD PARK SERVICE COMPANY, AN ARIZONA CORPORATION, FOR AUTHORITY (1) TO ISSUE EVIDENCE OF INDEBTEDNESS IN CONNECTION WITH THE CONSTRUCTION OF TWO RECHARGE WELL INFRASTRUCTURE IMPROVEMENTS AND (2) TO ENCUMBER ITS REAL PROPERTY AND PLANT AS SECURITY FOR SUCH INDEBTEDNESS.	DOCKET NO. W-01427A-09-0116
IN THE MATTER OF THE APPLICATION OF LITCHFIELD PARK SERVICE COMPANY, AN ARIZONA CORPORATION, FOR AUTHORITY (1) TO ISSUE EVIDENCE OF INDEBTEDNESS IN AN AMOUNT NOT TO EXCEED $1,170,000 IN CONNECTION WITH THE CONSTRUCTION OF ONE 200 KW ROOF MOUNTED SOLAR GENERATOR INFRASTRUCTURE IMPROVEMENT AND (2) TO ENCUMBER ITS REAL PROPERTY AND PLANT AS SECURITY FOR SUCH INDEBTEDNESS.	DOCKET NO. W-01427A-09-0120 **NOTICE OF FILING STAFF'S OPENING BRIEF**

Arizona Corporation Commission
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...

The Arizona Corporation Commission ("Commission") Utilities Division Staff ("Staff") hereby provides its opening brief in the above-referenced matters.

RESPECTFULLY SUBMITTED this 10th day of February, 2010.

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I. INTRODUCTION.

Litchfield Park Service Company ("LPSCO" or "Company") is a public service corporation engaged in providing water and wastewater utility services in portions of Maricopa County, Arizona, pursuant to a Certificate of Convenience and Necessity ("CC&N") granted by the Arizona Corporation Commission ("ACC" or "Commission") in Decision No. 28660, dated January 14, 1955. The Company's CC&N territory was subsequently expanded pursuant to several subsequent Commission Decisions.

Currently, LPSCO provides water service to approximately 14,700 customers and provides wastewater service to approximately 15,700 customers. LPSCO's current rates were approved by Commission Decision No. 65436, dated December 9, 2002, and were based upon a test year ending December 31, 2000.

On March 9, 2009, LPSCO filed before the Commission an application for a rate increase for its Wastewater Division (Docket No. SW-01428A-09-103) and its Water Division (Docket No. W-01427A-09-0104). The applications in both rate cases were filed using a test year ending September 30, 2008. The Company simultaneously filed a Motion to Consolidate the individual rate cases.

On March 13, 2009, the Company filed an application requesting authority to issue evidence of indebtedness in the amount of $1,755,000 for the purpose of constructing two recharge well improvements in Docket No. W-01427A-09-0116.

On March 13, 2009, the Company also filed an application requesting authority to issue evidence of indebtedness in the amount of $1,170,000 for the purpose of constructing a mounted solar roof generator in Docket No. W-01427A-09-0120.

On May 28, 2009, the Residential Utility Consumer Office ("RUCO") filed an Application to Intervene in dockets SW-01428A-09-103 and W-01427A-09-0104.

On June 22, 2009, the Hearing Division granted RUCO's Application to Intervene.

On June 30, 2009, Pebble Creek Properties Limited Partnership ("Pebble Creek") filed an Application to Intervene in dockets SW-01428A-09-103 and W-01427A-09-0104.

On September 22, 2009, the City of Litchfield Park ("Litchfield") filed an Application to Intervene in dockets SW-01428A-09-103 and W-01427A-09-0104.

On October 2, 2009, the Hearing Division granted Pebble Creek's Application to Intervene.

On October 30, 2009, the Hearing Division granted Litchfield's Application to Intervene.

On November 12, 2009, due to a discovery dispute with RUCO, the Company filed an Application for Subpoena, requesting that the Hearing Division order the taking of a deposition for Residential Utility Consumer's Office ("RUCO") witness Matt Rowell.

On November 16, 2009, Commission Utilities Division Staff ("Staff") filed a motion requesting a consolidation of all four of the outstanding dockets.

On November 23, 2009, the Hearing Division issued a procedural order which consolidated all four outstanding matters for hearing. The order also granted LPSCO's request to take the deposition of Matt Rowell and set forth the modified procedural schedule for the pre-filing of testimony.

On January 5, 2010, hearing commenced in all four of the instant matters. At the close of testimony on January 15, 2010, the Hearing Division confirmed the briefing dates for these matters. Final Schedules were directed to be filed no later than February 1, 2010. Opening briefs were to be filed on or before February 8, 2010, with reply briefs due on or before February 22, 2010. In this brief, Staff will address the major disputed issues. On any issue not specifically addressed in this brief, Staff maintains its position as presented in its testimony.

II. RATE BASE ISSUES.

The Company has requested that its Original Cost Rate Base ("OCRB") be used as Fair Value Rate Base ("FVRB") for both the Water and the Wastewater Division.[3] The Company proposes $37,762, 676 for the Water Division and $28,222,289 for the Wastewater Division.[4] Staff is recommending an OCRB of $37,401,639 for the Water Division and $27,746,122 for the Wastewater Division.[5] These differences are based upon several adjustments, primarily: (1) adjustment to accumulated deferred income taxes, (2) exclusion of deferred regulatory assets, (3) adjustment to customer deposits, and (4) various adjustments to plant in service.

