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BEFORE THE ARIZONA CORPORATION C...

COMMISSIONERS

KRISTIN K. MAYES - Chairman
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IN THE MATTER OF THE APPLICATION OF BELLA VISTA WATER CO., INC. 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 SERVICE BASED THEREON.	DOCKET NO. W-02465A-09-0411
IN THE MATTER OF THE APPLICATION OF NORTHERN SUNRISE WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS WATER RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO. W-20453A-09-0412
IN THE MATTER OF THE APPLICATION OF SOUTHERN SUNRISE WATER COMPANY, INC., 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 SERVICE BASED THEREON.	DOCKET NO. W-20454A-09-0413
IN THE MATTER OF THE JOINT APPLICATION OF BELLA VISTA WATER CO., INC., NORTHERN SUNRISE WATER COMPANY, INC., AND SOUTHERN SUNRISE WATER COMPANY, INC. FOR APPROVAL OF AUTHORITY TO CONSOLIDATE OPERATIONS, AND FOR THE TRANSFER OF UTILITY ASSETS TO BELLA VISTA WATER CO., INC., PURSUANT TO ARIZONA REVISED STATUTES 4-285.	DOCKET NO. W-02465A-09-0414 DOCKET NO. W-20453A-09-0414 DOCKET NO. W-20454A-09-0414 **STAFF'S OPENING BRIEF**

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby files its closing brief in the above captioned matter. This brief only addresses the disputed issues between Staff and the Company. Staff maintains its position as presented in its testimony, on any issue not specifically addressed here.

I. INTRODUCTION.

Bella Vista Water Company ("Bella Vista"), Inc, Northern Sunrise Water Company, Inc ("Northern Sunrise"), and Sunrise Water Company, Inc ("Southern Sunrise"), or collectively "the Company," are certified Arizona public service corporations that provide water utility services in Cochise County, Arizona.[1] Bella Vista, Northern Sunrise, and Southern Sunrise are owned by Liberty Water, Inc, a wholly-owned subsidiary of Algonquin Power & Utilities Corporation ("APUC"), a publically-traded corporation on the Toronto Stock Exchange.[2] Bella Vista was acquired by Algonquin in 2002. Algonquin acquired Northern and Southern Sunrise in 2006; these systems were formerly the McClain Systems, a group of troubled water companies which were acquired out of bankruptcy.[3]

Bella Vista provides water service to approximately 7,500 customers, Northern Sunrise provides service to approximately 349 customers, and Southern Sunrise provides service to approximately 789 customers.[4] Bella Vista's current rates were approved in Decision No. 65350, dated November 1, 2002.[5] Northern Sunrise and Southern Sunrise's current rates were approved in their original Certificate of Convenience and Necessity ("CC&N") applications, Decision No. 68826, dated June 29, 2009.[6]

The Company filed its application for permanent rate increases based on a test year ending March 31, 2009.[7] In addition to the application, it filed a Joint Application for Approval of Authority

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[1] Ex. S-6 at Executive Summary (Direct Test. of Crystal Brown).
[2] In October 2009, Algonquin Power Income Fund converted to Algonquin Power and Utilities Corporation.
[3] Ex A-2 at 4 (Direct Test. of Greg Sorenson).
[4] Ex. S-6 (Direct Testimony of Crystal Brown at Executive Summary).
[5] Ex. S-6 at 3 (Direct Test. of Crystal Brown).
[6] Ex. S-6 at 3 (Direct Test. of Crystal Brown).
[7] Ex. A-13 (Direct Test. Consolidated of Thomas Bourassa).

to Consolidate Operations, and For The Transfer Of Utility Assets To Bella Vista Water Co., Inc. "Bella Vista (Consolidated)" or "the Company" will be used when referring to the proposed consolidated entity in this brief.

For Bella Vista (Consolidated), Staff is recommending a total revenue requirement of $4,589,644. This represents an increase of $427,509 or 10.27 percent over adjusted test year revenues;[8] Staff is proposing an Original Cost Rate Base ("OCRB") of $7,914,522 and a rate of return of 8.80 percent. Staff recommends that the Commission adopt a capital structure for the Company that consists of 18.7 percent debt and 81.3 percent equity.[9] Staff is recommending a Cost of Debt of 6.3 percent, and a cost of equity ("COE") of 9.3 percent.

For Bella Vista (Consolidated), the Company is proposing a total revenue requirement of $5,267,035. This is an increase of $1,104,899 or 26.55 percent over adjusted test year revenues;[10] and it is proposing an OCRB of $7,857,799 and a rate of return of 9.85 percent.[11] The Company is requesting to treat its OCRB as its fair value rate base ("FVRB"). The Company's proposed consolidated capital structure is 22.6 percent debt and 77.4 percent equity. The Company recommends a cost of equity of 10.9 percent, which results in a weighted cost of capital ("WACC") of 9.85 percent.

In the event the Commission decides not to consolidate Bella Vista, Northern Sunrise, and Southern Sunrise, Staff and the Company have proposed separate stand alone rates. Staff recommends that the Commission approve consolidation, and would note that rates would be higher on a stand-alone basis because the Company could not take advantage of economies of scale.

While the Companies, Staff and RUCO worked diligently through the pre-filed testimony process to narrow the issues in this case, there are still a number of contested issues and adjustments. Rate base adjustments that remain at issue: plant in service; accumulated deferred income taxes ("ADIT"); accumulated depreciation; advances in aid of construction ("AIAC") balance; accumulated amortization of contributions in aid of construction ("CIAC"); interest cost associated

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[8] Staff's Opening Brief Schedules CSB-1.
[9] Ex. S-2 at 2 (Surrebuttal Test. of Pedro Chaves).
[10] BVWC Final Schedules at 2.
[11] BVWC Final Schedules at 2.

with customer security deposits; and Hook-up Fee Tariff. Income Statement Expense Adjustments that remain at issue: central cost allocation and rate case expense. There are also issues that remain in dispute concerning proposed rate design and cost of capital.

