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AZ CORP COMMISSION
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BRENDA BURNS

IN THE MATTER OF THE APPLICATION OF ARIZONA WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR ADJUSTMENTS TO ITS RATES AND CHARGES FOR UTILITY SERVICE FURNISHED BY ITS EASTERN GROUP AND FOR CERTAIN RELATED APPROVALS.	DOCKET NO. W-01445A-11-0310

Arizona Corporation Commission
DOCKETED
JUL 11 2012
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STAFF'S REPLY/CLOSING BRIEF

JULY 11, 2012

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I. INTRODUCTION.

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby responds to the Closing Brief submitted by Arizona Water Company ("Company" or "AWC"), and the Opening Brief submitted by the Residential Utility Consumer's Office ("RUCO"). Despite the efforts of Staff, the Company and RUCO to come to agreement, there are still a significant number of outstanding issues. The issues remaining in this case are: revenue requirement; operating income adjustments; rate base adjustments and exclusions of plant items; cost of capital; and reductions in water loss; an adjustor mechanism for water loss and infrastructure replacement; and rate design and consolidation of the SaddleBrooke Ranch and Oracle systems.

II. STAFF'S REVENUE REQUIREMENT.

A. Operating Income Adjustments.

There are four operating income adjustments still at issue in this case. The Company and Staff continue to disagree regarding the appropriate amount for pumping and transmission and distribution maintenance expenses, rate case expense, the proper period for the amortization of deferred CAP charges, and the appropriate amount for fleet fuel expenses.

1. The Company's Normalization of Pumping and Transmission and Distribution Maintenance Expenses Should Be Rejected.

The Commission should reject the Company's proposed normalization of pumping and transmission and distribution maintenance expense. The company has not demonstrated that the actual test year expenses were abnormally low, and the evidence shows that the result of the Company's regression analysis are unreliable.

a. The Company failed to provide sufficient evidence to support its assertions that its costs were 'abnormally' low.

The Company contends in its Closing Brief that it presented "overwhelming evidence" that the test year levels of pumping and transmission and distribution (T&D) expenses were abnormally low.[1] To support this assertion, the Company cites as evidence the testimony of Mr. Reiker and Mr. Harris. That testimony consisted merely of conclusory statements that the Company adopted a

[1] AWC's Cl. Br. at 42, 43.

program to reduce costs, that costs were abnormally low and that the Company had in place a procedure whereby two officers were required to review purchases.[2] However, as addressed in Staff's Opening Brief, the Company presented no evidence to support this, or to specify what maintenance was not performed that otherwise would have been. In fact, although the Company's witnesses avowed that measures had been put in place to cut costs, Company president William Garfield conceded that there was no plan, no policy, no budget limit, nor any specific criteria for reducing expenses, but that "it was just a general directive to cut expenses to the bone."[3]

Both Staff and RUCO reviewed and analyzed the schedules filed by the Company regarding these expenses and agreed that the expenses were lower than they had been earlier. Neither agreed that this was abnormal,[4] as the reductions could have been the result of other factors such as efficiencies.[5] Regardless of the number of witnesses testifying that cost-cutting measures were put in place, without specifics as to what costs were actually cut, it cannot be determined that actual costs were abnormally low.

b. <u>The results of the Company's regression analysis are unreliable.</u>

Staff has fully addressed this issue in its Opening Brief, and will not reiterate those arguments here. Staff would note that, although the Company asserts that its methodology of using least-squares trend fitting is consistent with Staff's recommendation in prior rate proceedings, it provides no specific instances thereof.[6] Rather, it merely refers to the testimony of Mr. Reiker wherein he makes only the same conclusory statement.[7]

There has been a great deal of discussion of the purported consistency of statistical significance of Mr. Reiker's analysis[8] and of Staff's analysis which finds no consistency of results.[9] The parties do agree that the outcomes of the analyses vary based on which time period is being evaluated.[10] Given that fact and the inconsistencies in the results addressed in Staff's Opening Brief,

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[2] *Id.*
[3] Tr. at 132, 134.
[4] Mease Dir. Test., Ex. R-6 at 21; Michlik Dir. Test., Ex. S-3 at 22.
[5] Michlik Dir. Test., Ex. S-3 at 22.
[6] AWC's Cl. Br. at 43.
[7] Reiker Dir. Test., Ex. A-2 at 16-17.
[8] AWC's Cl. Br. at 43-44.
[9] Staff's Op. Br. at 8-10.
[10] Tr. at 260.

it cannot be said that the Company's regression analysis in this instance is reliable or appropriate. Therefore, the proposed normalization is not based on known and measurable data and must be rejected.

