ORIGINAL

BEFORE THE ARIZONA CORPORATION CC

COMMISSIONERS

GARY PIERCE - CHAIRMAN
BOB STUMP
SANDRA D. KENNEDY
PAUL NEWMAN
BRENDA BURNS

IN THE MATTER OF THE APPLICATION OF CHINO MEADOWS II WATER COMPANY FOR A RATE INCREASE.

DOCKET NO. W-02370A-10-0519

STAFF'S OPENING BRIEF

I. Introduction

Chino Meadows II Water Co., Inc ("Chino" or "Company") filed an application for a rate increase and determination of the fair value of its utility plant in the above captioned docket on December 30, 2010, with the Arizona Corporation Commission ("Commission"). The Company's current rates were established in Decision No. 59078 (May 4, 1995). According to its application, Chino serves approximately 889 customers. Exhibit A-1, Application at 2:3-4. Further, the Company states that it had a revenue deficiency of $49,573. Exhibit A-4 Supplemental Rejoinder Testimony of Ray Jones attached Schedule RLJ-1. In order to improve its cash flow, the Company is requested an operating margin of 12.5 percent. *Id.*

During Commission Utilities Division Staff's ("Staff") review of the application, Staff found numerous areas of disagreement with the Company. For the most part, these disagreements fell within two categories: operating expense adjustments and the method to determine the operating revenue increase. Staff identified a number of items that the Company included within its operating expenses that Staff disputed including employee salaries, allocation of employee compensation for work done on behalf of Chino's sister company Granite Mountain Water Company, Inc. ("Granite Mountain"), rate case expense amortization and various miscellaneous expenses. With regard to the methodology utilized to determine the operating revenue increase, Staff performed a cost of capital analysis rather than simply utilizing an operating margin.

In the evidentiary hearing, the Company provided, for the first time, a proposal to resolve a number of issues related to operating expense adjustments. Exhibit A-5 at 1:11-24. In its proposal, Chino offered to accept Staff's operating expense adjustment related to the Granite Mountain allocation if Staff accepted (1) a related expense adjustment related to transportation, general insurance, and income tax also associated with performing work for Granite Mountain; (2) a three year rate case expense amortization period; and (3) Staff endorsement of an extension of the rate case filing for Granite Mountain so as to synchronize Granite Mountain's and Chino's next rate cases to eliminate further disputes related to cost allocations. Staff provided its notice of acceptance of the Company's proposal by a filing docketed on October 19, 2011.

A consequence of Staff's acceptance of the Company's proposal is that the only issues remaining in dispute are the rate of return methodology, various additional operating expense adjustments, and Staff's recommendation related to Arizona Department of Water Resources ("ADWR") Best Management Practices ("BMP").

II. Discussion

A. Rate Base

Per Company witness Ray Jones' testimony Chino Meadows and Staff are for all intents in agreement on the appropriate rate base for the Company.

> On rate base, we have come, essentially have come to agreement. And, again, the only difference is in cash working capital, which we are calculating the same, but, again, the difference in the allowable level of expenses causes the difference in the cash working capital amount.

Tr. at 17:5-10. Because Staff continues to recommend adoption of its expense adjustments, Staff recommends the adoption of its final rate base amount of $212,349. Staff's Post Hearing Final Schedules docketed November 10, 2011 ("Post Hearing Schedules"), Schedule CSB-3.

B. Rate Design

Likewise, both Staff and the Company agree on the appropriate rate design to employ. Both agree on an inverted tier conservation oriented rate design with common break points. The only differences relate to different revenue requirements to be recovered under the respective rate designs being proposed by the parties. Because Staff recommends adoption of its revenue requirement, Staff likewise recommends adoption of its rate design.

C. Revenue Requirement

The Company proposed, and Staff accepted test year total revenue of $351,633. Post Hearing Schedules, Schedule CSB-11. Staff originally recommended a revenue decrease of $9,287. Exhibit S-6, Brown Supplemental Surrebuttal Schedule CSB-11. In light of the various adjustments incorporated by Staff's acceptance of Chino's "settlement", Staff is now recommending a modest revenue increase of $2,128. Post Hearing Schedules, Schedule CSB-11. The use of a three year rate case expense amortization period increased annual rate case expense from Staff's earlier recommendation of $6,000 to $10,000. *Id.* Likewise, where Staff had been recommending a $1,582 decrease to transportation expense[1], a $3,784[2] reduction to general liability expense and a $1,673 reduction to payroll tax expense[3], Staff is no longer recommending these reductions to the Company's proposed operating expenses. Post Hearing Schedules, Schedules CSB-11, -17, -18, and -23. In light of these adjustments, Staff's final total operating expense recommendation has increased from $324,109[4] to $332,909[5]. Likewise, Staff anticipates that the Company now accepts Staff's recommended adjustments to salary to reflect the allocation to Granite Mountain of $19,563 for salary and wages and $1,611 for Granite Mountain's share of salary and wage increases. Post Hearing Schedules, Schedule CSB-13.