II. RATE BASE ADJUSTMENTS.

The Company is seeking to treat OCRB as its FVRB. Therefore, the Company requests a FVRB of $7,857,799.[12] The difference in the parties' rate base amounts is due to the following rate base adjustments.

A. <u>Plant in Service Balance</u>.

1. Staff has properly excluded inadequately documented plant from Rate Base.

Staff recommends disallowing $185,038 from Plant in Service because the Company failed to provide adequate documentation to support its inclusion in rate base.[13] It is the duty of the utility to maintain appropriate accounting records reflecting the cost of its properties.[14] Staff witness Crystal Brown testified that source documents are essential to verifying plant costs. In the absence of such verification of costs, there is the potential that ratepayers could over-pay or pay for non-existent plant. [15] The Company contends that its books and records substantiate the amount of plant in service sufficiently to support the plant's inclusion in rate base.[16]

Staff's recommendation is consistent with other dockets in which the same recommendation was made. *In the matter of Groom Creek Water Users Association*,[17] 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.[18] *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

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[12] Company's Final Schedules at 2.
[13] Staff's Closing Schedule, Bella Vista CSB-6, Northern Sunrise CSB-5, Southern Sunrise CSB-5.
[14] A.A.C. R14-2-610(D)(1).
[15] Ex. S-6 at 13-14 (Direct Test. of Crystal Brown).
[16] Ex. A-16 at 4-5 (Rejoinder Test. of Thomas Bourassa (rate base).
[17] Docket No. W-01865A-07-0385 et. al.
[18] Decision No. 70627, FOF 54, 57.

recommendation. *In the matter of Arizona-American Water Company*, Staff recommended a sizeable disallowance of plant for lack of documentation and Staff's recommendation was adopted by the Commission.[19]

Staff's adjustment to Plant in Service is appropriate given the aforementioned circumstances.

2. The Company needs to appropriately retire Plant.

During the evaluation of the Company's application, Staff discovered that neither Northern Sunrise nor Southern Sunrise had retired any plant since the last rate case, and Bella Vista had only pro forma retirements related to post test year plant.[20] For the purpose of this rate application, Staff and the Company worked together to come up with a number for plant retirement[21] and are in agreement that the amount of plant retirement should be $1,333,228.

The Company filed as a late filed exhibit, Liberty Water's Asset Retirement Policy. During the hearing, Judge Rodda asked Staff to provide comments on that policy. The policy proposes to record plant retirements only for plant that originally cost $5,000 or more. However, Staff would like to note that the NARUC guidelines recommend recording all plant retirements, regardless of its cost. Additionally, Staff believe that the retirement work orders should show the following: (a) whether the retirement cost utilized is actual or estimated; (b) the name of the water company or system from which the plant was removed; (c) the date of the retirement; (d) the NARUC account number from which the plant cost was removed; (e) reason for the retirement; and (f) appropriate approvals on the work orders. Taking note of the above, Staff has no major objection to the Company's proposed plant retirement policy.

B. <u>Accumulated Deferred Income Taxes (ADIT)</u>.

Accumulated deferred income taxes ("ADIT") represent the accumulated temporary tax differences between income taxes calculated for ratemaking purposes and the actual income taxes that a company pays. The timing difference occurs because straight line depreciation is used for ratemaking purposes while accelerated depreciation is used for income tax reporting purposes. The

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[19] Docket No. W-01310A-080227, Decision No. 71410 at 25-26.
[20] Ex. S-6 at 15 (Direct Test. of Crystal Brown).
[21] Tr. Vol. V at 887.

Statement of Financial Accounting Standards ("SFAS") No. 109, Accounting for Income Taxes, requires companies to use deferred tax accounting to recognize income tax timing differences.[22] While the Company and RUCO disagree over the appropriate amount, Staff has adopted the Company's consolidated ADIT[23] of $654,740.

C. **The Company Should Utilize Individual Asset Depreciation Methodology.**

The Company currently uses the group method of depreciation wherein it applies straight line depreciation to a group of assets rather than to individual assets, as is typically recommended by Staff.[24] While Staff did not recommend the discontinuance of the group method of depreciation in Bella Vista's last rate case, Staff does so now recommends that the Company begin using the individual asset method on a going forward basis for the reasons discussed below.

For group depreciation to be calculated correctly, it requires plant retirements to be recorded properly and timely, because a plant asset is not considered fully depreciated until it is retired.[25] The problem arises when an asset has been taken out of service but the cost of that asset has not been removed from the associated plant account; depreciation expense will continue to be calculated on the plant asset indefinitely even though it is not in service, and thus not used by the ratepayer.[26] If a company makes appropriate retirements, group depreciation can be an appropriate methodology; however, the Company here did not keep track of its retirements (in fact it made zero retirements since its previous rate case) and has not removed the cost from the associated plant accounts. This creates a scenario that will cause depreciation expense to be overstated.[27]

Staff recommends that the Company should use straight line depreciation, as stated in NARUC. [28]

> Straight line method as applied to depreciation accounting means the plan under which the service value of property is charged to operating expenses

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[22] Decision No. 69164 at 5.
[23] Tr. Vol. IV at 725:18, Staff's Closing Schedule, Revenue Requirement Consolidated CSB-3.
[24] Ex. S-7 at 12 (Surrebuttal Test. of Crystal Brown).
[25] *Id.*
[26] *Id.*
[27] *Id.* at 12-13.
[28] *Id.* at 13-14 & Tr. Vol. IV at 732.

