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BEFORE THE ARIZONA CORPORATION COMMISSION

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.	DOCKET NO: W-02234A-07-0557

H2O, INC.'S

EXCEPTIONS TO RECOMMENDED OPINION AND ORDER

November 9, 2009

Arizona Corporation Commission
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H2O, Inc. ("H2O" or the "Company") hereby submits these Exceptions to the Recommended Opinion and Order ("ROO") in the above-captioned matter. H2O does not agree with the recommendation contained in the ROO to confiscate approximately $2.7 million of the Company's rate base, or with the elimination of its Off-Site Capacity Reservation Charge ("CRC") tariff.[1] The related adjustments to rate base and elimination of the CRC tariff punish H2O for following a Commission-approved tariff. The ROO's result-driven reduction artificially depresses the value of shareholder equity in the Company, despite the fact that H2O derives no financial or other benefit from the unexpended test-year contributions-in-aid of construction ("CIAC"). Therefore, H2O strongly encourages the Commission to modify the ROO and adopt the Company's proposed fair value rate base of $1,995,685,[2] and deny the recommendation to eliminate its CRC tariff.

INTRODUCTION

The Commission approved the Company's current CRC tariff in Decision No. 63259 (December 14, 2000). The tariff requires developers to pay non-refundable fees for the construction of utility plant needed to serve growth. As CIAC, these funds are revenue neutral and the plant paid for with CIAC earns the Company no return. In short, "growth pays for growth," resulting in lower rates for customers. At the end of the 2006 test year, the Company had approximately $2.7 million in unexpended hook-up fee amounts.

Staff proposed that the amount of these unexpended CRCs at the end of the test year be deducted from the Company's rate base because these funds are CIAC. However, CIAC that is deducted from rate base to ensure that the utility does not earn a return on the developer's capital should be made once the corresponding plant is placed in service.

[1] The CRC is a non-refundable hook-up fee.

[2] The Company's proposed rate base and revenue require is listed in the ROO at page 4.

Nevertheless, the ROO adopts Staff's proposal based on the conclusions that such treatment is: (1) required by Commission rule A.A.C. R14-2-103 [Appendix B, Schedule B-1], and (2) traditional ratemaking. As explained in more detail below, other than citing two previous Commission orders, the ROO is devoid of any evidence or an articulated policy reason for adopting Staff's recommendation, and will result in a confiscation of the Company's used and useful property. Moreover, the recommendation to eliminate the Company's CRC tariff and access to zero-cost capital due to a lack of equity investment is unreasonable without the artificial reduction to rate base.

DISCUSSION

I. The Rules Do Not Mandate Taking Away Rate Base.

According to the ROO, acceptance of H2O's position would confer "special treatment" that falls outside the Commission's rules and would reward the Company for its "failure" to undertake significant equity investment.[3] The Company respectfully disagrees with these two characterizations. H2O is not seeking to be rewarded by removing unexpended hook-up fees from the rate base calculation; rather, the Company is seeking "equitable" treatment based on what it asserts are traditional ratemaking principles and the record in *this* proceeding. Staff's application of A.A.C. R14-2-103 and Schedule B-1 is incorrect, and the negative adjustment to rate base adopted in the ROO will result in a total elimination of shareholder equity, producing an absurd result that is simply untrue.

The National Association of Regulatory Utility Commission's (NARUC) Uniform System of Accounts for water utilities defines CIAC as follows:

271. Contributions in Aid of Construction

A. This account shall include:

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[3] ROO at 8.

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> 1. Any amount or item of money, services or property received by a utility, from any person or governmental agency, any portion of which is provided at no cost to the utility, which represents an addition or transfer to the capital of the utility, **and** which is utilized to offset the acquisition, improvement or construction costs of the utility's property, facilities or equipment **used to provide utility service to customers**. [Emphasis added]

The Company agrees with Staff that CIAC should be deducted from rate base. However, this deduction is proper only when there is some corresponding plant built with the CIAC at issue which is placed into rate base. Otherwise, the deduction creates a "mismatch." The NARUC definition of CIAC makes clear that deducting CIAC is intended to offset plant built with other's funds that used to provide service to customers. An illustration of how shareholder equity – not developer funded plant – is reduced by adopting Staff's proposal is attached hereto as **Exhibit 1**.