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13 A-14 at 7:13-15 and 39: 4-5 (Bourassa RBDir.).
4 Company Final Schedules B-1, Water Division; B-1, Wastewater Division.
5 Staff Final Schedules JMM-W1 and JMM-WW1.
7 Tr. at 1159:21-25, Staff Final Schedules JMM-W10 and JMM-WW10.

A. Accumulated Deferred Income Taxes ("ADIT").

Staff is recommending $335,487 in ADIT for each of the Divisions.[7] The Company changed its position on this issue several times during the course of filing testimony in this case.[8] As Staff was unable to verify the Company's proposed numbers, Staff recommends using the $670,974 as reported by the Company in its annual report, allocating 50 percent or $335,487 to each Division.[9]

B. Deferred Regulatory Assets.

In 1981, the Arizona Department of Health Services ("ADHS") discovered that groundwater in the Phoenix-Goodyear Airport ("PGA") area was contaminated with solvents and chromium. Additional sampling of wells in 1982 and 1983 by ADHS and the U.S. Environmental Protection Agency ("EPA") revealed eighteen wells contaminated with Trichloroethylene ("TCE"). As a result, the EPA added the PGA area to the National Priorities List, and designated it a superfund site. The site was eventually divided into the PGA North and PGA South sites due to different contamination sources and different potentially responsible parties.

In March 2006, Unidynamics/Crane Company, under the oversight of the EPA began installation of numerous groundwater monitoring wells and an extraction well. The purpose of these monitoring wells was and is to assist the EPA in determining the extent of TCE and percholate contamination in groundwater at the PGA North site.

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[8] Tr. at 1160:6-9.
[9] Tr. at 1161:8-18.
[27] A-1 at 12:3-6 (Sorensen Dir.).

In December 2006, LPSCO filed an application before the Commission seeking an accounting order authorizing a deferral of the costs incurred in connection with the Company's response to the potential contamination, including, but not limited to: (1) litigation costs related to defending the Company against lawsuits; (2) litigation costs related to seeking restitution from polluters/contaminators; (3) increases in operations and maintenance expenses from alternative or replacement water sources; (4) capital costs of acquiring and/or constructing alternative or replacement sources of water; (5) capital costs and/or operating expenses to treat contaminated water supplies; (6) settlement costs and/or amounts received as a result of settlements with polluters/contaminators; and (7) punitive damages received as a result of litigation against polluters/contaminators.

In Decision No. 69912, dated September 27, 2007, the Commission granted the Company's application.

Since then, "TCE has recently been detected in subunit C less than ½ mile from [the Company's] nearest well, 34C, which yields 1,000 gpm or roughly 8 percent of our required water production during the summer months."[27] As a result, the Company has increased its monitoring of that well for TCE, and now tests it monthly.

In the instant matter, the Company is seeking to recover the costs it has incurred to date in conjunction with the accounting order. Staff believes that it is premature to authorize recovery of these costs at this time.

The Commission granted the accounting order with the intention that the deferred costs should be recovered in a future rate proceeding, but the appropriate time for recovery is not yet at hand. The testing associated with Well 34C is but one of the many cost areas for which the order was granted. The remaining cost categories all relate to any potential legal expenses that the Company may incur. Currently, though the Company admits to working closely with Crane Company, the Company has not yet filed any legal action against Crane or any other party in association with the plume. The Company admits that the situation has not yet reached a point at which legal action would be appropriate.

...

In Staff's view, the costs being deferred under the accounting order are not yet ripe for recovery. Specifically, there exists the potential that the Company could reach some type of settlement that would reimburse LPSCO for all of these costs, including testing expenses, or possibly even punitive damages in addition. If the Company has already been allowed to build these increased testing expenses into its existing revenue requirement, it could possibly be "reimbursed" for these costs through the ratepayers in addition, which would result in a double recovery of the costs. The Company has suggested that this could easily be corrected in a subsequent rate case, but Staff disagrees.

Decision No. 69912 specifically indicates that "the appropriate forum in which to consider the deferred costs, as well as proceeds related to the TCE Plume threat, is in a future rate case when all parties will be entitled to litigate the appropriateness of recovery of deferrals in rates."[28] The inclusion of the word "proceeds" in the order clearly indicates that the Commission recognized the potential that LPSCO could recover damages from polluters, and that, once recovered, those proceeds should be used to offset the added costs the Company was forced to incur. Nothing in the language of the Decision suggests that these costs would be recovered incrementally, without the benefit of the full record of costs, recoveries, and the sources for each.

These increased testing costs are simply one of the many reasonably-expected risks associated with operating a water utility. If the Company is allowed to be reimbursed now, with the intention of paying the customers back in the future, if necessary, it will in effect have shifted the business risk that is rightfully its own to its ratepayers. Obviously, this is unacceptable. The Company should bear its own risks and wait to be reimbursed in a future rate case at a time at which the other categories of costs are more readily identified. At this time there is nothing to be accounted for in any other area of the accounting order, and it would be premature to act on just one piece of the order at this time. There is nothing that precludes the Company from seeking recovery in a future rate proceeding.[29]

Staff recommends that the Commission order the Company to continue to defer the costs and to address the situation in its next rate proceeding when there will be more information available.

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[28] A-8 at 5:21-23 (Dec. No. 69912).
[29] Tr. at 1162:20-22.

