

OPEN MEETING ITEM



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GARY PIERCE - Chairman
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PAUL NEWMAN
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ARIZONA CORPORATION COMMISSION

2011 JAN 18 A 10:25

DATE: JANUARY 18, 2011

DOCKET NO.: W-03718A-09-0359

AZ CORP COMMISSION
DOCKET CONTROL

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Jane L. Rodda. The recommendation has been filed in the form of an Opinion and Order on:

SAHUARITA WATER COMPANY, LLC
(RATES)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and thirteen (13) copies of the exceptions with the Commission's Docket Control at the address listed below by 4:00 p.m. on or before:

JANUARY 27, 2011

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Open Meeting to be held on:

FEBRUARY 1, 2011 and FEBRUARY 2, 2011

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Director's Office at (602) 542-3931.

Arizona Corporation Commission
DOCKETED

JAN 18 2011

DOCKETED BY

ERNEST G. JOHNSON
EXECUTIVE DIRECTOR

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 COMMISSIONERS

3 GARY PIERCE - Chairman
4 BOB STUMP
5 SANDRA D. KENNEDY
6 PAUL NEWMAN
7 BRENDA BURNS

8 IN THE MATTER OF THE APPLICATION OF
9 SAHUARITA WATER COMPANY, LLC FOR A
10 RATE INCREASE.

DOCKET NO. W-03718A-09-0359

DECISION NO. _____

11 OPINION AND ORDER

12 DATES OF HEARING:

July 19, 20, and 23, 2010

13 PLACE OF HEARING:

Tucson, Arizona

14 PUBLIC COMMENT:

March 11, 2010

15 PLACE OF PUBLIC COMMENT:

Sahuarita, Arizona

16 ADMINISTRATIVE LAW JUDGE:

Jane L. Rodda

17 IN ATTENDENCE

Kirstin K. Mayes, Chairman
Paul Newman, Commissioner

18 APPEARANCES:

Mr. Lawrence V. Robertson, Jr., on
behalf of Sahuarita Water Company,
LLC;

Mr. Wes Van Cleve and Ms. Ayesha
Vohra, Staff Attorneys, Legal Division,
on behalf of the Utilities Division of the
Arizona Corporation Commission.

19 **BY THE COMMISSION:**

20 **I. INTRODUCTION**

21 Sahuarita Water Company, LLC ("SWC" or "Company") is an Arizona Limited Liability
22 Company that provides water utility service to approximately 4,700 connections in the Rancho
23 Sahuarita Master Planned Development in the Town of Sahuarita, in Pima County, Arizona.

24 The Company's current rates were approved as part of its original Certificate of Convenience
25 and Necessity ("CC&N"), in Decision No. 58431 (December 28, 1995). SWC began serving its first
26

1 permanent residential customer in 2000.¹

2 SWC filed an application with the Commission for a rate increase on July 17, 2009, using a
3 December 31, 2008, test year.

4 The Company proposes a total revenue requirement of \$3,484,737, an increase of \$1,269,594,
5 or 57.3 percent, over test year revenues of \$2,215,143, and an Original Cost Rate Base ("OCRB")
6 and Fair Value Rate Base ("FVRB") of \$10,059,443. SWC is seeking a capital structure comprised
7 of 18.2 percent debt and 81.8 percent equity and is requesting a cost of equity of 10.9 percent, a cost
8 of debt of 4.2 percent, and a weighted average cost of capital ("WACC") of 9.69 percent.²

9 The Commission's Utilities Division ("Staff") recommends a total revenue requirement of
10 \$2,608,189, which is an increase of \$393,046, or 17.74 percent over adjusted test year revenues.³
11 Staff recommends an OCRB and FVRB of \$8,709,357.⁴ Staff recommends a capital structure
12 consisting of 17.8 percent debt and 82.2 percent equity, a 4.2 percent cost of debt and 10.3 percent
13 cost of equity, resulting in a WACC of 9.2 percent.⁵

14 II. RATE BASE ISSUES

15 The parties proposed the following rate base amounts:

	OCRB	FVRB
Company	\$10,059,443	\$10,059,443
Staff	\$8,709,357	\$8,709,357

16
17
18
19
20 The major difference is attributable to the Company including \$1,844,270 in post-test year
21 plant associated with Well No. 23 that went into service in November 2009; a difference in
22 Accumulated Depreciation associated with Well No. 23; a \$338,625 difference associated with
23 Accumulated Deferred Income Taxes ("ADIT"); and whether Customer Security Deposits in the
24 amount of \$96,204, should be deducted from rate base.

25
26 ¹ Ex A-2 Bourassa Direct at 3.

27 ² Ex A-7, Bourassa Rejoinder Cost of Capital at 1.

28 ³ Ex S-9, Michlik Surrebuttal at 2.

⁴ Staff's Final Schedule JMM-1.

⁵ Ex S-6 Manrique Surrebuttal at 2.

1 **A. Post Test Year Plant**

2 **1. SWC's Position**

3 The Company includes \$1,844,270 in rate base for the cost of Well No. 23, which was put
4 into service in November 2009, after the end of the test year. SWC argues that Well No. 23 is "used
5 and useful" in connection with the Company's ongoing provision of adequate and reliable water
6 utility service and consequently, should be included in rate base in this proceeding despite being post-
7 test year plant. SWC asserts that A.A.C. R18-5-501 et seq.; various water system design criteria; and
8 the age and condition of SWC's other wells are central to a decision on this issue, and support a
9 determination that Well No. 23 is used and useful at this time.⁶

10 SWC asserts that A.A.C. R18-5-501 et seq. is silent with respect to the calculation of well
11 capacity for water system adequacy purposes, and that A.A.C. R14-2-503(A) and (B) are intended to
12 be used in suggesting a minimum storage requirement, and not for the purpose determining the sizing
13 of well capacity. SWC believes that Staff improperly assigned an exclusive role to A.A.C. R18-5-
14 503(A) and (B) in reaching the conclusion that Well No. 23 is not "used and useful." SWC asserts
15 that Staff's reliance on A.A.C. R18-5-503(A) and (B) for determining both storage and well capacity
16 is misplaced and that whether Staff has been using this methodology for at least the past 23 years,
17 does not redeem an otherwise mistaken engineering precept. In the same vein, the fact that the
18 Commission's Engineering Staff does not acknowledge the established engineering design concept of
19 "well redundancy" in connection with system capacity or "used and useful" does not "constitute a
20 reasonable or responsible rationale."⁷ SWC believes that A.A.C. R18-5-502(A), which pertains to
21

22 ⁶ A.C.C. R18-5-503 provides:

- 23 A. The minimum storage capacity for a CWS or noncommunity
24 water system that serves a residential population or a school
25 shall be equal to the average daily demand during the peak
26 month of the year. Storage capacity may be based on
27 existing consumption and phased as the water system
28 expands.
29 B. The minimum storage capacity for a multiple-well system for
30 a CWS or a noncommunity water system that serves a
31 residential population or a school may be reduced by the
32 amount of the total daily production capacity minus the
33 production from the largest producing well.

34 ⁷ SWC Reply Brief at 18.

1 “Minimum Design Criteria” and provides: “[a] public water system shall be designed using good
2 engineering practices” also should play a role in the analysis of whether Well No. 23 is used and
3 useful.

4 SWC claims that it has demonstrated that without the existence and availability of Well No.
5 23, the Company would not be in a position to maintain ongoing adequate and reliable water service
6 to its 4,670 test period connections during periods of peak hourly demand if its largest well (Well No.
7 14) was out of service.⁸

8 SWC asserts that in disallowing Well No. 23, Staff failed to consider both the age and
9 physical condition of Well Nos. 14 and 18 in Staff’s system adequacy analysis, and did not consider
10 the Company’s pumping and delivery obligations to the Town of Sahuarita.⁹ SWC’s engineering
11 witnesses, Mr. Taylor, and its president, Mr. Seamans, testified that the loss of a well from a casing
12 failure could affect the system for a period of six months to a year. The Company’s witnesses
13 believed that the probability of a well casing failure on either Well No. 14 or 18 in the next few years
14 is high given the age of these wells.¹⁰ Furthermore, the Company asserts that Well No. 14 was out of
15 service for two months due to an equipment failure and that during that time Well No. 23 was
16 indispensable to the Company’s ability to provide ongoing adequate and reliable service.

17 The Company states that Well No. 23 has been part of SWC’s long-range system plan since at
18 least 2007 when it was learned that its Well No. 17 was not going to be useable due to water quality
19 problems.¹¹ Furthermore, the Company states that Well No. 23 would have been in service in the
20 test year, but for a letter from the Arizona Department of Environmental Quality (“ADEQ”) directing
21 SWC not to connect Well No. 23 to the system until the arsenic treatment facility for Well Nos. 14
22 and 18 was placed in service, which did not occur until 2009.¹²

23 2. Staff’s Position

24 Staff removed the cost of Well No. 23 from SWC’s rate base, and reduced Accumulated
25 Depreciation by \$327,565 to reflect removing the well and an associated pump motor. Well No. 23

26 ⁸ Hearing Transcript (“Tr.”) at 72 and 93-94; SWC Initial Brief at 5-7.

27 ⁹ Tr. at 433.

¹⁰ Tr. at 55, and 270-71.

¹¹ Tr. at 274 and 279.

28 ¹² Tr. at 278.

1 was not put in service until November 2009, almost a year after the end of the test year. Staff
 2 inspected the entire water system and determined that the test year well production and storage
 3 capacities were sufficient, and that Well No. 23 was not needed to serve test year customers.¹³ Using
 4 the same methodology it has used for the past 23 years, Staff states that the test year well capacity of
 5 2,800 gallons per minute (“GPM”) and active storage capacity of 1,374,063 gallons is adequate to
 6 serve the present customer base and projected growth within a five year period.¹⁴ Staff asserts that
 7 “well redundancy” as described by Mr. Taylor, is not used to determine system capacity requirements
 8 or “used and useful” plant in a rate case.¹⁵

9 Staff’s calculations indicate that with Well Nos. 14 and 18, SWC could serve approximately
 10 9,333 connections, which is much more than the test year customer base of 4,670 connections, and
 11 that Well No. 14, alone, could service 5,833 connections, and Well No. 18, alone, could service
 12 approximately 4,833 connections. Staff asserts that Well Nos. 14 and 18 are more than adequate to
 13 serve the test year customer base of 4,670 connections as well as anticipated customer growth within
 14 a five-year period.¹⁶ Staff believes its recommendation to exclude Well No. 23 is reasonable and
 15 based on sound engineering methodologies and calculations utilized by this Commission for many
 16 years.

17 Staff notes that the Peak Daily Demand (“PDD”) of 0.47 gpm/unit that is used in the
 18 Company’s Opening Brief is inconsistent with the Company’s pre-filed rejoinder testimony, where
 19 Mr. Taylor used a 0.30 gpm/unit.¹⁷ Staff states that it understood that the Company accepted 0.30 as
 20 the well capacity factor. Staff states the Company is now adopting an estimated Peak Hourly Demand
 21 factor of 1.6 from an outdated 2007 Water System Master Plan in its attempt to argue that the water
 22 system has a well capacity deficiency without Well No. 23.¹⁸

23 Staff asserts that it correctly calculated storage capacity using the average daily demand
 24 during the peak month in conformance with ADEQ Rule 18-5-503(A). Staff states that Mr. Taylor
 25

26 ¹³ Ex S-7, Michlik Direct at 7.

¹⁴ Ex S-4.

¹⁵ Tr. at 430.

¹⁶ Staff Reply Brief at 3.

¹⁷ Ex A-13 at Exhibit A.

¹⁸ Staff Reply Brief at 2.