2. Rate Case Expense Proposed by Staff Should Be Adopted.

In considering an appropriate rate case expense to be allowed in this matter, Staff compared the costs in this case with previous similar cases and weighed the relative complexities thereof.[11] The Company correctly notes that there may be advantages to filing separate rate cases for each of its groups. However, there are also disadvantages, including increased rate case expense. The Company itself acknowledges this in arguing that certain costs, such as expert witnesses, do not decrease with the size of the rate filing.[12]

The Company compares this case to several others. For instance, it notes the Commission's acceptance of the $539,210 rate case expense incurred in the Epcor Water rate case, Docket No. W-01445A-10-0448. Staff would point out that the rate case expense was part of a global settlement in which each party made certain concessions to arrive at an agreement. Further, each case presents its own complexities and nuances, and the Commission must also evaluate the appropriate amount of rate case expense based on those criteria.[13] As to the Eastern Groups last rate case, that case involved 17 systems, each requiring its own analysis, schedules, and revenue determination.[14] There were also several intervenors that actively participated, one of whom even advocated for a specific rate design treatment due to its unique characteristics.[15] In addition, the Company was required to respond to various rate consolidation proposals through additional testimony and analysis.[16] This case, involved fewer systems, fewer intervenors, the consolidation of fewer systems, and, ultimately, fewer issues. Despite this, the Company is seeking a level of rate case expense that is commensurate with its prior, more complicated case.

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[11] Michlik Dir. Test., Ex. S-3 at 25-27.
[12] AWC's Cl. Br. at 47.
[13] Dec. No. 71845 at 31.
[14] *Id.*
[15] *Id.*
[16] *Id.*

The Company controls the cost of a rate case to a great extent. The Company retains its counsel and experts and the activities and procedures performed, and if the terms of hiring and compensation are not acceptable or reasonable, the Company may seek other, less costly options. Perhaps better management of the rate case activities would lower costs for a smaller rate filing. For these reasons and those raised at the hearing and in Staff's initial brief, the Commission should adopt Staff's more reasonable level of rate case expense.

3. Staff's Adjustment to the Annual Amortization of Deferred CAP Charges Should Be Adopted.

There is no dispute as to the total amount of the deferred Central Arizona Project ("CAP") charges or that there was an error that resulted in an under-recovery of those charges. The only dispute is the time period over which the amortization must be extended to allow full recovery. The Company proposes an increased annual amount and retention of the same ten-year period earlier ordered. Staff proposes retaining the annual amount ordered and slightly extending the amortization period. Given that the Company failed to address the error in a timely manner, its proposed increase, which favors the Company and negatively impacts the customer, should be rejected.

4. Staff's Determination of the Cost of Gasoline and Resulting Fleet Fuel Expenses Should Be Adopted.

The parties differ in the method by which they propose to determine the cost of gasoline which will result in fleet fuel expenses to the Company. Staff recommends an average over twelve months; the Company proposes to use the cost on a single date. The Company's Closing Brief correctly recites the various gas prices proposed throughout the course of this matter:

4/19/2010	\$3.671[17]
5/2010	\$3.77[18]
11/2011	\$2.77[19]
12/2011	\$3.18[20]
12/31/2011	\$3.38 (12 month average)[21]
1/2012	\$3.315[22]

[17] Reiker Rebuttal Test., Ex. A-4 at 14.
[18] Michlik Dir Test., Ex. S-3 at 19.
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] Mease Surreb. Test., Ex. R-9 at 23.

3/2012 $3.47 (12 month average)[23]
4/18/2012 $3.852[24]

This information shows significant fluctuation in fuel prices. This is further supported by the chart provided by Mr. Michlik in his surrebuttal testimony.[25] These prices do not show a steady increase. Given the fluctuations, it remains more appropriate to utilize a twelve-month average than a single date in time.

B. Rate Base.

Staff is continuing to recommend $63,194,812 as the rate base for the Eastern Group, which is $366,119 less that the Company's proposed $63,560,931. Two issues remain: disallowance of Well #17 and removing the equity component from working cash.