> (and to clearing accounts if used), and credited to the accumulated depreciation account through equal annual charges during its useful life.[29]

Under this method, an asset is considered fully depreciated when the full cost has been recovered, so the asset can remain in service, but not continue to be depreciated. This will prevent the ratepayer from re-paying the Company more than the cost of the asset. Staff understands the intricacies and laborious record keeping required, and believes that the Company could group assets per account by vintage year.[30] For example, if $2 million worth of mains were purchased and went into service in 2010, those mains could be put into a group based on the vintage year, 2010. If mains have a 30-year depreciable life, then in 2040, all of those mains in that 2010 vintage group should be fully depreciated.[31]

For the case at hand, Staff recommends an accumulated depreciation balance of $10,077,878.[32] Absent any record of which plant had been retired, Staff was required to adopt a reasonable method for determining accumulated depreciation - one which recognized fully-depreciated plant.[33] For Bella Vista, Staff used revised 1998 plant balances provided by the Company to calculate fully-depreciated plant. Staff subtracted the Company-provided retirements from the 1998 plant balances; the remainder is the fully-depreciated plant that continues to be in service, where no depreciation is calculated. Northern and Southern Sunrise do not have plant that has been in service long enough to be fully depreciated.[34] Staff's method for this case is a reasonable way to determine the appropriate accumulated depreciation given the fact that the Company was not recording plant retirements.

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[29] *Id.* - Accounting Instruction No. 33, "Operating Income – Depreciation Expense" of NARUC USOA.
[30] Tr. Vol. V at 896-7.
[31] *Id.*
[32] Staff's Final Schedule, Revenue Requirement Consolidated CSB-3.
[33] Ex. S-7 at 14 (Surrebuttal Test. of Crystal Brown).
[34] *Id.*

D. Customer Meter Deposits are Appropriately Part of the AIAC Balance.

Staff proposes an AIAC balance of $6,784,313.[35] The Company proposes an AIAC balance of $6,781,443,[36] a difference of $2,870. The Company believes that Staff has incorrectly included $2,870 in its AIAC balance instead of including it in its Customer Meter Deposits Balance. During the hearing, Ms. Brown testified that her calculations were correct, and that customer meter deposits are appropriately part of the AIAC balance.[37] According to Arizona Administrative Code R14-2-405.B B, "An applicant for service shall pay to the utility as a refundable advance in aid of construction the sum set forth in the utility's tariff for each size service and meter." Both Staff's recommended AIAC and customer meter deposits are correctly calculated and should be adopted.

E. Non-depreciable Land Should Not Be Included in the Accumulated Amortization of CIAC Calculation.

Staff recommends $230,987[38] in Accumulated Amortization of CIAC, whereas the Company proposes $230,570,[39] a difference of $417. The disagreement over accumulated amortization of CIAC concerns the correct methodology used to compute the composite rate. The Company believes that all plant funded with CIAC should be included. Staff correctly asserts that only depreciable plant funded with CIAC is used, and therefore excluded land from the calculation because it is not depreciable plant.

According to NARUC:

> Amortization of contributions in aid of construction, CIAC, if recognized by the Commission, shall be credited to account 403, depreciation expense. The concurrent debit is to account 272, accumulated amortization of CIAC. The resulting balance in the depreciation expense account will be the net of CIAC amortization. CIAC shall be amortized over a period equal to the estimated service life of the related contributed asset.[40]

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[35] Ex. S-7 at Consolidated Schedule CSB-3). (Surrebuttal Test. of Crystal Brown).
[36] Ex. A-16 at Schedule B-1 (Rejoinder Test. of Thomas Bourassa).
[37] Tr. Vol. IV at 740.
[38] Staff's Closing Schedules, Revenue Requirement Consolidated CSB-3
[39] Company's Final Schedule B-2, Consolidated.
[40] Ex S-7 at 36 (Surrebuttal Test. of Crystal Brown).

Thus, since straight line depreciation requires the cost of the asset to be equally allocated over its life,[41] for Staff to determine the depreciable life of land, it would have to divide one by a very large number, and the resulting number would be very close to zero.[42] This indicates that land is not depreciable, and therefore not amortizable.[43] Therefore, Staff's methodology and Staff's calculated amount for the amortization of CIAC should be adopted.

F. **Customer Security Deposits Should Be Deducted From Rate Base.**

Staff recommends decreasing the rate base by the customer deposit balance to reflect that customer security deposits are customer-provided capital.[44] During the test year, the Companies received security deposits as follows: $175,850 for Bella Vista, $7,972 for Northern Sunrise, and $22,298 for Southern Sunrise, for a total of $206,120.[45]

The Companies' main concern is that Staff should not deduct customer security deposits from rate base because Staff did not include the associated interest expense on customer deposits in operating expenses.[46] Staff will consider inclusion of the appropriate amount of interest expense on customer deposits in operating expenses if the amount is properly supported. Staff requested this documentation from the Company without success. Adequate documentation would include, but is not limited to, documentation showing the account, the amount of the deposit, the length of time the deposit was held, and the calculation of the interest expense.[47] The Company did not provide such documentation; in fact the Company's witness, Mr. Bourassa,when asked if he would meet with Staff to determine what documentation was still necessary, stated that it was his view "that it is not needed, if it is perfectly acceptable to accept the company's balance there."[48]

The Company believes that the expense is simply calculated by taking 6 percent of the total customer deposit balance of $206,120. However, as Ms. Brown testified, it is not that simple. Staff

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[41] Tr. Vol. IV at 743.
[42] *Id.*
[43] *Id.*
[44] Ex. S-7 at 18-19 (Surrebuttal Test. of Crystal Brown).
[45] *Id.*
[46] *Id.* at 19.
[47] *Id.*
[48] Tr. Vol II at 251:12-14.

needs "evidence that costs had actually been paid and that the costs were reasonable."[49] In this case, the Company provided no documentation to Staff demonstrating that any interest was paid back to customers during the test year. The Commission should adopt Staff's position to remove customers' deposits from rate base because they are customer funded capital and the Company is not entitled to receive a return on them.