1 incorrectly used the peak day demand during the peak month of the year.¹⁹ Similarly, Staff asserts
 2 that it correctly included well production capacity in calculating storage capacity requirements
 3 pursuant to ADEQ Rule 18-5-503(B). Staff asserts the Company's storage capacity number is
 4 incorrect because Mr. Taylor did not apply ADEQ Rule 18-5-503(B) to reduce the minimum storage
 5 capacity by the amount of the total daily production capacity minus the production from the largest
 6 producing well. Staff also asserts that the Company's proposed fire flow requirement of 660,000
 7 gallons per day is overstated as it assumes two fires occurring simultaneously. Staff utilized a fire
 8 flow calculation of 480,000 gallons per day based on the numbers provided by the Company and
 9 confirmed by the Sahuarita Rural Metro Fire Marshal's Office.²⁰

10 Staff states that it used the Company's actual water use data from the Water Use Data Sheet to
 11 calculate the well (0.31 gpm per connection) and storage (358 gpd per connection) capacity factors.²¹
 12 Staff argues that the actual water use data from the Water Use Data Sheet, and 25 percent well
 13 capacity factor, should be used in the water system analysis, not the Company's estimated 2007 plan
 14 production capacity ratio factor of 1.6.²² Staff asserts that the Company's 2007 Water System Master
 15 Plan, which forms the basis of the Company's position, is based on projected water use, while Staff's
 16 analysis is based on actual water use. Staff states that while it may make sense from a planning
 17 standpoint to over-build, test year customers should not be required to pay for plant that is not yet
 18 necessary to serve them. Staff utilizes A.A.C. R18-5-503(A) and (B) minimum storage requirements
 19 because customers should not be required to pay for more plant than is necessary to adequately serve
 20 them during the test year.

21 In addition, Staff states that it is not the Commission's practice to take into account both the
 22 age and condition of wells in its used and useful analysis. Staff asserts that the Company will have
 23 the opportunity to recover the costs associated with Well No. 23 in a later rate case, when that well
 24 becomes necessary to serve the Company's customers.

25 ...

26 _____
 27 ¹⁹ Tr. at 74; Ex A-13 Taylor Rejoinder at 2 cited in Staff's Closing Brief at 25.

²⁰ Tr. at 74.

²¹ Ex S-1, Scott Direct at Ex MSJ at 7; Tr. at 395

²² Staff Reply Brief at 2.

1 **3. Resolution**

2 Well No. 23 was not put into service until eleven months after the end of the test year. The
3 Company argues that it needs Well No. 23 to provide reliable service to test year customers. There
4 was no federal or state mandate that requires Well No. 23 be added to the system. When it brought
5 Well No. 23 online, the Company did not take either Well No. 14 or 18 out of service and these wells
6 continue to provide service to SWC's customers. The three wells together provide more capacity
7 than is needed to serve the test year level of 4,670 connections. Therefore, we find that Staff's
8 treatment of Well No. 23 is reasonable and we agree with Staff's recommendation not to include
9 Well No. 23 in rate base at this time.

10 We note that the arsenic treatment plant was also put into service after the test year. There
11 was no dispute regarding whether the arsenic treatment plant should be included in rate base as a post
12 test year adjustment because the arsenic plant was required for the Company to meet safe drinking
13 water mandates by the U.S. Environmental Protection Agency. It is appropriately included in rate
14 base as an alternative to an arsenic remediation surcharge mechanism.²³ The well production and
15 storage capacity in the test year were adequate, and unlike the situation with arsenic treatment, there
16 are no extraordinary circumstances that warrant adjusting the test year plant to include Well No. 23.

17 **B. Accumulated Deferred Income Taxes**

18 ADIT is a deferred tax benefit or liability which represents the accumulated temporary tax
19 differences between income taxes calculated for rate-making purposes and the actual income taxes
20 paid.

21 **1. SWC's Position**

22 SWC proposed a "credit" to or reduction in rate base of \$525,361 related to ADIT. The
23 Company argues that if income taxes are allowed in expenses then ADIT should be recognized in rate
24 base in order to account for the difference between the allowed income taxes included in rates and the
25 actual income taxes paid. In this case, the Company includes a reduction to rate base to account for
26
27

28 ²³ Ex S-7 at 8.

1 the income tax liability in the test year being lower than the income tax expense included in rates.²⁴

2 **2. Staff's Position**

3 Staff recommends not recognizing ADIT in rate base because SWC is an LLC, and as such, is
4 not a taxed entity and does not record income tax expenses. Because Staff recommends that the
5 Company is not entitled to include income tax expense as part of its operating expenses, Staff
6 believes that there should not be an adjustment for ADIT.

7 **3. Resolution**

8 SWC is an LLC and consequently does not pay income taxes. As discussed later in greater
9 detail in connection with the requested allowance for Income Tax Expense, the Commission does not
10 find that the hypothetical tax expense for this pass-through entity is fair and reasonable or in the
11 public interest. Both parties acknowledge that if Income Tax Expense is not allowed to be recovered
12 in rates, it is inappropriate to include ADIT in rate base.

13 **C. Customer Security Deposits**

14 **1. Staff's Position**

15 Staff includes \$96,204 in Customer Security Deposits as a reduction to rate base. The
16 Company did not include Customer Security Deposits in rate base. Staff views Customer Security
17 Deposits as funds received from ratepayers as security against potential losses from the failure to pay
18 for service, and ultimately as funds that are available to the Company to invest in plant.²⁵ Staff
19 asserts that as a source of non-investor supplied capital, they should be a reduction to rate base.

20 Staff notes that although the deposits are security for payment of receivables from customers
21 and a means for controlling bad debt expense, there is no rule or requirement that prevents SWC from
22 using the deposits for other purposes as long as it is able to refund them as required.²⁶ Staff gives
23 little or no weight to the Company's statement that it maintains a separate bank account for Customer
24 Security Deposits and does not use the account for other purposes because nothing prevents the
25 Company from eliminating the account and using all of the money. Staff states it is not disputed that

26 ²⁴ SWC Reply Brief at 4. Mr. Bourassa testified that "[i]n the instant case, the ADIT is a liability (a reduction to rate base)
27 which means that the actual income taxes through the end of the test year were lower than the income taxes included in
rates." Ex A-4 at 10-11

28 ²⁵ Ex S-7 at 10.

²⁶ Staff Closing Brief at 5.

1 the Company initially deposits the Security Deposits from customers in its operating account with
 2 money from other sources, and only reconciles the Customer Security Deposit account at the end of
 3 each month.²⁷

4 Staff argues that the National Association of Regulatory Utility Commissioners (“NARUC”) Rate Case and Audit Manual defines customer deposits as “a source of non-investor supplied
 5 capital,” and Staff believes its recommended methodology is consistent with NARUC guidelines.²⁸
 6 Staff states that where as here, the allowed return on rate base is higher than the required interest rate
 7 on the deposits, the utility may earn more than is necessary, to the benefit of shareholders and the
 8 detriment of ratepayers.²⁹

10 Staff states that it would consider including the appropriate amount of interest expense on the
 11 customer deposits in operating expenses if the Company provided the proper support.³⁰ Staff argues
 12 that the Company incorrectly ties the amount of interest expense accrued or paid during the year to
 13 the dollar amount of the customer deposits account balance on the last day of the test year.³¹ Staff
 14 states that the deposit balance at any given time during the year will vary considerably, and Staff’s
 15 witness testified that Staff would likely use a 13-month average deposit balance to determine the
 16 appropriate interest expense. Staff concludes that the Company did not provide sufficient
 17 information to allow an accurate determination of the appropriate interest expense on Customer
 18 Security Deposits.³²

19 Staff asserts that Staff’s position in this case is consistent with the Commission’s treatment of
 20 Customer Security Deposits in the recent rate cases for Arizona Water Company, Tucson Electric
 21 Company and UNS Gas.³³

22 2. SWC’s Position

23 SWC argues the Commission could either (1) accord no role to Customer Security Deposits in

24 ²⁷ Tr. at 351.

25 ²⁸ Ex A-6 Bourassa Rejoinder Revenue Requirement at Exhibit TJB RH-1. Staff Closing Brief at 5.

26 ²⁹ Staff Closing Brief at 5-6.

27 ³⁰ Ex S-9 at 4.

28 ³¹ The Company claimed that the calculation of interest expense on the customer security deposits is 6% times the ending balance in the account, or .06 x \$92,204, or \$5,772.

³² Staff Closing Brief at 6.

³³ Arizona Water Company Docket No. W-01445A-08-0440, Tucson Electric Power Company Docket No. E-01933A-07-0402, and UNS Gas, Inc. Docket No. G-04204A-08-0571.

1 connection with the determination of rate base, or (2) deduct Customer Security Deposits from rate
2 base, but allow recovery of the 6 percent interest paid thereon as an operating expense. SWC states
3 that it prefers the former treatment. SWC asserts that in the event the second option is adopted, the
4 amount included and deducted from rate base, and the amount upon which the interest expense is
5 calculated, should be the same.³⁴

6 SWC disagrees with Staff's recommended treatment because 1) the Company claims
7 Customer Security Deposits are not capital provided by non-investors, but rather are security for the
8 payment of a customer receivables and a means to control Bad Debt Expense; 2) if Security Deposits
9 are a source of capital, then the annual interest expense should be included in operating expenses; and
10 3) the Company uses a separate bank account for Customer Security Deposits and does not use the
11 cash for any other purpose but to refund the deposits. The Company argues that Staff could not point
12 to a NARUC directive or Commission Rule that equates customer deposits to advances in aid of
13 construction, and the Company argues that Customer Security Deposits are more akin to prepaid
14 expenses and materials. Moreover, SWC argues that if Customer Security Deposits are included as a
15 deduction to rate base, they should be offset with both prepaid expenses and material and supplies.³⁵

16 In its Reply Brief, the Company included information on Customer Security Deposits that
17 reflects: (1) the average Customer Security Deposit balance during the thirteen month period which
18 includes the 2008 test year and the month of January 2009; (2) the Customer Security Deposits
19 received by SWC during that same period; and (3) the Customer Security Deposits refunded by SWC
20 during that same period, inclusive of the 6 percent interest rate SWC paid. The information is
21 supported by the affidavit of the Company's controller, Ms. Homiak. The Company states that this is
22 the type of information that Staff suggested would be appropriate for ratemaking recognition. The
23 Company recommends that the \$96,204 of customer security deposits not receive ratemaking
24 recognition in any form for any purpose, but that if the Commission determines to treat Customer
25 Security Deposits as a deduction from rate base, then it should also recognize as an operating
26 expense, \$2,284 in interest that it actually paid.

27 _____
28 ³⁴ Tr. at 224-225. See SWC Initial Brief at 11.

³⁵ Ex A-4 at 14-15, Tr. at 26-28 and at 203-205.

1 **3. Resolution**

2 The NARUC Rate Case and Audit Manual provides three ways to treat Customer Deposits as
3 follows:

4 The first method does not reduce rate base by the customer deposits
5 balance and classifies any interest accrued or paid on those deposits as a
6 below-the-line (or non-operating) expense. This method allows the utility
7 to earn a return on a rate base that has not been reduced by the amount of
8 customer deposits, and then allows it to use that return to pay the interest
9 that is required to be returned to customers with the return of that deposit.
One consideration in using this method is whether the return allowed on
rate base is higher than the return that the utility is required to pay on its
customer deposits. If so, the utility may be allowed to earn more than is
necessary, and return that difference to shareholders.

10 The second method reduces rate base by the customer deposits balance,
11 and classifies any interest accrued or paid on those deposits as an above-
12 the-line (or operating) expense that is included in the revenue requirement
computation. The interest that the utility must pay is generally deemed to
be a legitimate expense that must be recovered in one form or another.

13 The third method includes the liability for customer deposits in the
14 utility's capital structure at zero cost, reducing the overall rate of return. If
interest is paid on the customers' deposits, the utility can recover that
interest expense as an above-the-line (or operating) expense.³⁶

15 Thus, NARUC sanctions either Staff's or the Company's general methodologies. The
16 Company advocates the first of the options identified by NARUC, while Staff recommends the
17 second. Staff's concern with the Company's chosen methodology is that where the authorized return
18 is higher than the interest rate paid by the Company, shareholders receive the benefit in the amount of
19 the difference between the two rates.