1. The Commission Should Exclude Well #17 from Rate Base and from Accumulated Depreciation.

The Company asserts that Well #17 has been returned to service and should be included in rate base. The Company further asserts that Mr. Michlik's schedules submitted with his Direct Testimony were inconsistent in that regard.[26] As to the latter, when this was pointed out to Staff, Staff filed a Notice of Errata on May 22, 2012, indicating that an error had occurred when Mr. Michlik prepared his schedules. Specifically, Mr. Michlik inadvertently did not remove accumulated depreciation from the Superstition System when he removed Well #17. The Errata further acknowledged that Mr. Michlik submitted his amended schedule JMM-5 for the Superstition system with his Surrebuttal Testimony.[27] Mr. Michlik also so testified at hearing regarding this correction.[28]

The Commission is mandated by its State Constitution to prescribe just and reasonable rates for public service corporations.[29] In addition to constitutional provisions, this Commission's own rules require plant to be used and useful to the ratepayer for it to be included in rate base.[30] Well #17

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[23] Michlik Surreb. Test., Ex. S-4 at 11.
[24] *Id.*
[25] *Id.* at 10.
[26] Reiker Rej. Test., Ex. A-5 at 4.
[27] Notice of Errata, Ex. S-13.
[28] Tr. at 1181.
[29] Ariz. Const., art. XV, § 3.
[30] A.A.C. R14-2-103(h).

was out of service during the entire test year, and for some 14 months after the test year. Non-operational plant is not used and therefore, does not meet the used and useful requirement. If the Commission includes plant in rate base that is not "used and useful" to the ratepayer the rates will not be just and reasonable.

The fact that the plant has been repaired and returned to service during 2012 does not change these facts. Rates are set on the basis of a test year. Including plant in test year that was not added until more than a year later destroys the balance of the test year concept. Moreover, if Well #17 was not operational, other plant must have been used to serve customers and other costs expended, so that inclusion of Well #17 could result in excessive plant or expenses. Staff urges this Commission to continue to disallow from rate base plant which is not used and useful during the test year and, in fact, was not placed back in service until March 2012, some 14 months after the end of the test year.

2. The Equity Component Should Be Removed from Working Capital.

Staff continues to maintain that the cost of equity is not a normal or appropriate component for inclusion in a lead-lag study, and therefore should not be included in the lead-lag study in determining working capital. However, the Company continues to assert that if the cost of debt is included in the lead-lag study, then the cost of equity should be included as well.

The Company still has not articulated any distinction between the current case and the ruling in its 2008 rate case, where the Commission made it clear that the cost of equity should not be included in working capital.[31] Traditionally, the cost of debt is appropriately included because it is a known and measurable item of expense, similar to the other cost components included in the lead-lag study. Cost of equity, however, is not a certain debt or obligation. It does not have to be paid, and if it is paid, it does not have to be in a certain predictable amount.

In this case, Mr. Garfield testified that dividends are paid at the discretion of the Board of Directors.[32] Thus there is no obligation for the Company to pay dividends. Because a dividend payment is neither a required nor a predictable amount, the commission should not include it in the

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[31] Dec. No. 71845 at 23.
[32] Tr. at 155.

lead-lag study. Staff urges the Commission to continue excluding the cost of equity from the lead-lag study and to adopt Staff's recommended working capital

III. COST OF CAPITAL.

Staff continues to recommend an 8.1 percent overall rate of return. Staff derived this recommendation using a 9.4 percent ROE, a 6.8 percent cost of debt, and a capital structure consisting of 51.0 percent equity and 49.0 percent debt.[33]

A. The Applicable Legal Standard Supports Staff's Recommended 8.1Percent Rate of Return.

The Company cites to *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*[34], and *Federal Power Comm'n v. Hope Natural Gas Co.*[35] in support of its request for a 12.5 percent ROE. While Staff acknowledges that these cases do provide the main standards for determining a fair rate of return for regulated utilities, the Company is only focusing on one aspect of these cases instead of the overall guidance they provide. However, these cases primarily stand for the proposition that a utility must be given the *opportunity to earn a return on its investment*. In order to provide a more complete picture of what these cases represent it is important to remember that the return permitted is compared not to all returns but those "generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding, risks and uncertainties....[36] Further, there are specific nuances in the ratemaking process where there is a divergence from *Hope* and *Bluefield,* in part. Specifically, in *Simms v. Round Valley Light & Electric Power Co.,*[37] the Arizona Supreme Court indicated that *Hope* could not be followed to the extent doing so would violate the requirement under the Arizona Constitution to make a finding of fair value.

The Company also cites to *Duquesne Light Co. v. Barasch*, wherein the Court indicated that "the impact of certain rates can only be evaluated in the context of the system under which they are imposed..." and that the "risks a utility faces are in large part defined by the rate methodology

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[33] Cassidy Surreb. Test., Ex. S-6 at 2.
[34] 262 U.S. 679 (1923).
[35] 320 U.S. 591 (1944).
[36] *Bluefield*, 262 U.S. at 692; *Hope*, 320 U.S. at 603.
[37] 80 Ariz. 145, 294 P.2d 378 (1956).

