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FROM: Steven M. Olea
Director
Utilities Division

AZ CORP COMMISSION
DOCKET CONTROL

Arizona Corporation Commission

DOCKETED

MAR 19 2012

DATE: March 19, 2012

DOCKETED BY	<i>[Signature]</i>
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RE: STAFF REPORT FOR COMPLIANCE FILING IN THE MATTER OF THE APPLICATION OF GLOBAL WATER FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES FOR UTILITY SERVICE DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF ITS PROPERTY THROUGHOUT THE STATE OF ARIZONA. DOCKET NOS. SW-20445A-09-0077, W-02451A-09-0078, W-01732A-09-0079, W-20446A-09-0080, W-02450A-09-0081 AND W-01212A-09-0082

Attached is the Staff Report, pursuant to the compliance filing ordered in the above-named docket, resulting from the series of workshops held in Docket No. W-00000C-06-0149, Generic Evaluation of the Regulator Impacts from the Use of Non-Traditional Financing Arrangements by Water Utilities and Their Affiliates.¹

Staff recommends:

1. Consideration of authorizing utilities to record and defer depreciation and a cost of money using an Allowance For Funds Used During Construction ("AFUDC") rate on qualified plant replacements² for up to 24 months³ after the in-service date to mitigate the effects of regulatory lag.
2. Consideration of allowing acquisition premiums and/or a premium on the rate of return on a case by case basis and subject to certain conditions, in those cases where the impacts may be offset to some extent by the effects of operational improvements. If granted, acquisition premiums would be subject to review and re-justification in future proceedings.
3. Consideration of establishing a mechanism to recognize the effect of delays in the processing of rate cases when applicant is not culpable for those delays.

¹ Staff will prepare separate reports to address distribution system improvement charge ("DSIC") and the treatment of income taxation for S corporations and limited liability companies.

² At a minimum qualified plant would need to be found used and useful during the 24-month period.

³ Terminates before 24 months if rates become effective that include the qualified plant in rate base in the 24-month period.

4. That monies received pursuant to Infrastructure Coordination and Financing Agreements ("ICFAs") continue to be treated as Contributions in Aid of Construction ("CIAC"). This recommendation may be modified as a result of the pending review of Global's ICFAs by an independent Certified Public Accountant firm.

SMO:GWB:kdh

Originator: Gerald W. Becker

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Docket Nos. SW-20445A-09-0077 et al.

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

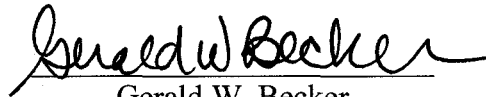
**STAFF REPORT FOR COMPLIANCE FILING IN THE MATTER OF THE
APPLICATION OF GLOBAL WATER FOR THE ESTABLISHMENT OF JUST AND
REASONABLE RATES AND CHARGES FOR UTILITY SERVICE DESIGNED TO
REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF ITS
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W-02451A-09-0078
W-01732A-09-0079
W-20446A-09-0080
W-02450A-09-0081
W-01212A-09-0082**

MARCH 19, 2012

STAFF ACKNOWLEDGMENT

Staff report for compliance filing in the matter of the application of Global Water for the establishment of just and reasonable rates and charges for utility service designed to realize a reasonable rate of return on the fair value of its property throughout the state of Arizona was the responsibility of the Staff members listed below.

A handwritten signature in black ink, reading "Gerald W. Becker". The signature is written in a cursive style with a horizontal line underneath the name.

Gerald W. Becker
Public Utilities Analyst V

TABLE OF CONTENTS

	<u>PAGE</u>
INTRODUCTION	1
PURPOSE OF THE WORKSHOPS	1
STAFF ANALYSIS	2
POST-IN-SERVICE AFUDC AND DEFERRED DEPRECIATION	2
ACQUISITION PREMIUMS	3
RATE OF RETURN PREMIUMS	4
UNTIMELY DELAYS	4
CONTINUED TREATMENT OF ICFAS CONSISTENT WITH DECISION NO 71878	5
CONCLUSIONS AND RECOMMENDATIONS	5

