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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF CHINO MEADOWS II WATER CO., INC. FOR A RATE INCREASE.

DOCKET NO. W-02370A-10-0519

REPLY BRIEF

Chino Meadows II Water Co., Inc., ("Chino Meadows") hereby submits its reply brief in the above-captioned docket.

I. THE COMMISSION SHOULD SET RATES USING ITS TRADITIONAL OPERATING-MARGIN METHODOLOGY

Chino Meadows extensively briefed why—consistent with Commission precedent, fairness, and regulatory practice—the Commission should provide Chino Meadows the opportunity to earn a 12.5% operating margin. In its brief Staff provided yet another reason why the Commission should use the operating-margin methodology.

Staff stated:

> 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.[1]

Chino Meadows is a very small utility with very little rate base. Therefore, as Staff acknowledges, the operating-margin methodology should be used to establish Chino Meadows' operating income.

The following table includes the same companies evaluated in Chino Meadows' initial brief and shows rate base per customer and the Commission-approved operating margin.

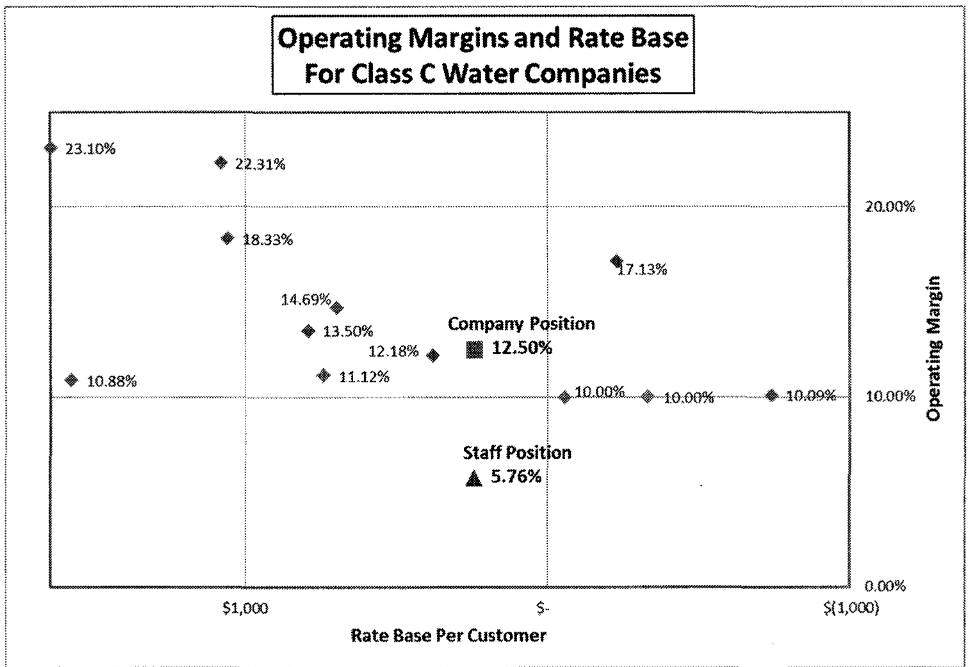
[1] Staff Brief at 7:23-25.

RATE BASE PER CUSTOMER AND OPERATING MARGIN

		Rate Base /Customer	Operating Margin
Valle Verde	$	(741)	10.09%
Farmers Water	$	(334)	10.00%
Appaloosa Water Company	$	(232)	17.13%
H2O Inc.	$	(58)	10.00%
Pineview Water	$	379	12.18%
Southland Utilities	$	697	14.69%
Abra Water	$	740	11.12%
Mt. Tipton Water	$	791	13.50%
Ehrenberg Improvement	$	1,058	18.33%
Yarnell Water	$	1,081	22.31%
Ash Fork Water Development	$	1,579	10.88%
Wickenburg Ranch Water	$	1,648	23.10%
Las Quinta Serenas	$	2,207	25.49%
Chino Meadows (Staff)	$	242	5.76%
Chino Meadows (Company)	$	242	12.50%

The table shows that Chino Meadows has only $242 of rate base per customer, which is easily the lowest positive rate base in the table. Yet Staff's recommended operating margin of just 5.76% is only one-half of the lowest operating margin provided by the Commission in the last several years.