G. A Hook-Up Fee Tariff is Appropriate As Long As the Fees Collected are Treated and Recorded as CIAC.

The Company has proposed the institution of a Hook-up Fee Tariff ("HUF Tariff"); Bella Vista currently has a HUF Tariff, however this will be a new tariff for Northern Sunrise and Southern Sunrise.[50] Staff is in agreement that a HUF tariff is appropriate in this situation, and recommends its approval if the tariff utilizes the language contained in Attachment B to the Surrebuttal Testimony of Marlin Scott. The language in the Tariff recommended by Staff removes the last sentence from section IV (B) Use of Off-Site Hook-up fee, "The Company shall not record amounts collected under this tariff as CIAC until such amounts have been expended for plant."[51]

The Company does not agree with removing this language; the Company contends that if the funds have not been used and converted to Plant in Service, then the HUF funds should not be treated as CIAC because there is no offsetting plant in service.[52] The Company asserts that the unexpended HUF funds will be placed in a separate, interest bearing, unaffiliated bank account, preventing co-mingling or benefit of the funds until they are spent on plant.[53] However, Staff believes they are contributions and should be deducted from rate base like other contributions.[54]

The Company's contention that a Hook-up Fee should not be considered CIAC until there is offsetting plant in service is not accurate. The classification of contributed funds as CIAC does not hinge upon whether it is spent or unexpended but on whether (1) it was provided by someone other

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49 Tr. Vol. IV at 742.
50 Tr. Vol. II at 261-62.
51 Ex. S-4 at Attachment B, p. 2 (Surrebuttal Test. of Marlin Scott).
52 Ex. A-5 at 8 (Rebuttal Schedule of Greg Sorensen).
53 *Id.*
54 Tr. Vol. IV at 749.

than the Company's owner/investor, (2) it is non-refundable, and (3) its purpose is to fund plant.[55] Additionally, the Company's position is contradicted by NARUC Staff Subcommittee's definition. According to NARUC, "CIAC and customer advances are *payments* made by customers generally to fund plant additions for new or expanded service." (emphasis added).[56] The language reinforces Staff's position that CIAC is non-investor supplied capital at the time the money is received by the Company as a payment, not when the plant is built.[57] Additionally, the Commission has taken this position, that hook-up fees in and of themselves should be treated as CIAC.[58]

Monies the Company received through its proposed Hook-up Fee Tariff are funds provided by someone other than the Company or its investors. Further, these funds are non-refundable and are used to fund the construction of plant. These monies received through a hook-up fee tariff are clearly CIAC. Because the funds are CIAC, the Company's recommended language that unexpended HUFs not be classified as CIAC should be denied.[59]

III. INCOME STATEMENT ADJUSTMENTS.

A major area of disagreement continues to be the central office cost allocation from the Company's parent. This allocation method and the amounts have been a source of disagreement between Staff and Bella Vista's (consolidated) sister companies, Rio Rico Utilities, Black Mountain Sewer Company and Litchfield Park Service Company, in their pending rate cases.[60]

A. <u>Staff Has Concerns Over the Company's Central Cost Allocation</u>.

The ultimate parent of Bella Vista, Northern Sunrise and Southern Sunrise is Algonquin Power & Utilities Corporation ("APUC"), which is an unregulated entity whose primary business activity is the acquisition and ownership of generation and infrastructure companies. Algonquin Power Trust ("APT") is an entity that provides services to the APUC family of companies. APUC consists of four major divisions, with 71 facilities. The infrastructure group is made up of the water and sewer companies.

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[55] Ex. S-7 at 32 (Surrebuttal Schedule of Crystal Brown).
[56] Ex. S-13.
[57] Tr. Vol. IV at 751-52.
[58] *Id.* at 759.
[59] Ex. S-7 at 32 (Surrebuttal Schedule of Crystal Brown).
[60] *See* Docket Nos. SW-02361A-08-0609 and SW-01428A-09-0103.

According to Company witness Peter Eichler, the shared services model contains two components. First, Liberty Water, the entity that provides all the day-to-day administration and operations personnel for its regulated utilities, including Bella Vista, Northern Sunrise and Southern Sunrise,[61] charges some services such as operations and engineering labor directly to Bella Vista, Northern Sunrise and Southern Sunrise. Some services, such as labor for accounting, billing and customer service and corporate finance, provided to Liberty Water are not directly allocated, but allocated based on customer count. Overhead costs, like rent and office furniture are allocated by use of a four factor methodology.[62] Staff is not generally opposed to the allocation of these costs from Liberty Water to Bella Vista, Northern Sunrise and Southern Sunrise.