C. **Customer Deposits.**

"Based on Staff data request JMM 1.56, Staff identified Customer Deposits in the test year that were not included in the rate application. Specifically, the Company only included customer meter deposits and no other Customer Deposits."[30]

"Customer Deposits represent funds received from ratepayers as security against potential losses arising from failure to pay for service. These funds are similar in nature to customer advances for construction."[32] "Like customer advances, the deposits are available to the utility for use in support of its rate base investment."[33] As a result, Staff includes customer deposits as a reduction to rate base.[34] Therefore, Staff recommends increasing Customer Deposits in the Water Division by $2,293,447, from $68,685 to $2,362,132, and in the Wastewater Division by $55,425, from $68,685 to $124,110.[35]

D. **Plant in Service.**

1. Inadequate Documentation.

Based on a review of the Company's and RUCO's testimony, Staff recommends disallowance from plant in service of $5,642 from the Water Division, as the Company was unable to provide invoices or other documentation to support certain items.[36] Staff's recommendation is consistent with other dockets in which the same recommendation was made. *In the matter of Groom Creek Water Users Association*,[37] Staff recommended the disallowance of test year plant where the utility lacked the documentation to support the plant. Decision No. 70627 adopted Staff's recommendation with respect to the disallowance of test year plant.[38] *In the matter of Cordes Lakes Water Company*, Staff recommended the disallowance of plant where the utility lacked the documentation. The Commission, in Decision No. 70170, adopted Staff's recommendation.

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30 S-14 at 10:9-11 (Michlik WDir.).
32 S-17 at 5:6-8 (Michlik WWSur.).
33 S-17 at 5:9-11 (Michlik WWSur.).
34 S-17 at 5:13-14 (Michlik WWSur.).
35 See Staff Final Schedules JMM-W4, JMM-W9, JMM-WW4 and JMM-WW9.
36 Tr. at 709:18-22; 803:25-804:25; 917:12-918:2. See also, Staff Final Schedules JMM-W4 and JMM-W7.
37 Docket No. W-01865A-07-0385 et. al.
38 Decision No. 70627, FOF 54, 57.

2. Retirement of Plant.

Staff recommends disallowance from plant in service of $17,150 from the Water Division for the calculated value of retirements where the Company included the costs of replacing certain plant but made no corresponding entry for the related retirements.[39] Similarly, Staff recommends disallowance of $7,231 from the Wastewater Division.[40]

3. Reclassification of Capitalized Items.

Staff recommends disallowance from plant in service of $3,571 from the Water Division for costs that were capitalized by the Company but that Staff has determined should be classified as operating expenses.[41] Similarly, Staff recommends disallowance of $169,136 from the Wastewater Division.[42]

E. Palm Valley Water Reclamation Facility.

The Company's most recent previous rate case was filed using a 2000 test year. At that time, the Company had approximately 5,541 water customers and 5,012 wastewater customers.[45] At the end of the test year in this matter, the Company had over 15,000 water customers and 14,000 wastewater customers.[46] The Company cites this approximate tripling of its customer base as the reason that it "deployed significant capital over the past several years to catch up with capacity needed to serve its expanding customer base".[47] During this time, the Company built and eventually upgraded the Palm Valley Water Reclamation Facility ("PVWRF"), a 4.1 MGD wastewater treatment plant.

The PVWRF was originally constructed in 2002 and 2003, and was completed just before Algonquin Power Income Fund ("APIF") acquired LPSCO.[48] The plant received an initial Aquifer Protection Permit ("APP") which would allow it to treat up to 8.2 MGD, but was built to treat only

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39 *Id.;* See Staff Final Schedules JMM-W4 and JMM-W7.
40 *Id;.* See Staff Final Schedules JMM-WW4 and JMM-WW7.
41 *Id.;* See Staff Final Schedules JMM-W4 and JMM-W7.
42 *Id.;* See Staff Final Schedules JMM-WW4 and JMM-WW7.
45 A-1 at 5:3-4 (Sorensen Dir.).
46 A-1 at 5:5-7 (Sorensen Dir.).
47 A-1 at 5:13-14 (Sorensen Dir.).
48 A-1 at 6:20-23 (Sorensen Dir.).

4.1 MGD.[49] The original facility consisted of an anoxic tank, two Sequential Batch Reactor ("SBR") tanks, a surge tank, and ultraviolet ("UV") disinfection. At the time of construction, the land surrounding the plant contained only a golf course, with some commercial office space planned as well. As a result, the Company received setback variances from both the City of Goodyear ("Goodyear") and the Arizona Department of Environmental Quality ("ADEQ") for an odor setback of only 150 feet, rather than the now-customary 350-foot minimum.[50]

Shortly thereafter, Goodyear re-zoned the area surrounding the PVWRP. The result was the approximate tripling of the Company's customer base over the next few years. The new growth encroached on the territory surrounding the PVWRP and as a result of its proximity, the Company began to receive odor complaints in 2006 and 2007. In addition, the Company experienced two separate spill incidents in the summer of 2007. These combined circumstances caused the Commission to open Docket No. SW-01428A-07-0602, an "Inquiry Into The Operational Practices Of Litchfield Park Service Company" on October 18, 2007.