ATTACHMENT

EXCERPT FROM DECISION NO 71878	ATTACHMENT A
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Introduction

On February 20, 2009, Global Water - Palo Verde Utilities Company ; Valencia Water Company - Greater Buckeye Division ; Willow Valley Water Company, Inc.; Global Water - Santa Cruz Water Company; Water Utility of Greater Tonopah, Inc.; and Valencia Water Company – Town Division, (collectively “Global” or “Company”) filed with the Arizona Corporation Commission (“Commission”) applications in the above-captioned dockets seeking increases in their respective permanent base rates and other associated charges. Decision No. 71878 arose from that proceeding in Docket Nos. SW-20445A-09-0077 et al.

In Decision No. 71878, the Commission approved Staff’s recommendation that approximately \$60.1 million of monies received under Infrastructure Coordination and Financing Agreements (“ICFAs”) be imputed as Contributions in Aid of Construction (“CIAC”). Decision No. 71878 further ordered that a generic investigation be commenced which looks at how best to achieve the Commission’s objectives with regard to encouraging the acquisition of troubled water companies and the development of regional infrastructure where appropriate. The workshop was to address whether ICFAs, or other mechanisms, if properly segregated and accounted for, could be utilized to finance the actual acquisition of troubled water companies, and a portion of the carrying costs associated with the unused water and wastewater facilities or infrastructure determined to meet the Commission’s objectives in this regard.

To comply with Decision No. 71878, Staff held a series of workshops. The workshop dates and subject matters are shown below:

November 1, 2010 – Introduction and timelines.

January 14, 2011 – Distribution System Improvement Charges (“DSICs”)

February 25, 2011 – Acquisition Adjustments and Rate of Return Premiums.

March 25, 2011- Imputed Income Tax for S Corporations and certain LLCs

June 16, 2011 – Generalized Cost of Equity. See also Docket No. 08-0149,

June 24, 2011 – ICFAs

November 4, 2011 – Cost of Equity, ICFAs, and Conclude Workshops

Purpose of the Workshops

The purpose of the workshops was to comply with the requirements of Decision No. 71878¹ as shown on Attachment A.

¹ Decision No 71878, 89 at 9-20.

Staff Analysis

Staff attended the workshops and has reviewed the filings of the various participants. In this filing Staff's comments are limited to its recommendations on:

1. Post-in-Service Allowance for Funds Used During Construction ("AFUDC") and Deferred Depreciation
2. Acquisition premiums and/or rate of return premiums.
3. A possible mechanism to capture the effects of untimely delays in the processing of a rate case.
4. Continued treatment of ICFAs per Decision No. 71878 pending results of an independent audit.

Post-in-Service AFUDC and Deferred Depreciation

At one of the workshops, participants expressed concern regarding the inability to earn an awarded Rate of Return ("ROR") due to the carrying costs incurred between the time when Construction Work in Progress ("CWIP") is transferred to Utility Plant in Service ("UPIS") and considered for recognition in rate bases. This occurs because the recording of AFUDC ceases when CWIP is transferred to UPIS.

Under present treatment, utilities record projects in the CWIP accounts and are allowed to record AFUDC on those balances using a rate that equals the utility's cost of capital. Upon transferring the cost of the completed project from CWIP to UPIS, the recording of AFUDC ceases and the utility begins depreciating the asset. During the interim period between the transfer from CWIP to UPIS and the date when the asset may be recognized in rate base, the utility bears the carrying costs of the asset which are unavoidable and unrecoverable under the present regulatory process. Once a project is completed, it is transferred to UPIS.

Staff recommends that some consideration be given to mitigating the effects of carrying costs of net plant additions between rate proceedings. Under optimal conditions, a utility would transfer plant to UPIS concurrently with filing a rate case which would require up to 12 months to process. In addition, Staff prefers 12 months of data after a Company has received new rates before it can file another rate case. Realistically, the utility will bear the carrying costs of the incremental net plant additions during the interim period which is at least 24 months. While the utility is technically not entitled to earn on that incremental plant absent a fair value determination, Staff recommends that some consideration be given to mitigate effects of associated carrying costs which could be significant. Staff recommends the deferral of post-in-service AFUDC for a period of up to 24 months to mitigate the effect of regulatory lag.