Despite Staff's agreement to these significant operating expense adjustments, a number of expense adjustment differences remain between Staff and Chino's positions. These fall into three basic categories: (1) salary and wages; (2) miscellaneous expense; and (3) leak detection program expense.

1. Salary and Wages

In addition to the issue of allocating salary expense to Granite Mountain for work performed by Chino employees on behalf of the Granite Mountain system, other issues remain related to salary

---

[1] Exhibit S-6, Schedule CSB-17
[2] Exhibit S-6, Schedule CSB-18
[3] Exhibit S-6, Schedule CSB-23
[4] Exhibit S-6, Schedule CSB-11
[5] Post Hearing Schedules, Schedule CSB-11.

and wage expense. Staff and the Company continue to disagree about the amount of expense to provide for employee bonuses. The Company proposes a 50 percent reduction to bonuses from salary expense. Exhibit A-4, Schedule RLJ-30. However, Staff recommends complete exclusion of bonuses from salary and wage expense.

The Company's argument for inclusion of any amount of bonuses in employee salary expense is that it believes this is ordinary for other utilities. *Id.* The Company's unsupported contention is not persuasive. As explained by Staff witness Brown,

> The Company has provided no studies or other type of documentation to show that the removal of $1,600 in total bonuses would cause a higher than normal turnover in employees. Bonuses are an optional cost and, therefore, should be recognized below-the-line (i.e., removed from rates).

Exhibit S-5, Surrebuttal Testimony of Crystal Brown at 7:8-11. Chino has provided no evidence to substantiate why this expense should be recovered from ratepayers. Staff's recommendation is reasonable and should be adopted.

Additionally, the Company has failed to substantiate its assertions as to the salary expense generated by its owner, Mr. Paul Levie. Chino proposes to include $35,498 in salary expense for Mr. Levie. Exhibit A-4, Schedule RLJ-14. However, the Company did not include any documentation to support that the hours of time spent working on the Company associated with Mr. Levie's salary expense actually occurred. Exhibit S-5 at 7–8. As conceded by the Company at hearing, Mr. Levie is the only employee of Chino for whom there were no time cards or time sheets. Tr. at 33:7-21, 56:18-20.

To reflect the lack of documentation, Staff estimated a reasonable approximation of the number of hours Mr. Levie spent working on behalf of Chino. Exhibit S-4, Direct Testimony of Crystal Brown at 22:1-14, Schedule CSB-13. Staff's methodology is appropriate in light of the number of other businesses that Mr. Levie operates out of the same office. As Staff noted, Mr. Levie operates nine separate businesses from the same office as he uses to manage the Company. *Id.* at 8:6-11. Because the Company has provided no documentation to support its salary expense request, Staff's recommendation continues to be the most reasonable estimate of Mr. Levie's actual hours spent working for the Company. As such, Staff recommends adoption of its salary expense adjustment by reducing Officer Salary Expense by $4,879. Post Hearing Schedules, Schedule CSB-14.

2. Miscellaneous Expenses

The Company likewise asks to include a number of individual expenses that would not typically be included within a utility's operating expenses. Chino seeks to include amounts for employee gifts, office food and drink, meals during main break repairs and employee holiday party expenses. Exhibit A-4, Schedule RLJ-30. The Company contends that these are expenses that are necessary, prudently incurred[6] and are "routinely accepted for larger companies." Tr. at 54:7-8. However, when asked to offer examples of where this has occurred, the Company did not offer any examples of the Commission explicitly approving such treatment. Rather, the Company's explanation was that larger utilities obtain recovery for these expenses because Staff is unable to scrutinize larger utilities in sufficient detail to specifically recommend denial of these expenses.

> Well, I think it is just a matter of the level of detail. The staff is able to, with the small companies, I mean they literally almost look at every single invoice for these small companies. They just don't do that for the big companies. And they can't do it for the big companies. And so it results in disparate treatment between small and large.

Tr. at 54:12-18.

Staff disputes that it performs a less rigorous review of rate case applications for larger utilities. Moreover, Staff's ability to accurately perform its analyses and provide recommendations is irrelevant to the issue of whether the expenses are recoverable in rates. The Company has provided no examples of the Commission ever approving such expenses for a utility. As Staff explained, "these costs are not necessary to provide service." Exhibit S-4 at 27:20; S-5 at 10:12.