In response to the odor complaints, the Company added a Granulated Activated Carbon (GAC) air polishing unit to the plant. The project was completed in 2007 at a cost of under $1 million. Thereafter, the Company commissioned the pilot installation of a technology that, while having been used in Europe for many years, was still new to the United States. The product utilized oxygen ion clusters to bind with the odor causing agents and neutralizes them. The project was successful and cost the Company approximately $600,000.[51] Since completing the project, the Company has had no odor complaints attributable to the PVWRF in the last twelve months.[52]

The spill incidents indicated to the Company that the plant was lacking certain redundancy capabilities and needed several upgrades in order to achieve an acceptable level of reliability.[53] In response, the Company spent approximately $7 million to upgrade and improve the plant. Among other things, the Company: (1) converted an aerobic digestion tank into a third SBR tank for maintenance/redundancy purposes, (2) improved influent screening, (3) added a surge tank return

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[49] A-1 at 6:25-26 (Sorensen Dir.).
[50] A-1 at 7:2-6 (Sorensen Dir.).
[51] A-1 at 8:9-20 (Sorensen Dir.).
[52] A-1 at 8:24-26 (Sorensen Dir.).
[53] A-1 at 7:13-16 (Sorensen Dir.).

line, (4) installed additional and upgraded UV disinfection equipment, and (5) upgraded the electrical service to accommodate added loads.[54]

RUCO has argued that "[t]he information provided by LPSCO indicates that there were significant design problems"[55] with the PVWFP. No party has disputed that the plant required *significant upgrades shortly after entering service*. The Company, however, disputes the existence of flaws in the design of the PVWRF.[56] LPSCO notes that the plant was "designed according to the rules and regulations of the county, of the city at the time it was constructed in 2002."[57]

The Company's engineer has stated that "[t]he upgrades were made to address certain operational challenges. The upgrades were intended to increase the reliability and redundancy of the plant, and decrease some of the operations and crisis management costs."[58] The Company argues that it undertook the upgrades because in order to "optimize the plant, you need to address certain issues that come up that were *not apparent in the original*, when the plant was originally operating under low flows that will reduce the cost of operating and maintaining the plant."[59] "[T]he cause of the operational challenges are a difference between the assumptions that were made when the plant was first brought on line and under lower flows, and what actually occurred as the flows grew."[60]

Essentially, the Company is arguing that the plant was constructed according to the known customer numbers and types at the time, and that it performed well as constructed, but the re-zoning that led to the encroachment on the facility, along with the approximate tripling of the customer count resulted in the need to modify the facility to meet demands on the system that had not been present previously.

RUCO has argued that the upgrades were necessary to increase the treatment capacity of the plant, but the Company denies this. "The capacity of the plant before and after the upgrades is 4.1

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[54] A-1 at 7:18-25 (Sorensen Dir.).
[55] R-22 at 4:19-20 (MRowell Dir.).
[56] Tr. at 31:2-4.
[57] Tr. at 31:4-6.
[58] Tr. at 138:15-19.
[59] Tr. at 139:7-11.
[60] Tr. at 139: 19-22.

million gallons a day."[61] Staff has described the PVWRF as a "4.1 million gallon per day ... sequential batch reactor ... treatment plant".[62]

In addition to its position that the upgrades increased treatment capacity, RUCO also seems to be arguing that the significant dollar value of the upgrades in comparison to the original cost of the facility is proof that the facility was poorly designed. The logic of such an argument, however, is lacking. If the plant was designed to meet the best-estimated demand, but real-world, actual operational factors required the Company to build in redundancies that would increase operational reliability, as opposed to capacity, then the dollar value of the repairs would be irrelevant, as would be the number of total projects needed to increase reliability. Obviously, the Company would have no way to know at the time the facility was constructed which of its design assumptions would turn out to be inaccurate, and certainly would have no way to plan for which components would need to be improved upon. Every utility must rely on capable engineering estimates to plan its facilities appropriately. Given the changes made to zoning and the changes in composition of the customer base as it tripled, Staff does not believe the Company acted unreasonably in relying on the design assumptions provided when the facility was first constructed. Likewise, Staff does not believe that the capacity of the plant was increased through any of the upgrades. Staff believes that the upgrades did exactly as the Company has suggested – improved system reliability.

RUCO, though, still relying on its theory that the need for the upgrades is proof that the plant was inaccurately designed, has taken the position that "the costs of the PVWRF upgrades necessitated by the PVWRF's design problems should be shared between the shareholders and the customers."[63]

RUCO has therefore recommended that "the costs of these improvements be split 50/50 between the ratepayers and the shareholders. This results in a disallowance of $3.5 million of test year plant additions."[64]

Staff does not agree with RUCO's recommended disallowance of plant. The PVWRF is currently used and useful in service to LPSCO customers and is currently in compliance with all

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[61] Tr. at 140:12-14.
[62] S-5, Ex. MSJ at 20, paragraph B. (Scott Dir.).
[63] R-22 at 5:10-12 (MRowell Dir.).
[64] R-22 at 5:14-17 (MRowell Dir.).

applicable ADEQ and ACC requirements.[65] Staff further disagrees that the current plant configuration contains any excess capacity.

F. Post Test Year Plant.

The Environmental Protection Agency ("EPA") recently lowered the maximum arsenic contaminant level from 50 parts-per-billion ("ppb") to 10 ppb. As a result, in order to meet federal guidelines regarding arsenic content, LPSCO must treat the water that is pumped from 9 of its 12 system wells. The Company currently treats for arsenic using two separate facilities. The first was completed in 2006 and the second in 2008.

However, a third treatment facility is necessary to treat the water pumped from Company Well 20B. Well 20B pumps 1,380 gpm, and the Company believes the well is essential to the Company's ability to meet peak demand during the summer months. The Company received an interim waiver from the EPA which allowed it to continue to operate the well until December 31, 2008, but since the Company had not completed and installed the arsenic treatment system by that date, the well had to be taken off line at that time.