20 The Company provided a calculation of the interest it paid on Customer Security Deposits in
21 the test year. NARUC guidelines recognize that when Security Deposits are deducted from rate
22 base, it is appropriate to treat the interest paid thereon as an operating expense. Consequently, under
23 Staff's approach, it would appear that we should allow an Interest Expense on Customer Security
24 Deposits in the amount of \$2,284 as an operating expense. However, the Company offered this
25 calculation in its Reply Brief after the opportunity for Staff to make further comment.

26 In addition to the method of calculating the appropriate interest expense, the Company raised
27

28 ³⁶ NARUC Rate Case and Audit Manual excerpted as Ex TJB-BJ-1 to Ex A-6.

1 the issue of the appropriate balance to use as a reduction of rate base. The Company argues that the
2 ending balance does not reflect the amount of Customer Security Deposits held during the year. The
3 Company suggests that a weighted average balance of the Customer Security Deposits is a more
4 appropriate deduction from rate base.

5 The Commission generally does not use an average balance to determine test year plant
6 balances, however, Customer Security Deposits, which fluctuate significantly throughout the year,
7 may warrant a weighted average treatment to be consistent with Staff's suggestion of how interest
8 paid should be calculated. The Commission has adjusted test year expenses by averaging in order to
9 normalize the test year expenses. In this case, neither the evidence nor legal argument adequately
10 explored the question a using a weighted average balance for customer Security Deposits. The
11 Company provided a calculation of the average balance in its Customer Security Deposit Account,
12 however, there was not sufficient discussion on how that balance was calculated, nor an opportunity
13 for Staff to investigate or comment. Thus, we cannot conclude this is the appropriate balance to
14 utilize in determining rate base adjustment.

15 Although we generally agree with Staff's approach that recognizes that customers are
16 supplying non-investor capital, because of questions about 1) the inclusion of the appropriate interest
17 expense; 2) the appropriate balance to deduct from rate base; and 3) because this Company segregates
18 Customer Security Deposits in a separate account, we find that a fair and reasonable approach in this
19 situation is to adopt the first NARUC sanctioned option which is to not recognize the Customer
20 Security Deposit balance in rate base and not include the interest expense as an Operating Expense.

21 In the Company's next rate case, we direct the Company and Staff to address the issue further
22 and provide evidence and analysis of how to calculate the deduction from rate base and the matching
23 interest expense that should be allowed. Our treatment of Customer Security Deposits in this
24 instance is premised on the specific circumstances of this case, and should not be interpreted as an
25 indication of Commission policy. Furthermore, the Company should continue to segregate Customer
26 Security Deposits in a separate account and be prepared to reconcile the account balance if requested
27 by the Commission.

28 ...

D. Rate Base Summary

Based on the foregoing, we adopt an OCRB of \$8,805,561 as follows:

Plant In Service	\$23,480,228
Less: Accumulated Depreciation	1,353,282
Net Plant in Service	22,126,946
Less:	
Contributions in Aid of Construction	4,314,264
Less: Accumulated Amortization	251,796
Net CIAC	4,062,468
Advances in Aid of Construction	9,258,917
Customer Deposits	--
Deferred income Tax Credits	--
Add:	
Unamortized Debt Issuance Costs	--
Deferred Regulatory Assets	--
Original Cost Rate Base	\$8,805,561

The Company did not request a Reconstruction Cost New Rate Base, and thus, its FVRB is the same as its OCRB.

III. INCOME STATEMENT ISSUES

The parties agree that adjusted test year revenues are \$2,215,143. The Company proposed adjusted test year operating expenses of \$2,062,338, resulting in test year operating income of \$152,805. Staff recommends adjusted operating expenses of \$1,806,928, resulting in adjusted test year operating income of \$408,215.³⁷ The difference is primarily the result of Staff removing \$134,410 associated with non-dedicated employee expenses and bonuses; reducing Rate Case

³⁷ Staff Final Schedules at JMM-9.

1 Expense by \$30,000; and eliminating the Company's proposed Income Tax Expense in the amount of
2 \$104,948.³⁸

3 **A. Management Fees**

4 SWC has no employees. Rancho Sahuarita Management Company ("RSMC"), an affiliate of
5 the Company, provides management services to SWC. The issue in this proceeding is whether the
6 salaries of RSMC employees, totaling \$100,831, who provide service to SWC on a part-time basis,
7 should be included in SWC's allowed operating expenses. Staff also removed \$33,579 associated
8 with bonuses.³⁹

9 **1. SWC's Position**

10 SWC argues that the services rendered to SWC by the RSMC non-dedicated employees
11 provided value to SWC; directly contributed to the efficiency and quality of service of SWC's
12 operations; and the costs were predicated upon appropriate allocations of the employees' base salaries
13 which are in-line with comparable water utility industry and regional compensation standards. SWC
14 denies Staff's assertions that the services provided by the non-dedicated employees were not
15 necessary in the day-to-day operations of SWC and that the salaries have not been adequately
16 substantiated.

17 Through the testimony of Mr. Seamans, its president, and Ms. Homiak, its Controller, SWC
18 asserts that it established that the non-dedicated employees provided SWC with long-range planning,
19 financial planning and oversight, oversight of capital improvements, contract negotiations and
20 management, rate case planning, human resources, bookkeeping and clerical services. The Company
21 believes that the expertise of the non-dedicated RSMC employees bring efficiency, quality of service
22 and expertise in the water industry, and real value to SWC's operations.⁴⁰

23 The Company acknowledges that it should have kept time sheets for the non-dedicated
24 employees, but that this proceeding was its first rate case since obtaining its original CC&N, and it
25 did not foresee that the absence of time sheets would become an issue. Nonetheless, the Company

26 _____
27 ³⁸ Staff's Final Schedules filed with Closing Brief.

³⁹ The Company agreed to remove bonuses from the revenue requirement to narrow issues in this proceeding, but
disagrees with Staff's position, and believes that bonuses are an effective management tool. Ex A-6 at 12.

28 ⁴⁰ SWC Opening Brief at 22.

1 argues that the absence of time sheets does not mean there is no evidence of the services provided or
2 time dedicated. The Company offered the personal observations of Mr. Seamans and Ms. Homiak to
3 support its allocation of the non-dedicated employee salaries.⁴¹ The Company argues that Staff
4 provided no probative evidence to rebut the testimony of Mr. Seamans and Ms. Homiak.

5 SWC asserts that the non-dedicated employee salaries in question are in-line with water utility
6 industry and regional employer compensation standards. The Company argues that although Staff
7 criticized the Company for not having used competitive bids to obtain the various services, and
8 criticized the salary surveys as an unreliable basis for comparison, Staff offered no evidence to
9 indicate that the services would have been available to SWC from a single entity under a competitive
10 bid procedure.⁴² The Company points to Ms. Homiak's testimony that the range of services and
11 expertise provided through the non-dedicated employee arrangement with RSMC probably could not
12 have been provided to SWC through individual consulting contracts with various firms at an
13 equivalent or lesser cost.⁴³

14 The Company argues that in focusing on the absence of timesheets, Staff ignores the sworn
15 testimony of Mr. Seamans and Ms. Homiak who testified based on their personal knowledge and
16 observations as to the value and array of services provided to SWC. SWC states that each testified to
17 their respective belief that the proposed salary allocations represented a reasonable approximation of
18 the time devoted to SWC by the non-dedicated employees. The Company also asserts that Staff
19 ignores that the services that the non-dedicated employees provided added value as well as the
20 opinion of its own witness who acknowledged that the employees provided actual value.⁴⁴ SWC
21 argues that the record in this proceeding shows that there was no duplication of job duties and thus,
22 Staff's concerns about possible duplication of duties has been dispelled. In light of the evidence of
23 the value of the non-dedicated employees to the Company, SWC argues that Staff's position on this
24 issue is irrational and punitive.⁴⁵

25
26 ⁴¹ Tr. at 259, 261-263, 313, 316, 345-346.

27 ⁴² SWC Opening Brief at 24.

28 ⁴³ Tr. at 345 and 347.

⁴⁴ Tr. at 536-37, cited in SWC Reply Brief at 7.

⁴⁵ SWC Reply Brief at 7.

1 **2. Staff's Position**

2 Staff reduces the managements fees by \$100,831, from \$637,012 to \$536,181, on the grounds
 3 that the Company did not provide adequate evidence that including the management fees for non-
 4 dedicated employees of its affiliate, RSMC, is fair and reasonable to ratepayers. Staff recommends
 5 disallowing the salaries of the non-dedicated employees because of concerns about the accuracy of
 6 the estimated allocation of time, the complete lack of documentation on the specific tasks the
 7 employees performed and the potential for duplication of job duties. Staff argues SWC did not
 8 provide adequate support for its non-dedicated employee salaries, and believes it would be
 9 inappropriate to accept the Company's full \$637,012 in requested affiliate management fees without
 10 evidence of a competitive bidding process or other assurance that the fees are fair and reasonable.⁴⁶
 11 Staff asserts that that Generally Accepted Accounting Principles ("GAAP") requires a close
 12 examination of affiliate transactions.⁴⁷

13 Staff asserts that the Company failed to provide an accurate accounting of "so called 'non-
 14 dedicated' management employees" and was unable to provide supporting documentation for the
 15 allocated costs of these employees. Staff states that the Company merely provided percentage
 16 estimates of time allocated, and in response to Staff's requests for time sheets to support the
 17 estimates, responded with "vague descriptions of the type of work conducted."⁴⁸

18 Staff questions the necessity of the non-dedicated employees because the Company's 10 year
 19 plan for management of the Company did not recognize all of the positions that SWC seeks to be
 20 allocated to SWC. Staff argues that the Company has not demonstrated a need for Mr. Bowman's
 21 contract oversight services, which Staff believes overlaps with Mr. Seaman's duties as president of
 22 the Company.

23
 24 ⁴⁶ Staff Opening Brief at 9.

25 ⁴⁷ Staff cited to GAAP which provides:

26 Transactions involving related parties cannot be presumed to be carried out on an arm's-
 27 length basis, as the requisite conditions of competitive, free-market dealings may not
 exist. Representations about transactions with related parties, if made, shall not imply
 that the related party transaction were consummated on terms equivalent to those that
 prevail in arm's-length transactions unless such representations can be substantiated.

28 ⁴⁸ Staff Closing Brief at 10.

1 Staff asserts that pursuant to statute and Commission rules, water utilities are required to
 2 maintain their books and records in accordance with the NARUC Uniform System of Accounts
 3 (“USOA”).⁴⁹ Staff argues that the allocation of the non-dedicated employee costs violates the
 4 NARUC requirement that “to the maximum extent practicable, in consideration of administrative
 5 costs, costs should be collected and classified on a direct basis for each asset, service or product
 6 provided.”⁵⁰ Staff asserts that direct costs (those which can be specifically identified with a
 7 particular service or product) such as those provided by the management company’s non-dedicated
 8 employees, should be supported by detailed time sheets or billing statements describing exactly what
 9 tasks were performed and how many hours were dedicated to each task.⁵¹ Staff states that although
 10 the Company witnesses acknowledged that it would be inappropriate to pay for professional services
 11 without a detailed invoice establishing exactly what services were performed and the associated
 12 costs, the Company is requesting that its customers pay for an estimated percentage of RSMC’s
 13 employee salaries.

14 Staff also notes that NARUC provides that generally, the price for services, products and the
 15 use of assets provided by a non-regulated affiliate to a regulated affiliate should be at the lower of
 16 fully allocated cost or prevailing market prices. Staff argues that NARUC does not permit allocation
 17 based on estimates or in an arbitrary fashion. Staff does not believe that testimony regarding various
 18 non-dedicated affiliate employee tasks is a substitute for the detailed record of accounts that the
 19 Company is required to keep.⁵² Staff argues that ratepayers should not have to pay for
 20 unsubstantiated costs.