A.A.C. R14-2-103(h) defines original cost rate base as "an amount consisting of the depreciated original cost, prudently invested, of the property (exclusive of contributions and/or advances in aid of construction) at the end of the test year, used or useful, plus a proper allowance for working capital *and including all applicable pro-forma adjustments.*" [Emphasis added]. A.A.C. R14-2-103(i) defines pro-forma adjustments as "Adjustments to actual test year results and balances to obtain a normal or more realistic relationship between revenues, expenses and rate base." The term "Rate Base" as used in Schedule B-1 includes an asterisk noting "Including pro forma adjustments." Furthermore, Schedule B-1 designates that customer advances (line 4) and contributions (line 5) – both calculated using Schedule E-1[4] – should be deducted from "Net Utility Plant in Service" (line 3), which itself is derived from Schedule B-2. This

[4] Schedule E-1 also requires supporting E-5 schedules.

demonstrates that any rate base valuation is not merely the result of one form schedule (Schedule B-1) as Staff suggests and the ROO adopts.

The Company's pro-forma adjustment to rate base is consistent with the definition contained in A.A.C. R14-2-103(i) in that it results in a more realistic relationship between CIAC and plant-in-service. Staff witness Brendan Aladi agreed that the underlying reason for deducting CIAC from rate base is to establish a more logical connection between CIAC and plant-in-service.[5] The basic principle is that when plant is built with CIAC and placed into service, a corresponding adjustment to rate base should be made recognizing this no-cost capital, thus holding ratepayers harmless.[6] The ROO's blind application of A.A.C. R14-2-103 (Schedule B-1) and reliance on two previous Commission orders ignores the evidence established in this proceeding, and is inconsistent with NARUC's definition of CIAC. Staff's policy concern that H2O would have unrestricted use of the unexpended CRC funds, or that the Company would earn a return on this CIAC, were addressed and resolved during the hearing.[7]

Assistant Chief Administrative Law Judge ("ACALJ") Nodes suggested during the hearing that the "remedy" for utilities finding themselves in H2O's situation is that "the utility has the ability to control the timing of its rate case such that once it has a test year that includes the plant for which the contributed capital was used, the company can then come in, seek recovery of the plant in rate base to the extent it was not -- capital was not provided by contributed capital."[8] However, H2O pointed out that the Company did not

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[5] Tr. at 117.

[6] The only logical basis to include unexpended HUFs in rate base as CIAC is to assume that these funds are funding plant that is in rate base. Following this logic, the Company can assume that the $2.7 million has already been spent. Therefore, the $2.7 million of cash is no longer restricted and the Company has the right to use this money for anything it chooses (dividends, expenses, capital expenditures).

[7] Tr. at 120-122.

[8] Tr. at 124.

control the timing of its rate case filing or chosen test year in this proceeding, which is an important distinction given the Commission's admonition to UNS Gas that the company should not "be heard to complain" when CWIP or post-test year plant is not included in rate base.[9] Focusing on the fact that H2O has not filed a rate case since 1994 instead of addressing this important factual distinction is a red herring, and underscores the inequitable and punitive approach taken in the ROO. The implied message is that H2O's inability to choose its test year is a factual distinction made irrelevant to the timing analysis due to the strong possibility that the Company had been over earning. It still does not address the obvious question, which is if a utility is unable to choose its test year, does the analysis and reasoning for adopting Staff proposal in the previous order still apply?

The ROO also finds that H2O's attempt to distinguish itself from the two previous Commission orders by comparing the effect of Staff's proposal on total rate base was made to justify special treatment and an exemption from A.A.C. R14-2-103.[10] This was not the intent, since the Company argues that there is no rule requiring the deduction of unexpended CRCs as CIAC from rate base. Rather, the purpose of the distinction was to highlight for the Commission that a "one-size fits all" approach is unreasonable given the different challenges facing small, privately owned water companies compared to large investor owned public gas and electric companies. If Staff or the ACALJ are unable or unwilling to try and make any distinction between H2O and UNS Gas, Inc. or UNS Electric, Inc. in this proceeding – *even if the alleged rule requires the rate base deduction proposed by Staff* – then H2O submits that the Commission should review this case on its

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[9] Decision No. 70011 at 8.

[10] ROO at 7.

own merits and recognize the inequities that will result from an artificial reduction to rate base for the Company.[11]

II. <u>The Recommendation to Eliminate H2O's CRC Tariff Is Based on an Erroneous Capital Structure That Results from Adopting Staff's Artificial Rate Base Deductions, And Would Shift the Risk of Development onto the Company and Its Customers</u>.

The ROO suggests that H2O's owners' failure to inject sufficient equity, combined with an over-reliance on developer contributions, has led to a negative rate base for the Company.[12] Again, the Company respectfully disagrees. While H2O readily concedes that the Company will require more equity (and/or debt) to fund future plant in order to achieve a more balanced capital structure, it is the misapplication of A.A.C. R14-2-103 in this proceeding that will lead to a negative rate base for H2O, not a lack of shareholder capital. The artificial reduction and *negative* rate base adopted in the ROO just happens to coincide with the conclusion to eliminate the Company's CRC tariff. The ROO correctly points out the inherent tension that exists between the policy of requiring growth to fund growth and assuring that there is sufficient equity investment for sustainable financial viability.[13] And, the Company agrees that over-reliance on developer contributions is not sustainable in the long-term. However, eliminating the CRC is premature at this time.[14] Absent the artificial reduction to rate base, the reason for eliminating the Company's CRC tariff becomes far less compelling.