"The construction of this arsenic treatment project commenced on October 2008 and completed in January 2009. On January 30, 2009, MCESD issued a Certificate of Approval to Commence Operations to begin the facilities operation for the Validation and Commissioning Testing requirements. On June 24, 2009, MCESD issued the Certificate of Approval of Construction for this project. Based on these approvals, along with Staff's field inspection to confirm the plant operation, Staff concludes that the requested PTY item is used and useful for the provision of service to customers."[66]

As such, the Company is seeking recovery of the $1,866,965 associated with this plant item as post test year plant. Staff does not oppose inclusion in rate base.

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[65] S-5 at 23, paragraphs E and F (Scott Dir.).
[66] S-5 at 8, paragraph I (Scott Dir.).

III. OPERATING INCOME ISSUES.

A. Employee Bonus Expense.

Staff has recommended a reduction in the Company's Contractual Services - Other account, to remove the expenses associated with employee incentive pay and bonuses. It is Staff's position that including bonuses in operating expenses harms customers because the customers would be required to pay for an expense that is not needed in the provision of service.

Further, bonus pay is not part of an employee's base salary; payment is conditional on performance, so there is no guarantee that the money will actually to be paid to any employee.[73] Including incentive pay in the Company's revenue requirement guarantees enough money to pay employees who are not guaranteed to receive it. This is unfair to ratepayers and should not be allowed. Staff recommends that $52,954 for employee bonuses be removed from the Contractual Services account, allocating $26,447 to each of the Divisions based on Staff's allocation of corporate expenses.[74]

B. Rate Case Expense.

The Company has estimated that it will incur well over half a million dollars in rate case expense by the end of this proceeding.[75] The Company is requesting rate case expense of $210,000 for each division, for a total rate case expense of $420,000.[76]

While Staff does not dispute the amount of rate case expense claimed for either division, Staff typically recommends that rate case expense be normalized over a three to five year period. Because the Company has not filed a rate application in close to nine years, so Staff recommends normalizing the rate case expense over five years.[77]

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[73] Tr. at 1232:17-1233:3.
[74] S-15 at 11:4-6 (Michlik WSur.), S-17 at 9:4-6 (Michlik WWSur.).
[75] A-14 at 13:14-15 (Bourassa RBDir.).
[76] A-14 at 13:13-14 (Bourassa RBDir.).
[77] Tr. at 1154:1-5.

As a result, Staff recommends decreasing rate case expense by $28,000, from $70,000 to $42,000 as shown on Final Schedules JMM-W13, and JMM-W19[78] for the Water Division and on Final Schedules JMM-WW12 and JMM-WW16[79] for the Wastewater Division.

C. Cost Allocation.

LPSCO is a wholly-owned subsidiary of its ultimate parent company, APIF.[80] In turn, APIF owns and operates Liberty Water Services ("Liberty"). Liberty is the entity which acts as a management company for the seven regulated Arizona utilities, including LPSCO. Using a shared services model to reduce costs to the utilities operated by APIF, Liberty employs all of the employees necessary to perform the day-to-day operations of each of APIF's Arizona utilities.[81] The costs of the services provided by these employees are divided among the utilities according to a set of criteria developed by APIF and Liberty.[82]

In previous rate cases, the management functions performed by APIF that were allocated to the Arizona utilities included a profit to APIF. The Commission determined that this practice was unacceptable and in Decision No. 69164 and Decision No. 69666 directed that these associated profits be removed from the allocation in future rate cases. LPSCO indicates that it has taken that direction to heart and has modified its allocation methodology. As it now functions, "operation labor costs are directly allocated based on operator time, accounting and billing costs are allocated based on a customer allocation factor, and corporate overhead is allocated based upon a 4-factor methodology."[83]

The Company allocated $3.95 million in expenses from the unregulated affiliate based on a single allocation factor of 26.98 percent.[84] Staff reviewed the amounts comprising the amounts being allocated, including the underlying invoices for the costs, and determined that the Company did not identify the costs as direct or indirect as consistent with the guidelines provided by the

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78 S-14 at 20:7-8 (Michlik WDir.).
79 S-16 at 18:11-12 (Michlik WWDir.).
80 S-14 at 15.
81 S-14 at 15-16.
82 *Id.*
83 A-14 at 15:12-15 (Bourassa RBDir.).
84 S-14 at 17:2-3 (Michlik WDir.).

National Association of Regulatory Utility Commissioners ("NARUC") for Cost Allocation and Affiliate Transactions.[85]

Staff's review indicated that nearly all of the costs were obviously attributable to the operations of APIF or one of its affiliates. As a result, Staff assigned 90 percent of the costs to APIF.[86] The remaining ten percent constitutes Staff's recognition that the other affiliates receive a benefit from the common costs, and therefore should be allocated a percentage greater than zero.[87]

Staff disagrees with the Company's assertion that the cost pool to be allocated amounted to \$3.95 million. As shown on Final Schedule JMM-W18, page 2, Staff identified \$191,828 in unallowable costs.[88] In addition, the formula the Company used to allocate the costs divided the costs among 17 utilities out of 63 total facilities, which equaled 26.98 percent of the total allocation pool being passed on to the regulated utilities[89], where it was then divided according to customer counts.

Staff compared this information to the 2007 Annual Report filed by APIF, and found that these numbers did not agree.[90] Staff believes that the information in the APIF Annual report should be used to determine the total number of facilities, 71. Using this number, Staff determined that the appropriate percentage of the total cost pool that should be allocated to each individual subsidiary would 1.41 percent.[91] Staff's recommended common costs and allocation factor are shown on Final Schedule JMM-W18 for the Water Division and JMM-WW15 for the Wastewater Division.