21 Staff argues that the salary surveys are not a substitute for a competitive bidding process and
 22 accurate detailed record keeping. Staff states the Company’s New York Times survey is not industry
 23 specific and the American Water Works Association survey does not address regional differences. In
 24 addition, Staff claims that the Company’s comparison of operating costs to other Arizona utilities
 25 does not provide adequate support for the Company’s claimed affiliate non-dedicated employee costs

26 _____
 27 ⁴⁹ A.R.S. § 40-221(A); A.A.C. R14-2-411(D)(2).

⁵⁰ Ex S-9 at 12.

⁵¹ Ex S-9 at 12, cited in Staff Closing Brief at 10.

⁵² Tr. at 320 and 364-65.

1 because the comparison includes utilities that vary in size from the Company and several of the
2 companies have no salary information.

3 3. Resolution

4 The Commission scrutinizes affiliate transactions carefully, to ensure that ratepayers are only
5 paying for services which provide benefit to the utility and which are fair and reasonable when
6 considering the size of the utility.

7 A direct cost is an expense that can be traced, or identified with, a specific cost center or cost
8 object such as a department, process or product. An indirect cost is not directly related to a specific
9 cost center, good or service, but rather is incurred in joint usage, and is therefore difficult to assign to
10 a specific object. Indirect costs are also known as overhead and often include administrative costs,
11 personnel, computing, security, etc. When the non-dedicated RSMC employees provide specific
12 services to SWC they appear to be a direct cost of SWC. As direct costs, NARUC guidelines provide
13 that services or assets provided by a non-regulated affiliate to a regulated affiliate should be at the
14 lower of cost or market. The Company attempted to use its salary survey to show that the direct costs
15 were in line with market rates, however, the New York Times information is not sufficiently targeted
16 to provide much help in this regard.

17 The Company's estimated times and duties of its non-dedicated employees are not sufficient
18 to meet its burden of proof. There was testimony from Mr. Seamans and Ms. Homiak concerning
19 services that the non-dedicated employees provided to SWC, which include payroll and human
20 resources, book-keeping, construction contract review and administration, and long-range planning.
21 The non-dedicated employees evidently were asked to estimate the time they spent on SWC
22 business.⁵³ It is not clear how each employee estimated his or her time.⁵⁴ Without time records, the
23 Commission cannot evaluate the accuracy of the estimates or determine whether the activities of
24 these employees did not duplicate the activities of the full-time employees. Mr. Seamans and Ms.
25 Homiak testified to their personal interactions with the non-dedicated employees, but these two
26 individuals are not in a position to judge whether the percentage estimates are reasonable. RSMC

27 _____
28 ⁵³ Tr. at 371.

⁵⁴ *Id.*

1 provides services to various entities, with which neither Mr. Seaman's nor Ms Homiak, whose
 2 activities are dedicated to the water company, are involved. There are various ways to allocate
 3 management services, but in all of the methods, the Commission requires a degree of confidence that
 4 the methodology is accurate and leads to a fair and reasonable allocation.

5 Finally, there remains the appearance of overlap between the duties of the non-dedicated
 6 employees and the full-time employees, and without a specific contemporaneous description of what
 7 the non-dedicated employee did, the Commission does not have adequate proof that the services are
 8 not duplicative, or that the non-dedicated employee was acting on behalf of the water company and
 9 not for the developer. Because of the lack of reliable evidence, SWC has not shown that its
 10 allocations are reasonable and therefore has not met its burden of proof on this issue. Consequently,
 11 we accept Staff's adjustment to remove the costs of the non-dedicated employees.

12 **B. Income Tax Expense**

13 **1. SWC's Position**

14 SWC requests that the Commission re-examine its general policy to date of not recognizing
 15 income taxes as an operating expense for LLCs. SWC notes that in the Sunrise Water Co. rate case
 16 (Decision No. 71445) and Farmers Water Co. rate case (Decision No. 71510), the Commission
 17 determined not to allow income tax expense for Subchapter S corporations ("S-corps"). SWC argues
 18 that each of the four reasons for the decision not to allow the income tax expense expressed in the
 19 Sunrise Water case is distinguishable in the instant proceeding. In pertinent part, in the Sunrise Water
 20 Decision, the Commission found:

21 [1] Because it has long been our policy not to allow recovery of these
 22 hypothetical income tax expenses for non-taxable pass-thru entities, [2]
 23 because we recognize that C corporation subsidiaries included in a parent
 24 corporation's consolidated income tax return are different than an S
 25 corporation because they are actually taxable entities, [3] because we have
 26 no documentary evidence before us of Sunrise's income passed through to
 27 Mr. Campbell or that Mr. Campbell has actually paid any income taxes on
 28 that income, and [4] because Sunrise can easily become a C corporation if
 it chooses to do so in order to obtain recovery of income tax expenses in
 future rate cases, we will not allow Sunrise to recover any income tax
 expenses in this matter.⁵⁵ (brackets added)

⁵⁵ Decision No. 71445 at page 37.

1 SWC asserts that it distinguished the current case from previous cases by demonstrating that:
2 (1) SWC, in fact, reported its 2008 test period income to members; (2) its members, in fact, paid
3 federal and state income taxes on such income; and (3) SWC did not reimburse its members for the
4 income taxes paid. In addition, SWC argues that it demonstrated that the Internal Revenue Service
5 and federal tax policy do not require that denial of income taxes for rate making purposes.

6 SWC argues that only if income tax expenses are recovered from ratepayers can SWC's
7 owners fully recover their expenses of ownership and be afforded the opportunity to earn a fair and
8 reasonable return on their investment.⁵⁶ The Company argues that the ratemaking approach reflected
9 in the Sunrise Water Co., Farmers Water Co. and Johnson Utilities, LLC, decisions "punishes" the
10 owners of an S corporation or an LLC for having selected a form of business organization because it
11 might have a favorable tax treatment. The Company claims that the owners' decision as to the type
12 of business organization does not increase the tax liability which would otherwise be attributable to
13 the income of the regulated entity and ratepayers would not be worse off than if the Company was not
14 a pass-through entity.⁵⁷

15 2. Staff's Position

16 Because SWC is a limited liability company, and as such neither incurs an income tax liability
17 nor pays income taxes at the company level, Staff recommends an adjustment that decreases the
18 Company's income tax expense by \$104,948, from \$104,948 to \$0. Ultimately, Staff does not believe
19 that the Company has met its burden to include income taxes in rates because it is a pass-through
20 entity and does not pay income taxes at the entity level. Staff notes that the Commission recently
21 denied the recovery of income taxes in the rate case of Johnson Utilities, LLC, because "it is not
22 appropriate or in the public interest to allow pass through entities such as the Company to recover
23 income tax expenses through rates. Staff claims the Company has not proffered any evidence that
24 should cause the Commission to deviate from its clear policy."⁵⁸ Staff states that since it has long
25 been the Commission's policy not to allow recovery of hypothetical income tax expenses of S
26 corporations and LLCs, it should not allow recovery in this case.

27 ⁵⁶ *Id.* at 9.

28 ⁵⁷ SWC Reply Brief at 9-10.

⁵⁸ Decision No. 71854 at 47.

1 Staff states that it does not dispute that the Company generated income from water utility
2 operations during the 2008 test year, however, Staff notes that the Company did not pay any taxes on
3 that income because it is a limited liability company and does not generate taxable income to itself.
4 While Staff does not believe the issue is relevant,⁵⁹ Staff notes that the Company did not demonstrate
5 that each of its members actually incurred federal and state tax liability. In fact, Staff notes, SWC is
6 comprised of three members (Interchange Opportunity Fund LLLP, Mission Peaks 4000 LLC, and
7 Sharpe and Associates, Inc.) all of which are also pass-through entities and pay no taxes. Staff argues
8 that while the Company attempted to “calculate” the taxable income of SWC, it is not clear how the
9 Company arrived at its figure.⁶⁰

10 Staff does not believe that the analysis need extend beyond determining whether the utility is
11 a taxable entity. However, Staff also asserts that SWC has failed to overcome the other requirements
12 set forth in the Sunrise Water Decision. Staff states that the shareholder K-1’s that the Company
13 provided as evidence in this proceeding do not fill any relevant evidentiary gaps because they do not
14 reflect taxable income for the regulated entity.⁶¹ In addition, Staff believes that the Company did not
15 demonstrate that the members of SWC actually paid income taxes or that the amount of pro forma
16 income tax proposed was based in any way on the amount of the members’ actual income tax
17 liabilities. Staff believes the main flaw in the Company’s argument is that the tax rates that the
18 Company’s members actually pay is a poor predictor of what the tax liability of the pass-through
19 entity should be.⁶²

20 In addition, Staff believes that there is a sound basis in tax law for treating LLCs and S-Corps
21 differently than C-Corps. Staff believes that the Company is misguided to claim the advantages of a
22 pass-through entity, as well as the benefits associated with being a C-corporation. Staff argues that if
23 the Company wants the ability to include income tax expense in rates it can change from an LLC to a
24

25 ⁵⁹ Staff does not believe that the evidence the Company presented that purports to demonstrate that the utility had reported
26 taxable income to the shareholders and that the shareholders actually paid income taxes on that income or were subject to
27 the prospect of taxation, disposes of the issue because the lack of such evidence was not the only basis for the Sunrise
28 Water or Farmers Water Decisions.

⁶⁰ Ex. A-15, Appendix D.

⁶¹ Staff Closing Brief at 14.

⁶² Id.

1 C-Corp.”⁶³ Staff asserts that the IRS does not consider the difference between a pass-through entity
 2 and C-Corp to be a mere technical distinction and neither does Staff. Staff notes that even SWC
 3 admits that by including income taxes in the revenue requirements of an LLC or S-Corp, the
 4 ratepayers end up paying the personal income taxes of the company’s owners.⁶⁴

5 Staff argues that limiting the allowance of Income Tax Expense to taxable entities does not
 6 result in discriminatory ratemaking. Staff argues that the Company’s claim that limiting ratemaking
 7 recognition and recovery of income tax expense to taxable entities puts form over substance⁶⁵ is
 8 misguided. Staff argues that the important distinction is that while owners of S-corporations and
 9 LLCs are entitled to a return on their investment, income taxes are not an expense of the entities and
 10 therefore should not be included in their revenue requirement determination. Staff believes that to
 11 allow these entities to recover income taxes would be like allowing the recovery of the income tax
 12 obligation of the individual shareholders of C-corporations.⁶⁶ Staff believes that to allow recovery of
 13 an income tax expense would be giving preferential treatment to S-corporations or LLCs, and that the
 14 Company is requesting that the Commission “follow the income taxes, and ascertain if paid, and by
 15 whom.”⁶⁷

16 3. Resolution

17 As an LLC, SWC does not pay income taxes. It has long been the policy of this Commission
 18 not to impute a hypothetical income tax expenses to “pass through” entities such as SWC. SWC’s
 19 owners chose the business form they believed was beneficial to the owners, and knew, or should have
 20 known about the long-standing Commission policy. Regardless of the members’ knowledge,
 21 however, we find that it is fair and reasonable to continue the Commission policy not to impute an
 22 income tax expense when the utility is a pass-through entity for tax purposes.

23 The Company argues that S-corps and LLCs and C-Corps should be treated the same with
 24 respect to allowing an income tax expense. The situation is distinct from a C corporation that is part
 25 of a corporate structure where taxes are paid at the parent level, as the tax obligation of the C

26 ⁶³ Id. at 15.

27 ⁶⁴ Ex A-6 at 20, cited in Staff’s Opening Brief at 15.

28 ⁶⁵ See SWC Brief at 14.

⁶⁶ Staff Reply Brief at 7.

⁶⁷ Staff Reply Brief at 7.