Rather, the history of Commission cases both large and small has been that these expenses are routinely denied. For example, in the last Rio Rico rate case both its water and wastewater divisions were Class B utilities. As noted in the hearing, "hootenannies" are not allowable expenses. Docket No. WS-02676A-09-0257, Transcript of Hearings Vol. II at 261:17-25. In the last rate case of H2O, Inc., a Class C utility like Chino, Staff recommended disallowance for food expense and the utility agreed Staff's recommendation was appropriate rate treatment. Docket No. W-02234A-07-0557,

---

[6] Exhibit A-4, Schedule RLJ-30.

Staff Direct Testimony of Brendan Aladi filed January 23, 2009 at 14; Rebuttal Testimony of Thomas Bourassa filed March 10, 2009 at 12:9-10.

Against this context, the Company has offered no examples where the Commission has allowed rate recovery of these types of expenses. As Staff noted, these expenses are not necessary to the provision of utility service and as such its recommendation that these expenses be denied is appropriate.

3. Leak Detection Program Expense

Finally, the Company asks to include the pro forma expense of instituting an as yet non-implemented leak detection program. As discussed further below, Staff does not disagree with the implementation of a leak detection program as described by Chino's request. However, Staff believes that it is inappropriate to include in test year expenses the cost of implementing the program as it was not implemented during the test year, nor has it been implemented as of the time testimony was filed more than 20 months after the end of the test year. Exhibit S-5 at 11. It would be inappropriate to permit the Company to recover an expense that it has not actually incurred, and may never incur if it does not institute the described leak detection program. The Company is free to seek cost recovery for BMPs that it has implemented in a future rate case.

D. Rate of Return

The second area of major difference between the Company's and Staff's positions relates to the methodology utilized to determine an appropriate operating income for the Company. Chino proposes the use of an operating margin approach and is requesting a 12.5 percent operating margin. Exhibit A-4, Schedule RLJ-1. Staff recommends using a rate of return approach based on consideration of the Company's rate base. Staff is recommending the use of a 9.6 percent cost of equity be applied as the rate of return on the Company's $212,349 rate base to produce an operating income of $20,385. Post Hearing Schedules, Schedule CSB-1. The Company does not dispute that Staff's cost of capital recommendation is appropriate if a rate of return methodology is adopted in this case. Tr. at 36:19-21. Staff's recommendation is appropriate because it is lawful, acknowledges the Company's fair value rate base, and produces a sufficient cash flow for the Company. For those reasons, Staff's recommendation should be adopted.

At the outset, Staff would note that it is the only party recommending a rate of return. Operating margins, as the Company proposes to use, do not produce a return on the utility's rate base and are consequently not a rate of return on the fair value of the utility's rate base. Although both methods may be used to produce an operating income for a utility, and operating margins may be appropriate in some circumstances, those circumstances are not presented in this application.

Arizona courts have held that the state constitution requires the Commission to both determine a utility's fair value rate base and then apply a rate of return to that rate base. *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 534, 578 P.2d 612, 615 (Ariz.App. 1978). The purpose of this method is to provide a utility's shareholders with a reasonable rate of return on their investment in the utility. *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 153, 294 P.2d 378, 383 (1956). However, the Commission has long recognized that there are circumstances where rate of return methodology will not produce just and reasonable rates for a utility. As such, Staff has recommended, in appropriate circumstances, consideration of operating margins, cash flows, debt service, and other methods where it was clear that a cost of capital premised return methodology would produce illogical results.

Staff explained one such illogical result that has appeared frequently in the recent past: the occurrence of a negative rate base for a utility. In such instances a rate of return methodology might suggest that the utility was required to perform a refund to ratepayers. Tr. at 95:9-18. Staff acknowledges that in cases such as that, where a rate of return methodology may prevent the utility from recovering its operating expenses as well as precluding any operating income, that alternative methodologies may be appropriate. Tr. at 95:19-24. Likewise it would be appropriate in circumstances of a non-profit utility that may not seek a return on investment to use an alternative means to establish its operating income. Additionally, it may be appropriate for very small utilities, that have little rate base, to utilize an alternative means to establish their operating incomes so as to ensure adequate cash flow to cover contingencies. None of these circumstances are present in this case, however.

Chino has a positive rate base of $212,349. Post Hearing Schedules, Schedule CSB-1. Consequently, it will not be confronted with a possible negative rate of return scenario. Likewise, the

Company is not a non-profit and it would be appropriate to consider compensating the shareholders on the basis of their investment in the utility. Finally, Chino is not so small that it will not obtain sufficient cash flow to cover contingencies from operations.