Staff recommends decreasing corporate allocation expense for the Water Division by \$339,423, from \$2,382,976 to \$2,043,553, as shown on Final Schedules JMM-W14 and JMM-W18. Staff also recommends decreasing other contracted services for the Wastewater Division by \$235,528, from \$2,719,118 to \$2,483,590, as shown on Final Schedules JMM-WW13 and JMM-WW15.

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85 S-14 at 17:13-17 (Michlik WDir.).
86 S-14 at 17:22-24 (Michlik WDir.).
87 S-14 at 17:24 – 18: 1-2 (Michlik WDir.).
88 S-14 at 18:4-7 (Michlik WDir.).
89 S-14 at 18:16-17 (Michlik WDir.).
90 S-14 at 18:21-23 (Michlik WDir.).
91 S-14 at 19:1-5 (Michlik WDir.).

D. Potential Loss of Revenue from City of Goodyear.

"During the test year, the Company sold approximately $403,000 of bulk water to the City of Goodyear."[92] According to the rejoinder and final schedules as filed by the Company, LPSCO has reversed its pro forma adjustment to revenue related to the test year sales to Goodyear and increased its proposed revenue by $403, 707. Staff concurs with this adjustment.

IV. COST OF CAPITAL.

The cost of capital is the opportunity cost of choosing one investment over others with equivalent risk.[125] The cost of capital to a company issuing a variety of securities … is an average of

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[92] A-1 at 13:11-12 (Sorensen Dir.).
[125] S-12 at 4:7-8 (Manrique Dir.).

the costs on all issued securities adjusted to reflect the relative amounts for each security in the company's entire capital structure. Thus, the overall cost of capital is the weighted average cost of capital ("WACC").[126]

A. Capital Structure.

The capital structure of a firm is the relative portions of each type of security short-term debt, long-term debt (including capital leases), preferred stock and common stock that are used to finance the firm's assets.[127] The capital structure of a company is expressed as the percentage of each component of the capital structure . . . relative to the entire capital structure.[128]

LPSCO's capital structure is composed of 17.2 percent debt and 82.8 percent equity. In comparison to the sample water companies Staff used as proxies to conduct its financial modeling, the average capital structure for the proxy companies was comprised of approximately 50.8 percent debt and 49.2 percent equity.[129] For purposes of calculating an overall return on equity in this matter, Staff recommends using the Company's actual capital structure of 17.2 percent debt and 82.8 percent equity.

B. Cost of Equity Capital.

The cost of equity is the rate of return that investors expect to earn on their investment in a business entity given its risk.[130] A comparison of betas, a measurement of risk, between the market in general and the water utility industry in specific provides insight into the relationship between equity returns required for a regulated water utility and for the market as a whole.[131] The average beta for a water utility (0.82) is lower than the theoretical average beta for all stocks (1.0).[132] The lower beta for the water utility industry suggests that the required return on equity for a regulated water utility is below the average required return for the market as a whole.

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[126] S-12 at 4:13-16 (Manrique Dir.).
[127] S-12 at 6:4-6 (Manrique Dir.).
[128] S-12 at 6:9-11 (Manrique Dir.).
[129] S-12 at 7:14-16 (Manrique Dir.).
[130] S-12 at 8:4-5 (Manrique Dir.).
[131] S-12 at 11:1-5 (Manrique Dir.).
[132] S-12 at 11:5-6 (Manrique Dir.).

From an investor's perspective, LPSCO's capital structure makes LPSCO less risky than the sample water companies, since LPSCO's shareholders bear less financial risk than the shareholders of the sample companies.[133]

In order to estimate cost of equity, one simply applies the financial profile of the target company, in this case LPSCO, to a financial model developed for this purpose. However, since LPSCO is not a publicly traded company, it is not possible to directly estimate LPSCO's cost of equity due to the unavailability of financial information. Instead, a group of companies with similar traits, a proxy group, is chosen. The financial information of these proxy companies is then compiled and applied to one or more financial models.

In reaching its estimate, the both Staff and the Company utilized two widely recognized financial modeling tools, the Discounted Cash Flow ("DCF") model and the Capital Asset Pricing Model ("CAPM").

1. Discounted Cash Flow Model.

The DCF method of stock valuation is based on the theory that the value of an investment is equal to the sum of the future cash flows generated from the investment discounted to present time. The method uses expected dividends, market price and dividend growth rate to calculate the cost of capital.

As stated previously, LPSCO is not a publicly traded company, so a proxy group was necessary. Staff used a proxy group comprised of six publicly-traded water utilities, chosen due to their being publicly traded and receiving the majority of their earnings from regulated operations. When Staff applied their composite information to the DCF model, Staff reached an overall DCF estimate of 10.1 percent, as illustrated in Schedule JCM-3.[134] The Company used a proxy group consisting of the same six water companies chosen by Staff. However, the Company arrived at a range of values between 9.7 percent and 13.7 percent.[135] Staff disagreed with the Company's DCF estimates because they rely exclusively on analyst's forecasts, and its DCF constant growth analysis does not include dividend growth.

[133] S-12 at 13:3-10 (Manrique Dir.).
[134] S-12 at 27:13 (Manrique Dir.).
[135] A-15 at 3:22-23 (Bourassa COCDir.).