The Company, as operated by Liberty Water, utilizes a shared services model. The allocation to Bella Vista, according to the Company's final schedules, starts with $3,567,363, the expenses from the unregulated affiliate allocated to the infrastructure division based on a single allocation factor. That amount is then allocated to each company within the infrastructure division based upon customer count. In this case, the share of costs allocated to its Utility Infrastructure Group, which includes the Bella Vista Companies, based on the relative number of entities in the APUC family of companies, was $866,360 (17 utilities ÷ 70 entities = 24.29 percent of a total of $3,567,363). This amount was the apportioned among the 17 utilities based on the customer counts of each, with 14.52 percent allocated to the Bella Vista Companies. As a result, the Bella Vista Companies seek $125,830 in Central Office Costs.

In addition to operations and engineering costs and the allocated overhead administration costs, there are costs that are allocated from APT. This pool of costs is referred to as central office cost. These costs consist of expenses such as rent at the central office, strategic planning costs, audit and tax services, unit holder communication, trustee fees, etc. and are indirect costs. These costs are allocated to Liberty Water based on the relative number of utilities to total facilities and then further allocated by Liberty Water to each utility, such as Bella Vista, Northern Sunrise and Southern Sunrise, based on customer count.

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[61] Ex. A-18 at Ex. PE-RB1(Rebuttal Test. of Peter Eichler).
[62] *Id.*

Staff does not agree that all the of the cost pool are costs that should be allocated. Staff reviewed the underlying invoices for the costs and determined that the Company had not identified the costs as direct costs or indirect costs consistent with NARUC Guidelines of Cost Allocation and Affiliate Transactions.[63] Based on this review, Staff determined that almost all of the costs were obviously attributable to the operations of APUC or one of its affiliates; therefore, Staff assigned 90 percent of the costs to APUC. The 10 percent recognizes that the other affiliates receive a benefit from the common costs, and therefore should be allocated a percentage greater than zero.[64]

Staff also takes issue with the formula used to allocate common costs. The correct number of companies that are used to calculate the allocation factor is in dispute. Staff recommends an allocation factor of 1/70.5 or 1.42 percent.[65] Staff based its calculation on an average of 70.5 facilities. As explained by Staff witness Brown, a review of the APIF 2007 and 2008 Annual Reports lists 70 and 71 facilities owned.[66] In contrast, the Company contends that only 63 facilities should be the basis of the allocation factor. The Company argues that in Staffs allocation number, the Staff formula uses the incorrect number of facilities. The Company contends that there are several facilities of which APIF only has an equity interest as well as some facilities that are inactive and thus receive no benefit from the services provided by APT.[67] Staff argues that APT has to perform some type of monitoring of its interest in the affiliate companies, and thus there are costs associated with that activity and those entities should be counted in the allocation factor.

In its review of the Company's cost allocation, Staff relied on the NARUC Guidelines for Cost Allocation and Affiliate Transactions.[68] These guidelines require that costs primarily attributable to a business operation should be, to the extent appropriate, directly assigned to that business operation.[69] Company witness Peter Eichler asserts that the Company's allocation method is

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[63] Ex. S-6 at 33(Direct Test. of Crystal Brown).
[64] *Id.*
[65] *Id.* at 34-5.
[66] *Id.* at 34.
[67] Tr. at 533-5.
[68] Ex. S-7 at 21 (Surrebuttal Test. of Crystal Brown).
[69] *Id.* at 20.

consistent with these guidelines.[70] Staff disagrees. Staff reviewed the amounts being allocated, including the underlying invoices for the costs, and determined that the Company did not identify the costs as either direct or indirect as consistent with the NARUC guidelines. Additionally, a key consideration is whether or not the costs discussed by Mr. Eichler would have been incurred if APUC did not own the Companies. The answer is yes; APUC would have incurred approximately the same costs if it did not own Bella Vista, Northern Sunrise and Southern Sunrise.[71] This demonstrates that APUC's business objectives and the activities it performs to achieve those objectives are the driving force behind the cost.[72] So while under NARUC these costs should be directly charged to the affiliate, Staff understands that the Companies receive some benefit and has allocated an amount greater than zero.[73]

Staff asserts that the goal of cost allocation between an unregulated affiliate and a regulated affiliate is the fair distribution of costs through proper allocation. However, the amounts allocated to the regulated entities should not be in excess of the amounts that regulated entities would incur on a stand alone basis. When costs incurred primarily for the benefit of an unregulated affiliate's business are improperly identified and allocated as overhead/common costs, then costs of the unregulated affiliate are shifted to the captive customers of the regulated utility. This cost shifting results in the captive customers of the regulated utility subsidizing the business operations of the unregulated affiliate. This harms customers by creating artificially higher rates.[74]

State Commissions subject affiliate transactions to a greater scrutiny. For example, in *US. West Communications v. the Arizona Corporation Comm'n,* 185 Ariz. 277,915 P.2d 1232 (App. 1996), the Arizona Court of Appeals held that the "Commission has broad powers to scrutinize transactions between a regulated company and its unregulated affiliates" and disallow excessive costs. The Company alleges that its shared services model results in lower costs and efficiencies. While Staff is not opposed to the concept of a shared services model, Staff nonetheless still has

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[70] Ex. A-18 (Rebuttal Test. of Peter Eichler).
[71] Ex. S-7 at 20-21 (Surrebuttal Test. of Crystal Brown).
[72] *Id.*
[73] *Id.*
[74] Ex. S-6 at 33-35 (Direct Test. of Crystal Brown).

concerns. Staff urges the Company to review its cost pool and only include those expenses that are necessary to provide services to the ratepayer.

The Company has argued that its shared services model is comparable to the shared services model used by other Arizona utilities. Company witness Eichler discussed his understanding of the shared services model concept of Arizona-American.[75] In the Arizona-American case cited by the Company, Staff recommended recovery of approximately $1.7 million.[76] Bella Vista consolidated compares this amount to the APT costs requested by the Company approximately $125,830.