As explained by Staff, in addition to the operating income received through the rate of return recommendation, the Company will also be receiving the return of its investment through depreciation expense included within the revenue requirement. In addition to the $20,385 operating income, Chino will be receiving $39,709 in depreciation expense under Staff's recommendation. Post Hearing Schedules, Schedule CSB-1, CSB-11. As noted by Staff, the cumulative cash flows generated by the depreciation and operating income are more than twice the amount of any other expense aside from salaries. Tr. at 90:8-19.

The Company may argue that utilizing a rate of return in circumstances like Chino's may discourage investments in plant by the owners. Tr. at 41:3-42:3. The fallacy in the Company's contention is that whereas rate of return methodology incents investment in new plant under most circumstances, operating margin does not provide any incentive to invest in new facilities. Rather, operating margins produce an incentive to increase income by increasing operating expenses.

As Staff pointed out, operating margins compensate on the basis of a utility's expenses. Tr. at 76:23-77:8. To that extent, the higher the utility's expenses, the higher the utility's income will be. *Id.* The Company freely acknowledges this relationship between expenses and income under an operating margin methodology. Tr. at 44:20-45:21. Consequently, under an operating margin regime, it is to a utility's benefit for operating expenses to grow as it will be compensated more in operating income. Tr. at 76:23-77:8. Likewise, improvements in plant facilities will increase efficiency and typically reduce operating expenses related to the operation of that plant. Tr. at 42:4-23. Consequently, contrary to the Company's suggestion, because operating margins produce an incentive to allow expenses to increase, operating margins do not increase the incentive to make plant investments.

However, rate of return methodology does typically provide an incentive for the utility owner to invest in efficient new plant. As explained by Staff, rate of return methodology does not consider operating expenses at all. Tr. at 76:5-7. Moreover, to the extent that newer, bigger, and better plant improves efficient operation of the utility, the utility will be able to retain the savings generated by the increased efficiency of its plant. Tr. at 76:18-21. The utility will thereby realize greater compensation than was contemplated when its test year revenue requirement was determined in order to establish its rates going forward. *Id.*

E. BMPs

Staff is recommending that the Company implement five ADWR BMPs in this case. Exhibit S-1 Direct Testimony Jian Liu at 3:18-26, attached Exhibit JWL at 4; Tr. at 64-66. As explained by Staff witness Liu, Staff has been making BMP recommendations in rate cases for water utilities since BMPs were adopted in various decisions by Commissioner amendment. *See e.g.* Decision No. 70741 (February 12, 2009), Decision No. 70663 (December 24, 2008). In order to systematize Staff's recommendations, beginning in April 2011, Staff has been consistently recommending a number of BMPs relative to the size of the utility in question. "So now with A size company, we usually recommend 10 BMP. B size is seven. C size is five. So I think Chino Meadows II is a C size company. And that's why I recommend the five BMPs." Tr. at 65:16-19.

Staff would note that the Company is already proposing one BMP, the institution of a leak detection system. Staff does not oppose the implementation of that particular BMP. As discussed earlier, Staff's dispute with the Company regarding the leak detection program relates to the appropriateness of including the anticipated expense related to the program in operating expenses when the proposed program was not in effect during the test year. Consequently, Staff's disagreement with Chino Meadows on this BMP is related to revenue requirement treatment and is not related to the use of the method as a BMP.

Chino Meadows is located within the Prescott Active Management Area ("AMA"). Exhibit S-1, attached Exhibit JWL at 2. The Company stated that although Chino Meadows is within an AMA, ADWR would not require the implementation of any BMPs in this instance. Exhibit A-2 at 17:23-25. Even so, the Commission has required the implementation of BMPs regularly since 2009 and Staff's recommendation is reasonable.

. . .

. . .

III. Conclusion

For all the above stated reasons, Staff's recommendations are appropriate and should be adopted.

RESPECTFULLY SUBMITTED this 9th day of December, 2011.

Charles H. Hains
Attorney, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
(602) 542-3402

Original and thirteen (13) copies of the foregoing filed this 9th day of December, 2011, with:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Copy of the foregoing mailed this 9th day of December, 2011, to:

Craig A. Marks
CRAIG A. MARKS, PLC
10645 North Tatum Blve., Suite 200-676
Phoenix, Arizona 85028

Paul D. Levie, President
Matthew Lauterbach
CHINO MEADOWS II WATER CO.
2465 Shane Drive
Prescott, Arizona 86305

Roseann Osorio