2. *Capital Asset Pricing Model.*

The CAPM model describes the relationship between a security's investment risk and its market rate of return. The CAPM asserts that an investor requires the expected return of a security equal to the rate of a risk-free security plus a risk premium.[136] The expected market risk premium is the expected return on the market above the risk-free rate that an investor expects as compensation for market risk associated with the investment.[137] Market risk can be calculated using either an historical market risk premium or a current risk premium.

Applying the same group of proxy utilities to the CAPM that it previously applied to the DCF model, Staff arrived at a cost of equity of 8.5 percent using the historical market risk premium and a cost of equity of 11.8 using the current market risk premium. Staff then averaged the two results and arrived at an overall cost of equity of 10.2 percent.[138]

The Company likewise used the same proxy group for the CAPM as for the DCF model, arriving at a range of results between 9.3 percent to 23.5 percent.[139] The midpoint of the range is 14.1 percent, but the Company nonetheless recommended using only 12.5 percent of the cost of equity in this matter, a full 150 basis points below its calculated rate.[140]

The results of these two models were then adjusted based on the Company's judgments regarding the risks associated with small utilities like LPSCO that the Company believes are not captured by the market data and the financial risks associated with the level of debt in LPSCO's capital structure.

The Company points out that LPSCO is a much smaller utility than the utilities in the proxy group.[141] As a result, the Company argues that investors would require a greater return on an investment in LPSCO to compensate them for the risk presented by the smaller utility.[142] Staff disagrees. While it is true that LPSCO is smaller than the utilities in the proxy group, because LPSCO is not publicly traded, investors would not look to LPSCO's size, but rather to the size of the

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[136] S-12 at 27:19-22 (Manrique Dir.).
[137] S-12 at 30:2-3 (Manrique Dir.).
[138] S-12 at 31:9-15 (Manrique Dir.).
[139] A-15 at 3:23-25 (Bourassa COCDir.).
[140] A-15 at 4:4-5 (Bourassa COCDir.).
[141] A-17 at 6:4-5.
[142] *Id.*

company in which they would have to invest in order for LPSCO's size to become a factor – APIF. As stated earlier, APIF is a large, publicly traded fund with ownership in 71 subsidiary companies, making it much larger than any of the utilities in the proxy groups, and thus more stable. The Company's argument fails when the proper comparison is made.

In addition, the Company concedes that LPSCO's capital structure shows financial strength. In fact, none of the utilities in the proxy group were nearly as strong. LPSCO admits that this *financial strength may in fact offset the other factors* that LPSCO believes make it more risky than the proxy group companies.[143]

Staff reached an overall cost of equity of 10.0 percent for the sample companies. But just as the Company did earlier, Staff applied to the overall cost of equity an adjustment based upon what Staff estimates would be the effect on investors of LPSCO's capital structure. In Staff's view, LPSCO's demonstrated financial strength makes it a less risky investment than the proxy companies. As a result, investors who recognize the financial strength such a capital structure represents will require less of a return on an investment in LPSCO than in the riskier proxy groups. Therefore, Staff recommends a downward adjustment of 80 basis points (0.8 percent) to compensate.

Staff therefore recommends that the Commission adopt an overall return on equity of 9.2 percent.[144]

In its Direct testimony, the Company recommended an overall Return on Equity ("ROE") of 12.5 percent[145] based upon his assertion that LPSCO faces additional risks not captured by the market models. He therefore recommends an overall Rate of Return of 11.02 percent.

Staff disagrees. To the contrary, Staff believes that the Company is stronger than the modeling data would seem to indicate, which was the basis for Staff's adjustment of 80 basis points downward.[146]

Using a 9.2 percent cost of equity and a 6.4 percent cost of long-term debt applied to the Company's capital structure, Staff believes that the Company should be authorized an overall Rate

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[143] A-15 at 22:7-9 (Bourassa COCDir.).
[144] S-13 at 2.
[145] A-15 at 2: 25 (Bourassa COCDir.).
[146] S-13 at 2.

of return of 8.7 percent.[147] This will allow the Company to earn a fair rate of return on its rate base and to attract capital.

V. RATE DESIGN.

In its direct testimony, the Company states that it conducted a cost of service study which separated expenses and assets into three primary functions or components; commodity, demand, and customer.[148] The Company acknowledges that the cost of service study will provide the cost of the commodity, but will not provide data useful in the setting of tier break over points. Tiers must be set according to customer usage.[149]

The Company's current commodity rate is $0.87 per 1,000 gallons for the first 5,000 gallons and $1.32 per 1,000 gallons over 5,000 gallons. The first tier rate is approximately 1.25 times the actual cost to produce the water, while the second tier rate is approximately 1.9 times what it costs to produce the water.[150]

Under the Company's proposal, the commodity rate would be $1.70 for tier one, $2.30 for tier two, and $3.05 for tier three for the 5/8 inch and ¾ inch residential meters. The proposed first tier rates are over 2.4 times the cost to produce the water, while the second tier rates are approximately 3.3 times the cost, and the third tier rates are approximately 4.4 times the cost. The Company concedes that the commodity rates are "vastly overstated" when compared to how much it actually costs to produce the water.[151]

Staff's rate design is typically a three-tier design with break over points and monthly minimum charges set at levels designed to encourage the efficient use of water.