1 corporation is real. To calculate a hypothetical income tax expense for SWC, and pass that cost on to
2 ratepayers, is not in the public interest because of the uncertainty involved in calculating the
3 appropriate expense to determine a fair and reasonable rate. Moreover, the IRS treats S-Corps and
4 LLCs and C-Corps differently for tax purposes and it is not unreasonable for this Commission to also
5 recognize the differences in these forms of ownership for ratemaking purposes.

6 The shareholders of a C-Corp are taxed on the dividends received from the corporation. The
7 fact that the corporate entity pays taxes on its income and shareholders pay taxes on their dividends is
8 fashioned by some to be "double taxation," which is cited as a downside to the C-Corp form of
9 ownership. However, the C-Corp utility is able to recover its Income Tax Expense from ratepayers,
10 which is a benefit to C-Corp shareholders. There are many reasons investors choose to organize as a
11 C-Corp or S-Corp or LLC, of which tax consequences may be only one. The SWC owners are free to
12 choose the corporate form for the utility, but it is not unreasonable that they accept the less favorable
13 consequences of their choice, as well as the benefits.

14 **C. Rate Case Expense**

15 Staff and the Company agree on the total amount of the proposed rate case expense of
16 \$225,000, however, Staff proposed to normalize rate case expense over five years, for an annual
17 amount of \$45,000, while the Company proposes to amortize rate case expense over three years, for
18 an annual amount of \$75,000. There is a difference of opinion over the time period as well as
19 whether rate case expense should be "normalized" or "amortized." The distinction between
20 "normalization" and "amortization" is that under the former if within the normalization period, the
21 Company does not recover the entire \$225,000 rate case expense, it cannot seek to recover the
22 unrecovered amount. Under "amortization," any unamortized portion of the expense could be sought
23 to be recovered in the new rate case.

24 **1. SWC's Position**

25 The Company argues that although it hasn't been in for a rate case in fourteen years, it
26 expects to file a rate case more often than every 5 years.

27 SWC argues that Staff's five year normalization period is arbitrary, and asserts that the
28 Company's projection of a new rate case within three years is predicated on the unchallenged

1 testimony of its president, Mark Seamans, that SWC anticipates that the Company will incur
2 significant operating expenses and capital expenditures in the next year or two which will necessitate
3 rate relief. The Company asserts that based on the evidence, its proposed 3 year period is both
4 reasonable and appropriate.

5 The Company argues that its proposal to amortize the expense is more fair and that under
6 Staff's five year proposal, it would be unlikely that the Company will be able to fully recover its rate
7 case expense.⁶⁸

8 2. Staff's Position

9 Staff recommends normalizing the rate case expense over a five-year period. Staff states that
10 it usually normalizes rate case expense over a 3- to 5-year period. In this case, because the Company
11 has not been in for a rate case in 14 years, Staff believes that normalizing rate case expense over a 5-
12 year period is more appropriate.

13 Staff states that rate case expense is an operating expense that is included in rates at a
14 "normal" level for the test year. According to Staff, just as with any other "normalized" expense, it
15 should be reassessed in a subsequent rate filing to reflect the normal amount in rates. Staff asserts that
16 it is not a regulatory asset that is recovered over a specified time period. Staff states that since the
17 Company does not have a track record of filing rate applications at regular intervals, let alone any
18 track record, Staff believes that its recommended five year period is appropriate in this case. Staff
19 states the Company did not provide any particularized evidence prior to the hearing that would
20 warrant a shorter period. According to Staff, the risk of adopting a shorter time period is that SWC
21 may not file another rate application within 3 years and could over-collect its rate case expense.

22 3. Resolution

23 This Company does not have a track record upon which the Commission can rely to set a
24 reasonable time period to normalize the Rate Case Expense. The Company claims that the desire to
25 recover certain expenses associated with the arsenic treatment plant will motivate it to file a rate case
26 in three years. We do not have sufficient information to evaluate whether these costs will be a
27

28 ⁶⁸ SWC Reply Brief at 10-11.

1 sufficient motivator. We do know that this Company filed this rate case nine years after serving its
 2 first customer, (based on rates set many years earlier). In this case, we find that Staff's five year
 3 normalization period is reasonable, as it is approximately the result of dividing the years of providing
 4 service divided by the number of filed rate cases. Consequently, we authorize a Rate Case Expense
 5 of \$45,000, based on a normalization of \$225,000 over five years.

6 **D. Amortization Rate For Contributions in Aid of Construction**

7 Staff and the Company are in agreement regarding the CIAC balance of \$4,314,264, and the
 8 accumulated amortization balance of \$251,796. Staff and the Company dispute the amortization of
 9 rate for CIAC on a going forward basis.

10 **1. Staff's Position**

11 Staff asserts that when the exact amount of CIAC associated with each plant account is not
 12 known, the proper method for calculating a composite depreciation rate is to divide depreciation
 13 expense by depreciable plant.⁶⁹ Staff states that the Company is incorrect in its belief that non-
 14 depreciable plant items should be included in the composite rate calculated for the amortization of
 15 CIAC. First, Staff cites the NARUC USOA instruction for CIAC amortization which provides:

16 Amortization of contributions in aid of construction (CIAC), if recognized
 17 by the Commission, shall be credited to account 403 – Depreciation
 18 Expense. The concurrent debit is to account 272 – Accumulated
 19 Amortization of CIAC. The resulting balance in the depreciation expense
 20 account will be net of CIAC amortization. CIAC shall be amortized over
 a period equal to the estimated service life of the related contributed asset.
 A group composite or overall composite rate, whichever is applicable,
 may be used for CIAC that can not be directly related to a particular plant
 asset.

21 Staff states that although it may be true that a developer can contribute land, the NARUC
 22 instruction indicates that a composite rate is used for CIAC that can not be directly related to a
 23 particular plant asset. In this case, Staff states that its investigation showed that there is no CIAC
 24 associated with non-depreciable plant accounts.⁷⁰ Therefore, it is proper to exclude those accounts
 25 from the determination of the amortization rate.

26 Moreover, Staff states that the NARUC USOA directive that "CIAC shall be amortized over a
 27

28 ⁶⁹ Ex S-9 at 16.

⁷⁰ *Id.* at 18.

1 period equal to the estimated service life of the related contributed asset” also supports the exclusion
 2 of land value from the calculation, because land has an infinite service life, and essentially a zero
 3 amortization rate.

4 **2. SWC’s Position**

5 The Company believes Staff’s position on the composite amortization rate is inconsistent with
 6 Staff’s acceptance of the accumulated CIAC amortization balance at the end of the test year, and that
 7 the inconsistency will have a detrimental impact on SWC. According to the Company, the \$251,796
 8 accumulated CIAC amortization balance is based on a composite CIAC amortization rate which
 9 includes all plant, not just SWC’s depreciable plant. The Company argues that Staff’s position,
 10 which on a going-forward basis uses a composite CIAC amortization rate that only includes
 11 depreciable plant, but which is applied to a CIAC amount that includes all plant, not just depreciable
 12 plant, is not “revenue neutral” and results in a negative cash flow for the Company. The Company
 13 argues that for purposes of “going forward” and in order to be conceptually consistent, the composite
 14 CIAC amortization rate should be developed and applied either including or excluding non-
 15 depreciable plant both in the calculation and the application of the composite rate.

16 **3. Resolution**

17 The issue of a composite CIAC amortization rate is relevant when specific CIAC assets
 18 cannot be identified. Staff admits that CIAC can include land and other non-depreciable assets.⁷¹
 19 Staff does not believe that the CIAC in this case includes land because Staff was shown a warranty
 20 deed and purchase price for the land.⁷² A developer can contribute funds which are then used to
 21 invest in a wide range of assets. The fact that the Company has a deed for the land does not by itself
 22 establish the origin of the funds used to acquire the property. Without more, we accept the
 23 Company’s claim that specific plant cannot be identified as either CIAC or non-CIAC plant.

24 When as in this case, the CIAC balance was determined by including non-depreciable assets,
 25 and assigning them a zero percent amortization rate, it is reasonable to continue utilizing that
 26 methodology in order to be consistent. Being inconsistent in methodologies has negative cash flow

27 _____
 28 ⁷¹ *Id.*

⁷² *Id.*

1 results for the Company.⁷³ There is no demonstrated harm to rate payers from adopting the
 2 Company's methodology. Staff relies on the wording of the NARUC USOA and extrapolates that
 3 because the USOA refers to the service life of the relevant assets, that assets with an infinite life, such
 4 as land, should be excluded, rather than afforded a zero amortization rate. Without more indicia that
 5 the Company's method is incorrect under the NARUC USOA, we will adopt the Company's
 6 methodology in this case. To be consistent under Staff's proposed methodology, the CIAC balance
 7 would need to be recalculated. While such calculation is possible, it was not provided by either party
 8 in this proceeding.

9 **E. Test Year Operating Income**

10	Test Year Operating Revenue	\$2,215,143
11	Operating Expenses	
12	Purchased Wastewater Treatment	4,256
13	Sludge Removal Expense	147,364
14	Fuel for Power Production	11,866
15	Chemicals	75,423
16	Materials and Supplies	30,131
17	Contractual Services	635,442
18	Equipment Rental	10,382
19	Rents	1,896
20	Transportation	22,358
21	General Liability Insurance	21,111
22	Rate Case Expense	45,000
23	Miscellaneous	14,724
24	Bad Debt Expense	109
25	Depreciation	673,842
26	Taxes Other than Income	11,602

27

28 ⁷³ Ex A-6 at 7.

1	Property Taxes	103,864
2	Total Operating Expenses	1,809,370
3	Operating Income	405,773

4 **III. Cost of Capital**

5 **A. SWC's Position**

6 The Company's recommended capital structure consists of 18 percent debt and 82 percent
7 common equity. Based on a 10.9 percent recommended cost of equity and 4.2 percent cost of debt,
8 the Company proposes a weighted cost of capital of 9.69 percent. SWC argues that a return on equity
9 of 10.9 percent is fair and reasonable and takes into account SWC's financial and business risk.⁷⁴
10 The Company's cost of capital witness, Mr. Bourassa, applied the Discounted Cash Flow ("DCF")
11 model and Capital Asset Pricing Model ("CAPM") to the sample group of publicly traded water
12 utilities that are typically utilized by Staff and accepted by the Commission. He adjusted the returns
13 produced by those models downward by 70 basis points to account for less debt in the Company's
14 capital structure and then adjusted it upward by 50 basis points to account for the Company's small
15 size, lack of investment liquidity and the additional risk the Company alleges arises from Arizona's
16 rate-making methodologies. The Company's analysis results in a range of results for the cost of
17 equity from 9.6 percent to 12.4 percent, and the Company proposes a cost of equity near the midpoint
18 of the range.⁷⁵

19 The Company believes Staff's cost of capital witness failed to consider or accord appropriate
20 weight to several substantive factors that have a bearing on SWC's cost of equity. First, the
21 Company believes that Staff did not account for SWC being riskier than the publicly traded utilities
22 because of its small size, lack of liquidity and Arizona's "unfavorable regulatory climate." Second,
23 the Company argues that Staff double-counts historic growth rates in estimating future dividend
24 growth rates in the DCF model which tends to depress the DCF results, and fails to utilize analyst
25 forecasts, which the Company argues is the best estimate of expected dividend growth. Third, the
26 Company objects to Staff determining an after-tax rate of return, while recommending disallowing

27 _____
28 ⁷⁴ Ex A-7 at 6.

⁷⁵ SWC Opening Brief at 28.