Staff also recognizes that a utility records depreciation expense from the date that the asset is placed into service. If this occurs during or prior to the end of the test year in a rate proceeding, the utility incurs depreciation expense but has no opportunity to recover it. Similar to the reason associated with regulatory lag discussed more fully above regarding post-in-service

AFUDC, Staff further recommends that depreciation expense be deferred for a period of up to 24 months to mitigate the effects of regulatory lag. (The precise entries to effect this would need to be determined.)

The deferral of AFUDC and depreciation would allow a Company to request recovery of both amounts, which it would not normally be allowed to do absent an approved deferral.

Acquisition Premiums

Some participants cite two instances when Staff recommended and the Commission approved an acquisition premium. In researching this issue, there are two cases to consider which may serve to clarify the record.

1. Paradise Valley Water Company ("PVWC")/Mummy Mountain Water Company ("Mummy Mountain") – In this proceeding, Docket Nos. W-01342A-98-0678 and W-01303A-98-0678, Decision No. 61307, the owners of Mummy Mountain sold their system for approximately \$150,000 which included a \$40,000 payment to the sellers, approximately \$47,000 forgiveness of debt for the utility service owed by the seller to the buyer (PVWC), \$32,000 of property taxes owed by the seller but to be paid by the buyer, and administrative costs of \$20,000 associated with the sale. Unfortunately, the record is silent regarding the net book value of the assets transferred to PVWC, and Mummy Mountain's most recent rate case, Docket No. W-01342A-91-0224, Decision No. 57877, is too stale to provide reliable information regarding an appropriate valuation of the business. Staff is therefore unable to ascertain the existence, or lack thereof, of an acquisition premium associated with this transaction.
2. The sale of the "McClain systems" to Northern and Southern Sunrise Water Companies – Staff reviewed the record underlying Decision Nos. 68412 and 68826. Dated January 23, 2006, Decision No. 68412 was a rate case which approved a negative goodwill of \$52,141 for substandard operating conditions of the McClain systems. Dated June 29, 2006, Decision No. 68826 approved the transfer of the "McClain systems" to Northern and Southern Sunrise Water Companies and approved acquisition costs of \$300,000, including \$100,000 for reorganization, bankruptcy and other costs, \$100,000 for Commission related activities, and \$100,000 for transition costs such as support for an interim operator, capitalized labor costs, etc.² Thus, Staff could not find any evidence of the Commission granting recovery of a true acquisition premium, although Staff also notes that it is aware of few requests by utilities to recover an acquisition premium.

While a policy of granting acquisition premiums has the theoretical potential to encourage healthy utilities to acquire non-viable utilities, it also has the undesirable effect of providing owners an incentive to underperform and become non-viable by design to place their utilities in a position to become a lucrative acquisition target. Thus, establishing a general policy

² Decision No 68826, Findings of Fact, paragraph 47.

to grant acquisition premiums can have undesirable as well as desirable attributes. Accordingly, acquisition premiums are better considered on a case-by-case basis.

Staff concludes that the granting of acquisition premiums should be withheld at the time the proposed sale/transfer is being considered and that authority should be granted to allow potential recovery upon the acquiring utility meeting specified conditions such as 1) demonstrating clear, quantifiable and substantial benefits realized by ratepayers that are unlikely to have been realized had the transaction not occurred; 2) balancing the value of the realized benefits against the rate impact; and 3) granting any recovery of an acquisition premium over an extended time and requiring continued recovery to be re-justified in subsequent rate proceedings to encourage continuous delivery of improved, quality service.

Rate of Return Premiums

Rate of return premiums may be an alternative to acquisition premiums for encouraging healthy utilities to acquire non-viable utilities. However, unlike acquisition adjustments, it does not present the potential to encourage dysfunctional behavior by operators to intentionally underperform, and accordingly, it is generally a preferred mechanism. Rate of return premiums also have a benefit of inherently including a provision for revisiting the appropriateness of its continuation in each rate case. Staff concludes that the granting of rate of return premiums can be an appropriate mechanism for encouraging the acquisition of non-viable water companies under certain conditions. Similar to the granting of an acquisition premium as discussed above, granting of rate of return premiums should be predicated on the attainment of demonstrable, quantifiable and realized benefits to ratepayers that would not have occurred had the transaction not occurred. Rate of return premiums might be predicated on the attainment of certain operational goals and/or implementation of certain best management practices and/or other metrics.