However, the Company's attempted comparison between its requested $125,830 and Arizona-American's approximate recovery of $1.7 million presents some concerns because this is not an apples to apples comparison. First, in addition to the $125,830 in APT costs, the Company also requested recovery of the services that are directly billed by Liberty Water, approximately $1.0 million. The $1.7 million that Staff allowed for Arizona American includes not only the parent Company's corporate allocation, but also the cost to manage the Arizona operations – the cost that is equivalent to the approximate $1 million Staff has allowed for Liberty Water. Additionally, Arizona-American has over 100,000 customers, whereas Bella Vista (Consolidated) has approximately 8,600. There are numerous unknown variables, and Staff at this point is unable to determine whether costs similar to those in dispute here were originally excluded from Arizona-American's parent company corporate allocation filing.

During the pendency of the instant case, the Commission had the opportunity to review and rule on the application of Black Mountain Sewer Company.[77] The Commission acknowledged that cost of services provided by affiliated entities, under non-negotiated no-bid agreements must be given greater scrutiny because the company being billed for those services is effectively without input regarding the types of services provided or the cost of those services.[78] The Commission also noted that the subsidiary company has virtually no recourse against the parent company's decision to assess

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[75] Tr. Vol. III at 405-409.
[76] See Ex. A-30.
[77] Docket No. SW-02361A-08-0609, Decision No. 71865.
[78] Decision No. 71865 at 23.

common expenses that incurred at the parent level.[79] The Commission excluded certain costs, such as trustee fees and unit holder communication fees from expenses and allowed reasonable common expenses such as, audit expenses, tax service expenses, general legal expenses, and depreciation expense.[80] After allowing for reasonable common expenses, the total company allocation for each item was allocated based on the number of regulated Liberty Water companies (17) divided by the total number of companies owned or operated by APIF at the end of the test year (71) *(ie.,* 17/71 = 23.94 percent allocated to Liberty Water) The Liberty Water allocation was further allocated on the basis of number of customers.[81]

Staff's recommended $3,132 each in corporate expense allocation for Bella Vista, Northern Sunrise, and Southern Sunrise is the appropriate allocation based on NARUC guidelines and sound ratemaking principles.

B. <u>The Company's Proposed Rate Case Expense is Inexplicably Higher than Similar Companies and therefore Staff's more Reasonable Expense Should be Adopted.</u>

The Company has requested rate case expense of $450,000, even though the Company admits when multiple applications are filed for related companies and the cases are consolidated, the cost of each additional rate case is less than the cost for the first rate case. [82]

To determine the appropriateness of the requested rate case expense, Staff typically: reviews actual invoices at a given date; evaluates efforts made to minimize the component costs of rate case expense (consultant, outside legal counsel, and other miscellaneous expenses); and compares the proposed rate case expense to those of comparable current rate case proceedings. Here, Staff reviewed invoices and, as of February 2010, the Company had incurred $82,256 in rate case expense.[83] However, the Company has done little to minimize the components of rate case expense, mainly since the Company has relied on outside consultants and lawyers.[84]

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[79] *Id.*
[80] *Id.* at 24-25.
[81] *Id.* at 25.
[82] Ex. A-14 at 26-27 (Rebuttal Test. (Rate Base and Revenue Requirement) of Thomas Bourassa).
[83] Ex S-6 at 41 (Direct Test. of Crystal Brown).
[84] *Id.*

Here, the Companies present an estimate of the final cost of the rate case, since final billing has not occurred.[85] Invoices were presented to Staff, which Staff reviewed; evaluated to determine the extent of the Companies' efforts to minimize the component costs of rate case expenses, such as consultants and outside legal expenses; and compared the proposed rate case expense to those of the comparable current rate case proceedings. Staff determined that that the parent Company used few internal resources in an effort to minimize the cost of legal services, revenue requirement testimony and cost of capital testimony. Staff compared rate case expense for applications for multiple companies or systems and determined the Company's cost per system is much higher. [86]

Company & Case	Estimated Rate Cost Expense	Number Of Systems, Companies, Consolidation	Average Cost Per System/Company
Algonquin Company W-02465A-09-0411, et al	$450,000	4	$ 112,500
Arizona-American Water Company W-0 1303A-08-0227	$612,000	10	$ 61,200
Arizona Water Company I W-01445A-08-0440 I	$500,000	17	$ 29,412
Global Water Company	$133.376	7	$ 19.054

Based upon these comparisons, Staff recommends $112,398 for Bella Vista, $33,719 for Northern Sunrise, and $56,199 for Southern Sunrise, for a combined total of $202,316 in rate case expense.[87]

IV. RATE DESIGN.

Staff recommends a rate structure that is similar to that which is currently in place, but increases all the break-over points for larger meters. Staffs rate design recognizes the growing importance of managing water as a finite resource and promotes more efficient water use. Staff's rate structure also provides an economic benefit to customers who limit consumption.