1 income tax expense; the Company argues that the comparison to publicly traded water utilities is only
2 meaningful when SWC's earnings are determined on an after-tax basis, and that when income taxes
3 are disallowed, the cash flows available for dividends are significantly reduced and the value of an
4 investment in SWC is significantly diminished. Fourth, the Company claims that based on Staff's
5 recommendations, including the exclusion of Well No. 23, exclusion of Income Tax Expense, and
6 Staff's recommendation for a 9.2 percent overall rate of return, the Company will not have sufficient
7 earnings to pay dividends at a level comparable to the publicly traded utilities in the sample, and will
8 not be able to attract future capital. The Company argues that Staff's recommendations fail to meet
9 the standards set forth in the *Hope*⁷⁶ and *Bluefield*⁷⁷ decisions.⁷⁸

10 **B. Staff's Position**

11 Staff recommends an overall rate of return of 9.2 percent based on a 10.3 percent cost of
12 equity and 4.2 percent cost of debt, and a capital structure of 82.2 percent equity and 17.8 percent
13 debt. Staff states its recommended capital structure represents the Company's updated capital
14 structure as of February 23, 2010. Staff utilized both the DCF and CAPM to determine its
15 recommended cost of equity and argues its assumptions are well-founded and have been accepted by
16 the Commission in recent proceedings.

17 Staff utilized both the Constant Growth DSC and Multi-Stage DCF to determine its DCF
18 estimated cost of equity. Staff believes that analysts' forecasts are known to be overly optimistic and
19 that heavy reliance on analysts' forecasts inflates growth, and thus the cost of equity, and assumes
20 that investors discount other relevant information.⁷⁹ Staff asserts that its estimated DCF cost of equity
21 gives equal weight to historical data and analysts' forecasts. Staff also criticizes the Company's use
22 of only five years of historical data in calculating the DCF dividend growth rate, because Staff's
23 witness believed it may be too limited a period to capture a full business cycle.

24 Staff argues that the Company's claim that if it is denied recovery of income tax expense it
25 will be disadvantaged compared to a tax-paying entity, ignores the fact that investors in a tax-paying

26 _____
27 ⁷⁶ *Federal Power Comm'n v. Hope Natural Gas*, 320 U.S. 591 (1944).

⁷⁷ *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923).

⁷⁸ Ex A-7 at 4-5.

⁷⁹ Ex S-5 at 34-35.

1 entity also are liable for any individual income attributable to the tax-paying corporation.”⁸⁰ Thus,
 2 Staff claims that for an investor looking only at the tax issue, an entity that does not pay taxes is
 3 actually less risky than one subject to “double taxation.”⁸¹ Staff states that if the Commission were to
 4 accept the request to include an allowance for income taxes, the allowed return on equity should be
 5 lower than Staff’s current recommendation to account for the lower risk.

6 In addition, Staff argues that firm-specific risk should not be considered when determining
 7 cost of equity. Mr. Manrique asserts that unique regulatory environments are firm-specific risks for
 8 which investors cannot expect compensation and can be diversified away by investors.⁸² Staff does
 9 not accept that Arizona’s regulatory environment is disadvantageous to utilities and asserts that every
 10 regulatory jurisdiction has its own framework with its own specific advantages and disadvantages.

11 Staff argues that the Company is not entitled to a higher cost of capital if Well No. 23 is not
 12 included in rate base. Staff notes that the Arizona Supreme Court has held:

13 The amount of capital invested is immaterial. Under the law of fair value,
 14 a utility is not entitled to a fair return on its investment; it is entitled to a
 15 fair return on the fair value of its properties devoted to the public use, no
 more and no less.⁸³

16 Staff notes that the Commission has broad discretion in determining just and reasonable rates
 17 to ascertain the fair value of the utility’s property, and establish rates that meet the overall operating
 18 costs of the utility and produce a reasonable rate of return.⁸⁴ Staff argues that the Company is not
 19 entitled to earn a return on investments in plant that are not used and useful, and since Well No. 23 is
 20 not used and useful, SWC should not earn a return on it. Staff asserts that the Company’s investment
 21 in a well which in Staff’s opinion is not needed at this time is not “efficient and economical
 22 management” as contemplated in the *Bluefield* decision.

23 c. Resolution

24 Considering the entire record in this case, long-held Commission practices, as well as other
 25 recent Decisions of this Commission, we find that Staff’s recommended capital structure of 17.8

26 ⁸⁰ Staff Closing Brief at 21.

⁸¹ *Id.*

27 ⁸² Ex S-6 at 3, Ex S-5 at 12 and 41.

⁸³ *Arizona Corp. Commission v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412 (Ariz. 1959); cited by *City of Tucson v. Citizens Utilities Water Co.*, 17 Ariz. App. 477, 482, 498 P.2d 551, 556 (Ariz. App. 1972).

28 ⁸⁴ *Citing Scates, et al v. Arizona Corp. Comm’n*, 118 Ariz. 532, 534 (Ariz. App. 1978).

1 percent debt and 82.2 percent equity, and a weighted cost of capital of 9.2 percent, based on a cost of
2 equity of 10.3 percent, and cost of debt of 4.2 percent, is reasonable and should be adopted.

3 The fact that SWC's owners have decided to utilize a pass-through tax entity and selected a
4 test year that does not encompass all the plant they believe they are using to provide service, are not
5 bases for authorizing a higher return.

6 IV. REVENUE REQUIREMENT

7 Based on the foregoing, and as summarized below, we authorize an annual revenue level of
8 \$2,619,482, which is an increase of \$404,339, or 18.25 percent, over test year revenues:

9		
10	Adjusted Rate Base	\$8,805,561
11	Adjusted operating Income	405,773
12	Current Rate of Return	4.61
13	Required Rate of Return	9.2%
14	Required Operating Income	810,112
15	Operating Income Deficiency	404,339
16	Gross Revenue Conversion Factor	1.0000
17	Required Revenue Increase	404,339
18	Adjusted Test Year Revenue	2,215,143
19	Proposed Annual Revenue	2,619,482
20	Required Increase in Revenue (%)	18.25%

21 V. RATE DESIGN

22 A. Current and Proposed Rates

23 The Company's current rates, and those proposed by the parties based on their recommended
24 revenue requirements are as follows:

25	Present	Company	Staff
26	<u>Rates</u>	<u>Proposed</u>	<u>Recommended</u>
26	<u>MONTHLY USAGE CHARGE:</u>		
27	<u>All Classes</u>		
27	5/8" x 3/4" Meter	\$16.00	\$24.75
28	3/4" Meter	25.00	37.19
			\$16.00
			25.00

1	1" Meter	40.00	61.88	40.00
	1-1/2" Meter	75.00	123.76	80.00
2	2" Meter	120.00	198.02	128.00
	3" Meter	225.00	396.03	256.00
3	4" Meter	375.00	618.80	400.00
4	6" Meter	750.00	1,237.80	800.00
5	<u>COMMODITY RATES (per 1,000 Gallons)</u>			
6	<u>5/8" X 3/4" Meter (All Classes, Except Standpipe/Construction)</u>			
7	First 6,000	\$2.05	N/A	N/A
	Over 6,000	2.75	N/A	N/A
8	<u>5/8" x 3/4" Meter (Residential)</u>			
9	First 4,000	N/A	\$3.40	N/A
	4,001 to 10,000	N/A	4.29	N/A
10	Over 10,000	N/A	5.04	N/A
11	First 3,000	N/A	N/A	2.3100
	3,001 to 9,000	N/A	N/A	3.4760
12	Over 9,000	N/A	N/A	4.1660
13	<u>5/8" x 3/4" Meter (Commercial/Industrial)</u>			
	First 10,000	N/A	4.29	N/A
14	Over 10,000	N/A	5.04	N/A
15	First 9,000	N/A	N/A	3.4760
	Over 9,000	N/A	N/A	4.1660
16	<u>3/4" Meter (Residential)</u>			
17	First 6,000	N/A	\$3.40	N/A
	6,001 to 10,000	N/A	4.29	N/A
18	Over 15,000	N/A	5.04	N/A
19	First 3,000	N/A	N/A	2.3100
	3,001 to 9,000	N/A	N/A	3.4760
20	Over 9,000	N/A	N/A	4.1660
21	<u>3/4" Meter (Commercial/Industrial)</u>			
	First 15,000	N/A	4.29	N/A
22	Over 15,000	N/A	5.04	N/A
23	First 9,000	N/A	N/A	3.4760
	Over 9,000	N/A	N/A	4.1660
24	<u>1" Meter (All Classes, Except Standpipe/Construction)</u>			
25	First 6,000	\$2.05	N/A	N/A
26	Over 6,000	2.75	N/A	N/A
	<u>1" Meter (Residential)</u>			
27	First 10,000	N/A	\$3.40	N/A
28	10,001 to 25,000	N/A	4.29	N/A

1	Over 25,000	N/A	5.04	N/A
2	First 20,000	N/A	N/A	3.4760
	Over 20,000	N/A	N/A	4.1660
3	<u>1" Meter (Commercial)</u>			
	First 25,000	N/A	N/A	N/A
4	Over 25,000	N/A	N/A	N/A
5	First 20,000	N/A	N/A	3.4760
6	Over 20,000	N/A	N/A	4.1660
	<u>1" Meter (Commercial/Irrigation)</u>			
7	First 10,000	N/A	3.04	N/A
8	10,001 to 25,0000	N/A	3.99	N/A
9	First 20,000	N/A	N/A	3.4760
	Over 20,000	N/A	N/A	4.1660
10	<u>1.5" Meter (All Classes, Except Standpipe/Construction)</u>			
11	First 6,000	\$2.05	N/A	N/A
12	Over 6,000	2.75	N/A	N/A
13	First 50,000	N/A	\$3.40	N/A
	Over 50,000	N/A	3.99	N/A
14	First 55,000	N/A	N/A	3.4760
15	Over 55,000	N/A	N/A	4.1660
16	<u>2" Meter (All Classes, Except Standpipe/Construction)</u>			
17	First 6,000	\$2.05	N/A	N/A
	Over 6,000	2.75	N/A	N/A
18	First 80,0000	N/A	\$3.40	N/A
19	Over 80,000	N/A	3.99	N/A
20	First 90,000	N/A	N/A	3.4760
21	Over 90,000	N/A	N/A	4.1660
22	<u>3" Meter (All Classes, Except Standpipe/Construction)</u>			
23	First 6,000	\$2.05	N/A	N/A
	Over 6,000	2.75	N/A	N/A
24	First 160,0000	N/A	\$3.40	N/A
25	Over 160,000	N/A	3.99	N/A
26	First 200,000	N/A	N/A	3.4760
27	Over 200,000	N/A	N/A	4.1660
28				

4" Meter (All Classes, Except Standpipe/Construction)

1	First 6,000	\$2.05	N/A	N/A
2	Over 6,000	2.75	N/A	N/A
3	First 250,000	N/A	\$3.40	N/A
4	Over 250,000	N/A	3.99	N/A
5	First 350,000	N/A	N/A	3.4760
6	Over 350,000	N/A	N/A	4.1660

6" Meter (All Classes, Except Standpipe/Construction)

7	First 6,000	\$2.05	N/A	N/A
8	Over 6,000	2.75	N/A	N/A
9	First 500,000	N/A	\$3.40	N/A
10	Over 500,000	N/A	3.99	N/A
11	First 750,000	N/A	N/A	3.4760
12	Over 750,000	N/A	N/A	4.1660

Standpipe (Construction)