Untimely Delays

The Arizona Administrative Code prescribes certain times for the processing of rate cases. The time lines vary from 360 days³ for Class A and B utilities to 120 days for Class E utilities. In some instances, a case may experience delays for which an applicant is not culpable due to its actions or inactions. To the extent that a proposed rate increase is delayed, the applicant experiences a permanent loss of the incremental revenues that are ultimately approved. To mitigate the effect of foregone revenues under the aforementioned circumstances, Staff recommends the establishment of a deferral mechanism on a case by case basis to capture the estimated effect of untimely delays in the processing of rate applications. Such a mechanism would be subject to additional analysis in subsequent rate proceedings.

³ Time lines are from the "Sufficiency Date" when Staff determines that an application has met (initial) filing requirements.

Continued Treatment of ICFAs Consistent with Decision No 71878

At the time of this report, an audit of the ICFA monies received by Global and its parent under ICFAs through December 31, 2008, is underway. Staff will file a supplemental report upon receipt and review of the report from the independent audit firm.

Conclusions and Recommendations

Staff recommends:

1. Consideration of authorizing utilities to record and defer depreciation and a cost of money using an Allowance For Funds Used During Construction (“AFUDC”) rate on qualified plant replacements⁴ for up to 24 months⁵ after the in-service date to mitigate the effects of regulatory lag.
2. Consideration of allowing acquisition premiums and/or a premium on the rate of return on a case by case basis and subject to certain conditions, in those cases where the impacts may be offset to some extent by the effects of operational improvements. If granted, acquisitions premium would be subject to review and re-justification in future proceedings.
3. Consideration of establishing a mechanism to recognize the effect of delays in the processing of rate cases when applicant is not culpable for those delays.
4. That monies received pursuant to Infrastructure Coordination and Financing Agreements (“ICFAs”) continue to be treated as Contributions in Aid of Construction (“CIAC”). This recommendation may be modified as a result of the pending review of Global’s ICFAs by an independent Certified Public Accountant firm.

⁴ At a minimum qualified plant would need to be found use and useful during the 24-month period.

⁵ Terminates before 24 months if rates become effective that include the qualified plant in rate base in the 24-month period.

Decision No. 71878:

IT IS FURTHER ORDERED that a generic investigation shall be commenced which looks at how best to achieve the Commission's objectives with regard to encouraging the acquisition of troubled water companies and the development of regional infrastructure where appropriate. As part of this proceeding, the workshop shall address whether ICFAs, or other mechanisms, if properly segregated and accounted for, could be utilized to finance the actual acquisition of troubled water companies, and a portion of the carrying costs associated with the unused water and wastewater facilities or infrastructure determined to meet the Commission's objectives in this regard. Therefore, we will require Staff to notice and facilitate, and Global to participate in stakeholder workshops designed to address these issues, and make recommendations to the Commission on the issues discussed in the workshops, including whether it is appropriate to adopt the recommendations in the next Global Utility rate case, as well as other future rate cases. The workshops shall be noticed and held in the existing Generic Docket.

IT IS FURTHER ORDERED that Staff shall, within 30 days, provide notice to the parties to the Generic Docket, and to other stakeholders, of new workshops in Docket No. W-00000C-06-0149, for stakeholder workshops designed to address the issues set forth in Findings of Fact No. 84. Following the conclusion of the workshops, Staff shall, within 90 days, make recommendations to the Commission on the issues discussed in the workshops, including whether it is appropriate to adopt the recommendations in the next Global Utility rate case, as well as other future water cases.

IT IS FURTHER ORDERED that if the Commission workshop results in future treatment of ICFAs that is different than the result in this case, the Applicants may request review of the ICFAs subject to this Order in a future rate case for setting prospective rates consistent with the recommendations adopted from the future workshop process.