The following chart displays the same data contained in the above table.



Chino Meadow's requested 12.5% operating margin is clearly well within the range of operating margins that the Commission has provided for small water companies. Staff's recommendation would be an outlier – well outside the range of returns the Commission has provided for Class C water companies.

Staff concedes that:

> [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.[2]

Yet, Staff's proposal produces an illogical result. Staff would provide Chino Meadows far and away the lowest operating margin that Staff has recommended in at least in the last several years (if not forever). Staff's recommended operating margin is far lower even than it routinely recommends for companies with no rate base. Staff has offered no logical reasons why a company with an extremely small rate base should be treated worse than a company with a negative rate base.

For rate making to be logical and non-discriminatory it must depart from rate-of-return ratemaking when this methodology does not produce an operating margin comparable to that provided for companies with no rate base. By contrast, Staff's apparent methodology is to rely on rate-of-return ratemaking even as rate base and the resulting operating margins approach zero, but then, as the zero rate base threshold is crossed, to suddenly begin providing operating margins of ten percent or higher. Staff's methodology would actually provide a disincentive for a water company with a negative rate base to ever make investments if the result would be provides a drastically lower operating margin once its rate base entered positive territory. Clearly, this is contrary to Commission policy, which is to encourage prudent investments by small water companies.

Again, California recognizes that rate-of-return ratemaking should only be used for small water utilities if the resulting return exceeds that provided by operating-margin ratemaking. The

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[2] *Id.* at 7:12-15.

California Public Utilities Commission bases its revenue requirement on the method—either return on rate base or operating margin—that produces the *highest* revenue requirement.[3] CPUC Staff currently recommends a 23.4% rate of margin for Class C water utilities (501 – 2000 customers).[4] This return is almost twice what Chino Meadows seeks in this case.

Finally, Staff argues that use of the operating-margin methodology would motivate a utility to increase expenses.[5] This argument is not persuasive. First, any alleged motivation would only occur during a test year because increasing expenses reduces operating income. Second, increased test-year expenses would be a red flag for Staff's auditors. If the increased expenses were not prudent, then they would be disallowed. Third, Staff concedes that the rate-of-return methodology motivates plant investment. This is fine if the investment is prudent, but not if the investment was made simply to inflate rate base and gain a higher revenue requirement. Ultimately, Staff's prudency review disallows unwarranted expenses or investments regardless of whether the operating-margin methodology or the rate-of-return methodology is used to set rates.

II. EXPENSE ISSUES

Staff has raised nothing new in its brief that requires additional reply. Chino Meadows' reasons for recovering these expenses are persuasive

III. BEST MANAGEMENT PRACTICES

Staff has raised nothing new in its brief that requires additional reply. Staff's recommendation is contrary to current Commission policy and would unduly burden Chino Meadows.

IV. RATE DESIGN

In its brief, Staff did not explain, let alone justify, why it would decrease Chino Meadows' current monthly customer charges. As Chino Meadows explained, it would be

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[3] See CPUC STANDARD PRACTICE FOR PREPARING RESULTS OF OPERATION REPORTS FOR GENERAL RATE INCREASE REQUESTS OF WATER UTILITIES OTHER THAN MAJOR COMPANIES Standard Practice U-3-SM revised April 2006 and CPUC RESOLUTION NO. W-4524, dated March 17, 2005.
[4] Chino Meadows has 889 water customers. Liu Direct (Exhibit S-1) at Engineering Report p. 1.
[5] *Id.* at 8:16:25.

punitive to adopt an inverted three-tier rate design intended to conserve water and to simultaneously reduce customer charges. This would virtually guarantee that Chino Meadows would be unable to earn the operating income authorized by the Commission.

V. SUMMARY

For the reasons set forth in this reply brief and in its initial brief, Chino Meadows asks the Commission to adopt the positions set forth in its initial brief.

Respectfully submitted on December 30, 2011 by:

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