While the Company expresses concern that the amount of revenue increase Staff allocates to the residential customer class is not sufficient to cover its cost of service and that it overzealously

[85] Tr. Vol. II, 273-74.
[86] Ex S-6 at 41 (Direct Test. of Crystal Brown).
[87] Ex. S-7 at 27 (Surrebuttal Test. of Crystal Brown).

shifts recovery to the commercial class and away from the residential class. Staff believes this concern stems from issues with the Cost of Service Study ("COSS"), and that the COSS overstates the amount of costs to be allocated to the residential customer class.[88] Staff's major concern is with the Customer Function of the COSS; the Customer Function includes costs related to meter reading, billing, collections, and customer service.[89] However, the Company's COSS allocated 100 percent of the costs for building rental, health and life insurance, regulatory commission expense, rate case expense and miscellaneous expense to the customer function, in addition to disproportionate amounts of insurance and transportation costs, thus inflating it.[90]

The Company also claims that Staff's rate design does not accurately reflect the cost of providing service. However, Staff would note that the Commission has the discretion to set rates that do not exactly reflect the actual cost of service, with inverted tiered rates being a prime example. Staff uses the COSS as a guideline and starting point for its rate design and considers such other factors as gradualism, promotion of efficient water use and uniformity among customer classes.[91]

The rate impact on the typical residential bill under Staff's recommended consolidation bases is: for a Bella Vista Customer, the typical 5/8-inch x 3/4-inch meter residential customer with a median usage of 4,500 gallons would experience a $1.27 or a 6.53 percent *decrease* in his or her monthly bill, from $19.37 to $18.10; for Northern Sunrise, the typical 5/8-inch x 3/4-inch meter residential customer with a median usage of 4,500 gallons would experience a $21.90 or 54.75 percent *decrease* in his or her monthly bill, from $40.00 to $18.20; for Southern Sunrise, the typical 5/8-inch x 3/4-inch meter residential customer with a median usage of 4,500 gallons would experience a $21.90 or 54.75 percent *decrease* in his or her monthly bill, from $40.00 to $18.10.[92]

Staff is recommending consolidated rates for the Companies. However if the Commission were to adopt stand alone rates, a summary of the rate impact on the typical residential customer for each system on an individual basis is presented in Staff's Surrebuttal Schedules.

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[88] *Id.* at 33.
[89] *Id.*
[90] *Id.* at 34.
[91] *Id* at 34-5.
[92] Ex S-7 at 36-37 (Surrebuttal Test. of Crystal Brown).

V. COST OF CAPITAL.

Staff recommends that the Commission adopt a capital structure for the Companies of 18.7 percent debt and 81.3 percent equity.[93] Staff is recommending a Cost of Debt of 6.3 percent, and a cost of equity ("COE") of 9.3 percent, which is based on estimates for the sample companies ranging from 9.5 percent for the discounted cash flow ("DCF") method to 11.1 percent for the capital asset pricing model ("CAPM"). The COE recommendation includes a 100 basis points downward adjustment to reflect a lower financial risk in the Companies' capital structure compared to that of the sample companies.[94] Staff recommends an overall rate of return of 8.8 percent.[95]

The Company proposes a consolidated capital structure of 22.6 percent debt and 77.4 percent equity.[96] The cost of equity proposed by the Company is 10.9 percent, which it arrived at by averaging its DCF and CAPM estimates, then adjusting downward 60 basis points to account for the absence of debt and then finally upward 50 basis points to reflect what it terms 'specific company risk premium', due to the size of the Company.[97]

A. <u>Staff is Recommending a Well Reasoned Cost of Equity Given Recent Recommendations and Adoptions by the Commission</u>.

Staff's recommended 9.3 percent COE should be adopted by the Commission because it is based on sound and well accepted cost of equity estimation methodologies that have been consistently utilized by this Commission.[98] Because the Companies' are themselves not publically traded, six proxy publically traded water utilities were used to determine the appropriate COE in this case. Further, using an average of a representative sample group reduces the potential for random fluctuations resulting in a more reliable estimate *vis a vis* relying on a single entity.[99]

1. Discounted Cash Flow (DCF) Model.

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[93] Ex. S-2 at 2 (Surrebuttal Test. of Pedro Chaves).
[94] *Id.*
[95] *Id.* at 7.
[96] Ex. A-17 at (Rejoinder Test. (Cost of Capital) of Thomas Bourassa).
[97] Ex. A-17 at 1-2 (Rejoinder Test. (Cost of Capital) of Thomas Bourassa).
[98] Commission Decision Nos. 69440, 68858, 70209, dated May 1, 2007, July 28, 2007, and March 20, 2008, respectively.
[99] Ex. S-1 at 14 (Direct Test. of Pedro Chaves).

Staff utilized two versions of the DCF Model, the constant growth DCF and the multi-stage DCF in determining the DCF estimated cost of equity. As Mr. Chaves explained the constant growth model assumes that an entity will grow indefinitely at the same rate, whereas the non-constant growth DCF does not assume one constant, indefinite dividend growth rate.[100]

Staff's DCF cost of equity gives equal weight to historical and analysts forecasts. The Company argues that analysts' estimates should be given more weight than Staff's 50/50 recommendation. However, Staff's recommendation against heavy reliance on analysts' forecasts is well supported by experts in the financial community[101] and has been consistently adopted by this Commission. As Mr. Chaves has explained, analysts' forecasts can be overly optimistic, therefore Staff's DCF methodology presents the most reasonable and accurate alternative.

2. Capital Asset Pricing Model.

Staff's overall CAPM cost of equity estimate is 10.6 percent includes both Staff's CAPM estimate using the historical market risk premium (8.6 percent) and the current market risk premium CAPM (12.5 percent).[102] CAPM is reliable, widely used, and has been relied on regularly by the Commission. The Company has also used the CAPM analysis in its cost of equity determination.

3. The Financial Risk Adjustment and the Hamada Method.

The purpose of the Hamada Method is to quantify the cost of capital differences between an applicant company and the proxy group due to differences in capital structure. Staff calculated its recommended downward financial risk adjustment using the Companies' consolidated actual capital structure composed of 67.8 percent equity and 32.2 percent debt and assumed that the sample companies had a capital structure comprised of 60 percent equity and 40 percent debt. Staff's recommended 100 bases points downward financial risk adjustment is reasonable considering the Company's lower debt than the sample companies.