13	All Usage	4.50	5.04	4.1660
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	<u>Company</u>			<u>Staff Recommended</u>				
	Total Present Charge	Proposed Service Line Charge	Proposed Meter Installation Charge	Total Proposed Charge	Recommended Service Line Charge	Recommended Meter Installation Charge	Total Recommended Charge	
15	5/8" x 3/4" Meter	\$ 317.50	\$ 445.00	\$ 155.00	\$ 600.00	\$ 445.00	\$ 155.00	\$ 600.00
16	3/4" Meter	352.50	445.00	255.00	700.00	445.00	255.00	700.00
17	1" Meter	402.50	495.00	315.00	810.00	495.00	315.00	810.00
18	1-1/2" Meter	597.50	550.00	525.00	1,075.00	550.00	525.00	1,075.00
19	2" Turbine	997.50	830.00	1,045.00	1,875.00	830.00	1,045.00	1,875.00
20	2" Compound	1,487.50	830.00	1,890.00	2,720.00	830.00	1,890.00	2,720.00
21	3" Turbine	1,377.50	1,045.00	1,670.00	2,715.00	1,045.00	1,670.00	2,715.00
22	3" Compound	1,927.50	1,165.00	2,545.00	3,710.00	1,165.00	2,545.00	3,710.00
23	4" Turbine	2,207.50	1,490.00	2,670.00	4,160.00	1,490.00	2,670.00	4,160.00
24	4" Compound	2,822.50	1,670.00	3,645.00	5,315.00	1,670.00	3,645.00	5,315.00
25	6" Turbine	4,217.50	2,210.00	5,025.00	7,235.00	2,210.00	5,025.00	7,235.00
26	6" Compound	5,497.50	2,330.00	6,920.00	9,250.00	2,330.00	6,920.00	9,250.00
27	Over 6'	N/A	At Cost	At Cost	At Cost	At Cost	At Cost	At Cost

SERVICE CHARGES:

	<u>Present Rates</u>	<u>Company Proposed</u>	<u>Staff Recommended</u>	
23	Establishment	\$25.00	\$25.00	\$25.00
24	Establishment (After Hours)	40.00	40.00	40.00
25	Reconnection (Delinquent)	25.00	25.00	25.00
26	Reconnection (Delinquent and After Hours)		40.00	40.00
27	NSF Check	15.00	15.00	15.00
28	Meter Test (If Correct)	25.00	25.00	25.00
	Deposit	*	*	*
	Deposit Interest	6%	1%	6%
	Reestablishment (within 12 months)	***	***	***

1	Late Payment Penalty	\$5.00	\$5.00 or 1.5% per month	\$5.00 or 1.5% per month
2	Deferred Payment	1.5% per month	1.5% per month	1.5% per month
3	Moving Meter at Customer Request	At Cost	At Cost	At Cost
4	Main Extension and Additional Facilities	At Cost	At Cost	At Cost

- 5 * Per Commission Rule A.A.C. R14-2-403(B)
- ** Per Commission Rule A.A.C. R14-2-403(B)
- 6 *** Per Commission Rule A.A.C. R-14-2-403(D) – Months off the system times the monthly minimum.

B. SWC’s Position

7 SWC argues that Staff’s proposed rate design shifts recovery from the monthly minimum and
 8 the 5/8 inch residential meter customer class to small commercial and irrigation customers and to
 9 larger metered customers. SWC asserts that Staff has no cost-of-service study to support its position.

10 SWC argues that although cost of service is not the only criterion for designing rates, it is an
 11 important and relevant one. SWC believes this is particularly so when the goal is to provide the utility
 12 a reasonable opportunity to (1) fully recover its recognized operating expenses, and (2) realize the
 13 authorized rate of return. The Company argues that the *Bluefield* and *Hope* decisions establish that a
 14 utility is entitled to a reasonable opportunity to earn its authorized return, but that Staff has not
 15 demonstrated that its proposed rate design satisfies this legal requirement.

16 SWC argues that Staff’s claim that larger customers and larger consumption cause more wear
 17 and tear on assets does not “hold water” when evaluated in the context of SWC’s customer
 18 characteristics. SWC states that its system is predominately comprised of 5/8 inch meter residential
 19 customers who imposed more “wear and tear” in the aggregate than the other classes of customers.
 20 Thus, the Company argues, it is not appropriate to ignore this reality when assigning cost recovery
 21 responsibility.

22 Third, the Company believes that in the current economic situation, it is likely that SWC’s
 23 larger meter sizes and higher volume customers will reduce their future consumption under Staff’s
 24 proposed rate design. The Company asserts that reduced consumption by larger customers in
 25 combination with the alleged under-recovery of costs resulting from Staff’s proposed monthly
 26 minimums, increases the risk of SWC not being given a reasonable opportunity to fully recover its
 27 operating costs and realizing its authorized rate of return.

1 **C. Staff's Position**

2 Staff claims its proposed rate design is typical of the designs it has proposed in other rate
3 cases. Staff asserts that SWC did not offer any evidence that Staff's rate design will cause revenue
4 instability.⁸⁵ Staff admits its rate design shifts revenue recovery away from the monthly minimum
5 and the 5/8 inch meter residential class to small commercial and irrigation customers and the larger
6 meter classes,⁸⁶ but asserts that cost of service is not the only basis for rate design, and that the higher
7 volume users place more wear and tear on the system.⁸⁷

8 **D. Resolution**

9 The residential class comprised approximately 97 percent of the total number of connections
10 in this test year.⁸⁸ Under the existing rates, for the residential class, the monthly fixed charge was
11 responsible for 58.4 percent of the revenue from the residential class, while the commodity portion
12 comprised 41.6 percent. Under the Company's Rejoinder position, for the residential class, the
13 monthly fixed charge comprises 55.9 percent of the revenues for the class and the commodity charge
14 is 44.1 percent of the total. Under the rates set forth herein below, for the residential class, the
15 monthly fixed charge would comprise 50.6 percent of total residential revenues and the commodity
16 charge would comprise 49.4 percent.

17 The current rates for this Company were set many years before it actually provided service.
18 The portion of revenues derived from the fixed charge under the current rates is more heavily
19 dependent on the fixed charges than the Commission typically approves. The proportion of revenues
20 derived from the fixed monthly charges and commodity charges under the rates approved herein is a
21 step toward a more balanced rate structure.

22 Based on the revenue level approved herein, we adopt rates and charges as set forth below.

23 **MONTHLY USAGE CHARGE:**

24 **All Classes**

24	5/8" x 3/4" Meter	\$16.00
	3/4" Meter	25.00
25	1" Meter	40.00
26	1-1/2" Meter	80.00

27 ⁸⁵ Staff Closing Brief at 18.

⁸⁶ *Id.*

⁸⁷ Tr. at 188-89; Staff's Closing Brief at 18.

28 ⁸⁸ Ex A-6 at H-2 p 2.

1	2" Meter	128.00
	3" Meter	256.00
2	4" Meter	400.00
	6" Meter	800.00
3		
4	<u>COMMODITY RATES (per 1,000 Gallons)</u>	
5	<u>5/8" X 3/4" Meter (All Classes, Except</u>	
6	<u>Standpipe/Construction)</u>	
7	<u>5/8" x 3/4" Meter (Residential)</u>	
8	First 3,000	2.33
9	3,001 to 9,000	3.50
	Over 9,000	4.20
10	<u>5/8" x 3/4" Meter (Commercial/Industrial)</u>	
11	First 9,000	3.50
12	Over 9,000	4.20
13	<u>3/4" Meter (Residential)</u>	
14	First 3,000	2.33
15	3,001 to 9,000	3.50
	Over 9,000	4.20
16	<u>3/4" Meter (Commercial/Industrial)</u>	
17	First 9,000	3.50
18	Over 9,000	4.20
19	<u>1" Meter (Residential)</u>	
20	First 20,000	3.50
	Over 20,000	4.20
21	<u>1" Meter (Commercial)</u>	
22	First 20,000	3.50
	Over 20,000	4.20
23	<u>1" Meter (Commercial/Irrigation)</u>	
24	First 20,000	3.50
25	Over 20,000	4.20
26	<u>1.5" Meter (All Classes, Except</u>	
	<u>Standpipe/Construction)</u>	
27	First 55,000	3.50
28	Over 55,000	4.20

1 **2" Meter (All Classes, Except**
 2 **Standpipe/Construction)**

3 First 90,000 3.50
 4 Over 90,000 4.20

5 **3" Meter (All Classes, Except**
 6 **Standpipe/Construction)**

7 First 200,000 3.50
 8 Over 200,000 4.20

9 **4" Meter (All Classes, Except**
 10 **Standpipe/Construction)**

11 First 350,000 3.50
 12 Over 350,000 4.20

13 **6" Meter (All Classes, Except**
 14 **Standpipe/Construction)**

15 First 750,000 3.50
 16 Over 750,000 4.20

17 **Standpipe (Construction)**

18 All Usage 4.20

19 **SERVICE LINE AND METER INSTALLATION CHARGES**
 20 **(Refundable Pursuant to A.A.C. R14-2-405)**

	Service Line Charge	Meter Installation Charge	Total Charge
21 5/8" x 3/4 " Meter	\$ 445.00	\$ 155.00	\$ 600.00
22 3/4 " Meter	445.00	255.00	700.00
23 1" Meter	495.00	315.00	810.00
24 1-1/2" Meter	550.00	525.00	1,075.00
25 2" Turbine	830.00	1,045.00	1,875.00
26 2" Compound	830.00	1,890.00	2,720.00
27 3" Turbine	1,045.00	1,670.00	2,715.00
28 3" Compound	1,165.00	2,545.00	3,710.00
29 4" Turbine	1,490.00	2,670.00	4,160.00
30 4" Compound	1,670.00	3,645.00	5,315.00
31 6" Turbine	2,210.00	5,025.00	7,235.00
32 6" Compound	2,330.00	6,920.00	9,250.00
33 Over 6'	At Cost	At Cost	At Cost

34 **SERVICE CHARGES:**

35 Establishment \$25.00
 36 Establishment (After Hours) 40.00
 37 Reconnection (Delinquent) 25.00
 38 Reconnection (Delinquent and After Hours) 40.00
 39 NSF Check 15.00

1	Meter Test (If Correct)	25.00
	Deposit	*
2	Deposit Interest	6%
	Reestablishment (within 12 months)	***
3	Late Payment Penalty	\$5.00 or 1.5% per month
4	Deferred Payment	1.5% per month
5	Moving Meter at Customer Request	At Cost
	Main Extension and Additional Facilities	At Cost

6 * Per Commission Rule A.A.C. R14-2-403(B)
 7 ** Per Commission Rule A.A.C. R14-2-403(B)
 8 *** Per Commission Rule A.A.C. R-14-2-403(D) – Months off the system times the monthly minimum.

8 While the increase in the commodity charge may encourage conservation among the larger
 9 users, we do not believe that increase will have a detrimental effect on the Company’s ability to earn
 10 is authorized return. The magnitude of the overall increase in revenues approved herein is
 11 significantly less than requested by the Company.

12 Under the rates approved herein, a median 5/8 x 3/4 inch meter residential customer using
 13 5,000 gallons a month, would see a monthly increase of \$3.74, or 14.25 percent, from \$26.25 to
 14 \$29.00. An average 5/8 x 3/4 inch meter residential customer using 5,424 gallons, would see a
 15 monthly increase of \$4.35, or 16.06 percent, from \$27.12 to \$31.47.

16 **V. OTHER ISSUES**

17 **A. The Central Arizona Groundwater Replenishment District (“CAGR D”) Fee**
 18 **Adjustor**

19 The Company urges the Commission to adopt its proposed CAGR D Fee Adjustor together
 20 with the compliance conditions proposed by Staff. The Company’s revised proposed CAGR D Fee
 21 Adjustor is as follows:

- 22 1. The adjustor fee s hall apply to all water sold after October 1, 2010, or shall
 23 become effective on the date new rates from this case become effective, whichever
 24 is later.
- 25 2. The Company shall, on a monthly basis, place all CAGR D monies collected from
 26 customers in a separate, interest-bearing account (“CAGR D Account”).
- 27 3. The only time the Company can withdraw money form the CADRD Account is to
 28 pay the annual CAGR D fee to the CAGR D, which is due on October 15th of each
 year.
4. The Company must provide to Staff a semi-annual report of the CAGR D account
 and CAGR D use fees collected from customers and paid to the CAGR D, with the

1 reports due during the last week of October and the last week of April of each
2 year.