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[11] H2O contends that in the two previous orders, the Commission was concerned about the utility earning a return on CIAC through AFUDC. H2O has not requested, nor does it have, an AFUDC account.

[12] ROO at 7.

[13] *Id.* at 9.

[14] Tr. at 55-56.

A new subdivision with 1,500-2,000 new residential homes requires approximately $2,000,000 to $3,000,000 of new offsite facilities.[15] The water utility industry is highly capital intensive compared with other utility industries, and it is more economical to build infrastructure in large components rather than several small components (i.e. storage). Therefore, when plant is built in this fashion, there is an element of "build out" risk that neither the Company nor its customers should be exposed to. This risk is highlighted by the current state of the housing industry, and is one reason why the Commission has adopted its "growth pays for growth" policies. Municipalities and other private water utilities employ "impact" or hook-up fees to address the capital outlay requirements. Eliminating H2O's CRC tariff will deny the Company access to zero-cost capital and require upfront expenditures that H2O does not have for the benefit of large developers. And even if H2O had two or three million dollars in capital to invest for offsite facilities needed to serve a new 1,500-2,000 lot residential subdivision, it would earn a return only on that plant serving customers that is "used and useful." An investment in offsite facilities for large subdivisions may not be "used and useful" for several years, and the detrimental impact to the Company's financial viability will also hurt customers in the long run.

In light of these facts, H2O opposes the elimination of its CRC tariff. As an alternative to elimination at this time, H2O proposes that the Commission postpone any decision regarding the CRC tariff and wait until the Company files its equity capitalization plan as proposed in the ROO. This plan can focus on ways that H2O can increase its equity within a framework that also allows for continued developer contributions to ensure that growth does not place an undue financial burden on the Company and its customers. The Commission can then review the plan and determine whether continued collection of CRCs is proper.

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[15] Pinal County fire flow requirements require certain main sizing that increase the cost.

CONCLUSION

H2O's owners have been severely criticized for over-relying on CIAC to fund plant (which has resulted in a rate decrease), and admonished for their failure to allegedly inject equity into the Company. H2O has been directed to file an equity capitalization plan, and encouraged to find investors. But for a utility that the ROO recognizes should wean itself from relying on developer contributions to build future water facilities, eliminating *existing* shareholder equity does not portend much success in attracting an outside equity investor. H2O's shareholders have invested nearly $2.25 million in equity (and $250,000 debt) into the Company. Granting Staff's proposal to adjust rate base to a negative $363,842 will completely eliminate the value of this investment. The Company asserts that such a result would be confiscatory, punitive and not in the public interest. Therefore, H2O respectfully requests that the Commission amend the ROO and adopt the Company's proposed FVRB of $1,995,695, annual revenue requirement of $3,244,489, 11.45 percent cost of equity and overall rate **decrease** of 3.97 percent.

RESPECTFULLY SUBMITTED this 9th day of November, 2009.

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Exhibit 1

EXHIBIT 1

ILLUSTRATION OF HOW ARTIFICIAL REDUCTION TO RATE BASE REDUCES SHAREHOLDER EQUITY

1. Utility is granted a new CC&N to serve 100 customers in new subdivision, with a requirement to file a rate application after 5 years of operation.

2. Utility shareholders invest $100,000 to construct facilities to serve new subdivision.

3. In Year 3, Utility applies for and is granted a hook-up fee.

4. In Year 4, Developer approaches Utility and enters into a water main extension agreement to serve new subdivision #2. As part of the main extension agreement, Developer advances $50,000 to Utility in hook-up fees to fund offsite infrastructure required to serve new subdivision #2.

5. Prior to constructing new facilities, Developer informs Utility that new subdivision #2 has been delayed for two years.

6. At the beginning of Year 6, Utility files a rate application using Year 5 as the test year. At the end of the test year, Utility has $50,000 of unexpended hook-up fees restricted for use to build facilities to serve new subdivision #2.

7. The Commission decides to deduct $50,000 as CIAC from the existing $100,000 (less depreciation) rate base of used and useful plant serving existing customers, without a corresponding adjustment to plant in service.

8. Shareholder equity recognized in rate base is now approximately $50,000 (less depreciation), and rates are adjusted downward to reflect this artificial reduction in rate base even though there is roughly $100,000 of shareholder investment (less depreciation) in the Utility.