The Company's rate design is intended to provide "revenue stability," to make the Company less dependent on sale of commodity, thereby reducing risk to the Company. If customers successfully lower their water usage, the Company stands to lose revenue, and if a large portion of its profit comes from the sale of the commodity, as opposed to from the monthly minimum charges, then the Company will lose money, the more the consumer reduces usage. Thus, the Company's

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[147] S-13 at 2.
[148] A-14 at 23:10-13 (Bourassa RBDir.).
[149] A-14 at 24:10-12 (Bourassa RBDir.).
[150] A-14 at 28:22-25 (Bourassa RBDir.).
[151] A-14 at 29:1-7 (Bourassa RBDir.).

design eliminates the incentive to conserve, since the customer can substantially reduce usage and still not see any savings due to the increase in the monthly minimum charge. Additionally, the difference between the commodity rates for the tiers in the Company's rate design is relatively small. Use of small differences between the tier rates diminishes the effectiveness of a multi-tier rate structure. As the differential between the rates for the tiers approaches zero, a primary purpose for using tiered rates – to encourage efficient use of water - is essentially eliminated. As a result, Staff was opposed to the Company's initially proposed rate design.

At hearing, the Company and the City of Litchfield Park presented a joint rate design proposal which was intended to supersede the Company's original proposal. Staff testified that this rate design is deficient in that it has inequitable crossovers, i.e., usage levels at which the bill for a smaller meter is higher than the bill for a larger meter.[152]

After questioning each party's witnesses regarding the nuances of the rate design proposals up for consideration at the time, the Administrative Law Judge requested that Staff submit a filing which would represent "some kind of an alternative that - - and even if you have to even out the recovery . . . maybe make the three-quarter inch meter rates a little higher and the one-inch meter rates a little lower with a three-tier, maybe come up with something that you think is appropriate that still recovers the revenue requirement, just as an alternative?"[153]

Staff agreed to provide an alternative rate design that met the Judge's requirements, but Staff made clear that although it would gladly provide the documentation that would assist the Judge in reaching his decision, Staff did not intend to offer the alternative in place of the proposal it had already made in its pre-filed testimony.[154]

Staff continues to recommend that the Commission adopt the rate design proposed in Staff's pre-filed testimony, but in the event the Commission does not agree with Staff's position, then Staff believes the rate design option submitted at the Judge's request would be the preferred alternative.

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152 Tr. at 1036-37.
153 Tr. at 1059:2-11.
154 Tr. at 1247:14-21.

A. Low Income Tariff.

Staff supports the implementation of a low income program. In this case, the Company has proposed a low income tariff under which customers meeting the program criteria "would receive a 15 percent discount off their water bill."[155] The primary criterion for eligibility would be . . . the combined gross annual income of all persons living in the household."[156] The income guidelines would be based on 150 percent of the federal poverty guidelines. "The program costs (the discounts given to participants plus a 10% fee for administration and carrying costs) would be recovered from non-participants via a commodity surcharge."[157] The commodity surcharge to the non-participants would begin one year after the program begins[158] and would be separately identified on customer bills as "Low Income Assistance Charge."[159]

The Company does not currently have a low income tariff in place and, at hearing, Mr. Sorensen stated that the Company had little data on which to rely for projections of participation.[160] Mr. Sorensen further stated that the Company had no estimates for the labor costs that might be associated with administering the program,[161] raising some question as to the basis for the 10% administrative fee proposed in the tariff. Staff has requested more information from the Company[162] and anticipates gathering more data and monitoring closely any new low income programs approved by the Commission. At this time, Staff does not oppose the Company's proposed low income tariff.[163]

VI. FINANCING APPLICATIONS.

A. Docket No. W-01427A-09-0116.

In Docket No. W-01427A-09-0116, the Company requested authority to issue evidence of indebtedness in the amount of $1,755,000.[164] The financing primarily would be used for the purpose

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155 A-14 at 33:21-22 (Bourassa RBDir.).
156 A-14 at 33:22-23 (Bourassa RBDir.).
157 A-14 at 34:24-26 (Bourassa RBDir.).
158 A-14 at 35:4-6 (Bourassa RBDir.).
159 A-14 at 36:10-12 (Bourassa RBDir.).
160 Tr. at 339:20-340:7.
161 Tr. at 340:12-22.
162 Tr. at 1248:9-11.
163 Tr. at 1248:9-11.
164 Tr. at 1111:21-24.

of constructing two effluent recharge wells and two monitoring wells, as well as the piping and the permitting process associated with those wells.[165]

Staff has reviewed the application and concludes that the amount of $1,755,000 is appropriate for the scope of work contemplated in the application and the cost estimates are reasonable."[166]

Therefore, Staff recommends approval of this application. Staff further recommends that "the Company file with Docket Control, as a compliance item in the docket, by June 30, 2011, a copy of the Certificate for Approval to Construct for the recharge well project."[167]

B. Docket No. W-01427A-09-0120.

In Docket No. W-01427A-09-0120, the Company requested authority to issue evidence of indebtedness in an amount not to exceed $1,170,000 that would be used to construct one 200kW roof-mounted solar generator for the purpose of generating electrical power.

Staff reviewed the application and concludes that the amount of $1,170,000 for the construction of the solar generator is appropriate and the cost estimates are reasonable."[168] Staff recommends approval of this application.

VII. CONCLUSION.

Staff respectfully requests the Commission to adopt its recommendations in this proceeding.

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165 *Id.* at 16-20.
166 S-6 at 2: 2-4 (Scott Sur.).
167 S-6 at 2: 6-8 (Scott Sur.).
168 S-6 at 2: 2-4 (Scott Sur.).