- 3
- 4 5. The Company must provide to Staff, every June 30th, the new firm rates set by the
5 CAGR D for the following years.
- 6
- 7 6. The CAGR D fees for the most current year in the Tucson Active Management
8 Area (AMA) shall be divided by the gallons sold in that year to determine a
9 CAGR D fee per 1,000 gallons. This information shall be given to Staff, 60 days
10 prior to when the Company requests the adjustor to take effect. In addition, the
11 Company will provide Staff with supporting documentation from the relevant state
12 agencies, and gallons sold date. Failure to provide this information to Staff shall
13 result in the immediate cessation of the CAGR D adjustor fee.
- 14
- 15 7. By August 25th of each year, beginning in 2011, the Company shall submit its
16 proposed CAGR D adjustor fee for the Tucson AMA for review and approval by
17 the Commission, with the Commission-approved amount becoming effective the
18 following October 1st.
- 19
- 20 8. If the CAGR D changes its current method of assessing fees, (i.e. based on the
21 current volume of water used by customers) to some other method, such as, but not
22 limited to, future projection or water usage, or total water allocated to the
23 Company, the Company's collection from customers of CAGR D fees shall
24 continue under the CAGR D fee adjustor methodology previously approved by the
25 Commission until a revised methodology reflecting such change in CAGR D's
26 assessment methodology is approved by the Commission. In the event such
27 continued collection under the previously authorized methodology during the
28 interim period results in an over-collection or under-collection under the new
29 methodology approved by the Commission, the Company will "true up" such
30 over-collection or under-collection prior to its compliance with Condition No. 7 of
31 the following year.
- 32
- 33 9. As a compliance item, the Company shall submit yearly, a new tariff reflecting
34 the reset adjustor amount.

35 The parties are in agreement over every condition, except for Condition No. 8.⁸⁹ Staff
36 recommends the following for Condition No. 8:⁹⁰

37 If the CAGR D changes its current method of assessing fees, (i.e.
38 based on the current volume of water used by the customer) to
39 some other method, such as, but not limited to, future projection of
40 water usage, or total water allocated to the Company, the
41 Company's collection from customers of CAGR D shall cease.

42 The Company is concerned that it be allowed to continue to recover fees it paid to CAGR D.
43 The Company believes that given that the fees represent a significant operating expense and because
44 no one knows how long it would take for the Commission to consider and approve a revised CAGR D
45 Adjustor, it is reasonable to allow SWC to continue to recover fees under the previously approved
46 Adjustor, it is reasonable to allow SWC to continue to recover fees under the previously approved
47 Adjustor, it is reasonable to allow SWC to continue to recover fees under the previously approved
48 Adjustor, it is reasonable to allow SWC to continue to recover fees under the previously approved

49 ⁸⁹ SWC Reply Brief at 19.

50 ⁹⁰ Staff Opening Brief at 27; Staff Reply Brief at 14.

1 CAGR D adjustor until the Commission approves a replacement. SWC believes that the strong
2 likelihood is that CAGR D fees will steadily increase and the risk of over-collection is slight. SWC
3 argues that the risk of over-collection is eliminated by means of the annual "true up" which it
4 proposes in connection with its compliance with Condition No. 7.

5 Staff believes that the Company's concern, that if the CAGR D changes its method of
6 assessing fees that the Company's ability to recover CAGR D fees would cease immediately, is
7 unfounded. Staff notes that it is highly unlikely the CAGR D would implement an "abrupt change."
8 Staff believes that its recommended Condition No. 8 is needed because this is a new adjustor
9 mechanism with which Staff has no expertise. Thus, there is no track record or history of how this
10 adjustor will operate, and if the CAGR D changes the way it calculates fees, Staff would have to
11 analyze any change and recommend modifications to the adjustor mechanism. Staff is concerned that
12 under the Company's request, if CAGR D does make such a change, SWC would continue to collect
13 money from ratepayers under the old adjustor that may not represent the new fees imposed by the
14 CAGR D. Staff recommends approval of the CAGR D fees, but only if all of Staff's recommended
15 conditions are also approved. Staff notes further that in the recent Johnson Utilities case, the
16 Commission approved Staff's recommended CAGR D adjustor mechanism inclusive of all
17 conditions.⁹¹ Staff believes that standardization among companies is important, and Staff does not
18 believe that the Company has offered any evidence that warrants deviating from Staff's conditions.

19 We adopt the CAGR D adjustor mechanism as modified by Staff's recommendations for
20 Condition No. 8. This condition was included in the adjustor recently approved for Johnson Utilities
21 and we believe that because this is a new type of adjustor, standardization among utilities is in the
22 public interest.

23 **B. Arizona Department of Water Resources (ADWR") Best Management Practices**
24 **("BMPs")**

25 In Decision No, 70620, the Commission ordered SWC to file eleven ADWR BMPs by
26 December 31, 2009. In this proceeding, Staff's witness, Marlin Scott, testified that Staff and SWC
27

28 ⁹¹ Decision No. 71854 at 44.

1 agreed to revised formatting and certain language of the BMPs previously filed, and that Staff
2 recommends approving the Company's BMPs with the exception of BMP 7.8.⁹² According to Mr.
3 Scott, this BMP will only become effective if and when it is approved by ADWR, and he
4 recommends that if BMP 7.8 is not approved by ADWR by July 1, 2011, the Company should submit
5 a replacement BMP for Commission consideration.

6 The Company believes that there are no differences of opinion between the Company and
7 Staff concerning the BMPs that SWC has selected. SWC requests that the Order in this proceeding
8 find that SWC has complied with the applicable provision of Decision No. 70620 and that Staff's
9 recommendations concerning the proposed BMPs be adopted.⁹³ SWC states if ADWR does not act
10 with respect to BMP 7.8, SWC would be willing to select a replacement BMP and states that it does
11 not need to be "required" to do so.

12 Staff believes that the Company has complied with the portion of Decision No. 70620 that
13 required the submission of BMPs. We concur. The Company accepts Staff's recommendations
14 concerning BMPs, and BMP 7.8 in particular.⁹⁴ Consequently, we approve Staff's recommendations.

15 * * * * *

16 Having considered the entire record herein and being fully advised in the premises, the
17 Commission finds, concludes, and orders that:

18 **FINDINGS OF FACT**

- 19 1. On July 17, 2009, SWC filed the above-captioned rate application with the
- 20 Commission.
- 21 2. On August 14, 2009, and September 14, 2009, Staff notified the Company that its
- 22 application was not sufficient under the requirements of the Arizona Administrative Code.
- 23 3. The Company filed additional information on August 21, 2009, and August 31, 2009.
- 24 4. On September 30, 2009, Staff notified the Company that its rate application was
- 25 sufficient, and classified the Company as a Class B utility.
- 26 5. By Procedural Order dated October 27, 2009, a hearing was set to commence on June

27 ⁹² S-2 at 8.
 28 ⁹³ SWC Opening Brief at 35.
⁹⁴ SWC Reply Brief at 16.

1 17, 2010, and other procedural guidelines were established.

2 6. On December 15, 2009, SWC filed certification that it mailed the public notice of the
3 hearing to its customers on December 4, 2009.

4 7. On March 9, 2010, Staff filed a request to modify the hearing schedule due to time
5 conflicts of one of its witnesses who was also preparing testimony in other pending rate case dockets.

6 8. Pursuant to the October 27, 2009, Procedural Order, a Public Comment meeting was
7 held in the Town of Sahuarita on March 11, 2010. Five customers gave public comments. The
8 Commission also received two written public comments opposing the magnitude of the proposed
9 increase.

10 9. By Procedural Order dated March 23, 2010, the hearing was continued until July 19,
11 2010, and the testimony filing deadlines extended.

12 10. On April 22, 2010, Staff filed the Direct Testimonies of Jeffrey Michlik, Juan
13 Manrique and Marlin Scott.

14 11. On April 29, 2010, Staff filed the Direct Rate Design Testimony of Mr. Michlik.

15 12. On May 18, 2010, SWC filed the Rebuttal Testimonies of Thomas Bourassa, Marian
16 Homiak, Mark Taylor and David Cutler.

17 13. On June 8, 2010, Staff requested modification of the testimony schedule, which was
18 granted by Procedural Order dated June 9, 2010.

19 14. On June 17, 2010 (the originally scheduled and noticed hearing date) the Commission
20 convened for the purpose of taking public comment. One customer appeared to oppose the proposed
21 increase.

22 15. On June 21, 2010, Staff filed the Surrebuttal Testimony of Mr. Michlik, Mr. Manrique
23 and Mr. Scott.

24 16. On July 12, 2010, SWC filed the Rejoinder Testimony of Mr. Bourassa, Mr. Seamans,
25 Mr. Taylor and Mr. Cutler.

26 17. On July 15, 2010, Staff filed a Notice of Errata to correct schedules to Michlik's
27 Rejoinder Testimony.

28 18. On July 19, 2010, the hearing in this matter convened as scheduled and extended over

1 three days at the Commission's Tucson office. At the time for public comment at the commencement
2 of the hearing, one customer appeared to give comments opposing the proposed increase.

3 19. On September 15, 2010, Staff filed its Closing Brief.

4 20. On September 16, 2010, SWC docketed its Closing Brief.

5 21. On September 30, 2010, SWC and Staff filed their Reply Briefs.

6 22. In the test year, SWC provided water service to approximately 4,700 customers in the
7 master planned community of Rancho Sahuarita located in the Town of Sahuarita, Arizona.

8 23. As discussed herein, SWC's FVRB is \$8,805,561.

9 24. In the test year ended December 31, 2008, SWC had adjusted Operating Income of
10 \$405,773, on total revenues of \$2,215,143, a 4.61 percent rate of return on its FVRB.

11 25. A WACC of 9.2 percent is fair and reasonable.

12 26. Based on the foregoing, SWC has a revenue requirement of \$2,619,482, a \$404,339
13 increase, or 18.25 percent, over test year revenues.

14 27. The proposed GAGRD Fee Adjustor Mechanism, as modified by Staff, is fair and
15 reasonable and should be approved, to become effective as of March 1, 2011.

16 28. SWC has complied with the directive in Decision No. 70620 that it file BMPs by
17 December 31, 2009, however, because proposed BMP 7.8 requires ADWR approval to become
18 effective, if ADWR does not approve it by June 30, 2011, it is reasonable to require SWC to submit
19 an alternative BMP for Commission consideration by September 30, 2011.

20 29. It is reasonable to require SWC to segregate Customer Security Deposits in a separate
21 interest-bearing account.

22 CONCLUSIONS OF LAW

23 1. SWC is a public service corporation within the meaning of Article XV of the Arizona
24 Constitution and A.R.S. §§40-250, 40-251, 40-367, 40-202, 40-321, 40-331 and 40-361.

25 2. The Commission has jurisdiction over SWC and the subject matter contained in the
26 Company's rate application.

27 3. Notice of the proceeding was provided in conformance with law.

28 4. SWC's FVRB is \$8,805,561.

1 IT IS FURTHER ORDERED that Sahuarita Water Company LLC shall deposit Customer
2 Security Deposit funds in a separate interest-bearing account, and shall utilize such funds for the
3 support of bad debts expenses and the refund of deposits as authorized by Commission Rules.

4 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

5 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.
6
7

8 CHAIRMAN _____ COMMISSIONER

9
10 COMMISSIONER _____ COMMISSIONER _____ COMMISSIONER

11
12 IN WITNESS WHEREOF, I, ERNEST G. JOHNSON,
13 Executive Director of the Arizona Corporation Commission,
14 have hereunto set my hand and caused the official seal of the
15 Commission to be affixed at the Capitol, in the City of Phoenix,
16 this _____ day of _____, 2011.

17 _____
18 ERNEST G. JOHNSON
19 EXECUTIVE DIRECTOR

20 DISSENT _____

21 DISSENT _____
22
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25
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27
28

1 SERVICE LIST FOR: SAHUARITA WATER COMPANY, LLC

2 DOCKET NO.: W-03718A-09-0359

3

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