Mr. Bourassa has testified on behalf of utilities companies numerous times before this Commission and on numerous occasions has attempted to assert that "Staff's financial risk

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[100] *Id.* at 15.
[101] *Id.* at 37-41.
[102] *Id.* at 34.

adjustment is overstated because Staff uses book values rather than conceptually correct market values for equity in calculating the risk adjustment using the Hamada formula."[103]

Staff acknowledges that the Hamada methodology was originally developed utilizing market values of equity for estimating a financial risk adjustment, however, the case today must be dealt with in the context of a regulatory environment, and the use of book values to estimate a financial risk adjustment is prudent and reasonable in a regulatory environment.[104] The Commission has repeatedly accepted the use of book values and has rejected the use of market-value capital structures to determine the rate of return.[105] Staff's recommended financial risk adjustment of 100 basis points has been appropriately calculated by utilizing book value in the Hamada formula.

The Company additionally believes that Staff's use of the average beta of the sample utilities in the Hamada Method is a mistake due to the Companies' size and supposed risk.[106] However, Staff is correct in their use of the average beta because the market does not provide rewards for unique risk as it can be diversified away. [107] Therefore, Staff's use of the average beta of the sample companies should be adopted.

4. Firm Specific Risk should not be considered when determining Cost of Equity.

The Company argues that Arizona is somehow a less favorable regulatory environment to utility investors than other states and in addition to the Company's small size, it requires a risk adjustment. However, the Company is less risky than the sample water companies used by Staff in its analysis and, additionally, the existence of firm specific risk does not lead to the conclusion that it has more total risks than other companies.[108]

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[103] Ex. A-15 at 8:8-10 (Rebuttal Test. (Cost of Capital) of Thomas Bourassa).
[104] Ex. S-2 at 3(Surrebuttal Test. of Pedro Chaves).
[105] Commission Decision Nos. 69440, 68858, 70209, dated May 1, 2007, July 28, 2007, and March 20, 2008, respectively.
[106] Ex. S-15 (Rebuttal Testimony (Cost of Capital) of Thomas Bourassa at 8).
[107] Ex. S-2 at 5 (Surrebuttal Test. of Pedro Chaves).
[108] *Id.* at 4-5.

a. **Arizona's regulatory environment is no less favorable.**

The Company asserts that Arizona has a less favorable regulatory environment than those of the sample companies.[109] However, every regulatory jurisdiction has its own framework with its own identifiable advantage and disadvantages; but it's the overall effect that is relevant.[110] The mere fact that investors continue to invest capital in Arizona utilities[111], including the Companies' parent company, negates Mr. Bourassa's assertion that the Arizona utility regulation is disadvantageous to utilities.

b. **Small Firm Risk Adjustments are traditionally not adopted by the Commission.**

The Company contends its small size makes it more risky in comparison to the large publicly traded utilities utilized in the proxy group and therefore the Company requires a 'small firm risk premium' to compensate. However, past Commission Decisions support Staff's rejection of Mr. Bourassa's 'small firm risk premium.'[112]

More importantly, the Companies are owned by Liberty Water (formerly Algonquin Water Resources of America), which is an indirect, wholly owned subsidiary of APUC, a publically traded corporation on the Toronto Stock Exchange. As subsidiaries of a publically traded company, the Companies have access to the capital markets through their parent company, removing the main thrust of the Companies' argument for why a small firm risk adjustment is needed. The Commission should continue their tradition of not recognizing small firm risk as part of the Cost of Equity analysis.

VI. ENGINEERING ISSUES.

Staff makes the following engineering-related recommendations in this case:[113]

1. At this time, Staff does not know the "true" water loss for the Companies because of the mismatch of the meter reading data. For this reason, Staff recommends that the Companies monitor its seven water systems for a 12-month period to prepare a water loss report. The Companies should coordinate

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[109] *Id.* at 5.
[110] *Id.*
[111] *Id.*
[112] Decision Nos. 64282 and 64727.
[113] Ex. S-4 (Surrebuttal Testimony of Marlin Scott).

when it reads the production meters each month with customer monthly meter readings so that an accurate accounting can be made. If the reported water loss is greater than 10 percent, it should submit a detailed cost benefit analysis containing a detailed analysis and plan to reduce the water loss to 10 percent or less. If it's not cost effective it do so, the Companies should submit a detailed analysis that supports that.

2. Staff recommends an annual water testing expense totaling $51,155 ($43,192 for Bella Vista, $3,568 for Northern Sunrise, and $4,392 for Southern Sunrise).

3. As described under the Rate Base analysis, Staff concluded that the requested post-test year plant item for the Bella Vista – City System is used and useful for the provision of service to customers.

4. Staff recommends the adoption of the Staff's typical and customary depreciation rates.

5. Staff recommends the approval of Staff's proposed Service Line and Meter Installation Charges.

6. Staff recommends the approval of an Off-Site Hook-Up Fee Tariff for Bella Vista (consolidated), conditioned about the revised language being contained in the tariff, and the removal of the Company's proposed language concerning treatment of CIAC.

7. Staff recommends that Bella Vista, Northern Sunrise and Southern Sunrise be consolidated, but that the Company continue to report the data and information separately for each of its individual systems by ADEQ Public Water System, including but not limited to plant description, water use data, future Annual Reports and rate case filings.

VII. CONCLUSION.

Staff respectfully requests that the Commission adopt its recommendations on the disputed issues for the reasons stated above and the testimony provided.

RESPECTFULLY SUBMITTED this 6th day of October, 2010.

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