"because they are immune to the usual market risks.[38] However the risk the Court addressed was the State's decision to arbitrarily switch back and forth between methodologies in a way that required investors to bear the risk of bad investments at some times while denying those investors the benefit of good investment at other times.[39] In this case the Company has not alleged that the Commission switches back and forth between methodologies to depress its authorized returns. The Company instead places the blame of not having earned its authorized return for 15 years in a row, on the additional risk created by Arizona's particular ratemaking system.[40] As a result, the Company believes this, and this alone justifies an adjustment to the cost of equity.[41] The Company's blame is misplaced. The mere fact that AWC has been unable to actually earn the return authorized by this Commission does not mean this is an issue with the ratemaking system in Arizona. The Commission ultimately provides the Company with an opportunity to earn a specific return, but does not guarantee it.[42]

The Company also indicates that "the record compellingly demonstrates that investors continue to be cautious, demanding high returns on water utility stocks."[43] However, this statement is incorrect, and the Company directly contradicts this assertion in its prefiled testimony. Specifically, the Company acknowledged during the hearing that a higher stock price results in a lower dividend yield which would indicate investors are not demanding higher returns.[44] In TMZ-2 attached to Dr. Zepp's direct testimony, in Table 3, Dr. Zepp shows that the rate of growth in stock prices of his sample group of utilities exceeds the growth rate in dividends per share by a factor of three.[45] This is a clear indicator that as investors drive stock prices up, they drive dividend yields down, and thus, that they are not demanding higher returns.

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[38] 488 U.S. 299, 314, (1989).
[39] *Id.*
[40] AWC's Cl. Br. at 28-29.
[41] *Id.*
[42] It is not altogether clear how authorizing a higher cost of equity and therefore a higher overall rate of return will solve the Company's problem since it has been unable to earn what has been authorized in the past.
[43] AWC's Cl. Br. at 32; Zepp Dir. Test., Ex. A-32 at 14.
[44] Tr. at 937.
[45] Ex. A-32, TMZ 2 table 3. indicates an average stock growth rate of 9.6 percent and dividend per share growth rate of 2.9 percent which clearly indicates stock prices are growing at a much faster rate than dividends.

B. The Commission Should Authorize an Adequate Return on Equity of 9.4 Percent.

The Company correctly asserts that an adequate ROE benefits ratepayers, and that an ROE that is set too low will ultimately harm ratepayers since the utility will be unable to attract capital on reasonable terms to allow it to continue to provide reliable public utility service.[46] Staff does not disagree with this general concept. However, the Company in making this assertion is claiming an ROE of 12.5 percent is "reasonable if not conservative",[47] which far exceeds the connotations of "adequacy". In fact, despite categorizing an ROE of 12.5 percent as conservative, absent from the record in this case are any instances were the Commission has authorized an ROE in excess of 10 percent in a long time for any utility.[48]

C. Staff's Arguments in Support of a 9.4 Percent ROE Recommendation are Balanced and Supported.

In its brief, the Company levels six major criticisms regarding arguments that Staff presents in support of its ROE recommendations. First, the Company claims that Mr. Cassidy biased his DCF cost of equity estimates downward by excluding American Water Works from his representative sample group. However, both RUCO and Staff properly exclude American Water Works from their sample groups because Value Line does not have enough data for its inclusion.[49] More specifically, for the purposes of its constant growth DCF analysis, Staff measures historical growth in EPS, DPS and sustainable growth over a ten-year period.[50] Therefore, one criterion each utility must meet in order for Staff to include it in the sample group of companies is that it be publicly traded for period sufficiently long enough to calculate a 10-year growth rate for each of those growth parameters.[51] American Water Works was formerly owned by RWE, but was spun off as an independent publicly traded company in mid-2008. As a result there are less than four years of market data available by which growth might be measured to estimate the cost of equity.[52] Staff properly excluded American Water Works from its sample group. Ultimately, it is the Company not Staff that has biased its

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[46] AWC's Cl. Br. at 35.
[47] Ahern Rebuttal Test., Ex. A-34 at 30.
[48] Tr. at 976.
[49] Rigsby Dir. Cost of Capital Test., Ex. R-11 at 24; Cassidy Surreb. Test., Ex. S-6 at 7.
[50] Cassidy Surreb. Test., Ex. S-6 at 7.
[51] *Id.*
[52] *Id.*

estimates. Even Dr. Zepp acknowledges that because American Water Works only recently became publicly traded again that there is data lacking.[53] By including a sample utility without sufficient data his analysis is flawed.

Second, the Company incorrectly asserts that Mr. Cassidy's estimates of earnings per share are biased downward by excluding "readily available analysts' forecasts provided by Zacks, Yahoo! Finances and Rueters, each of which are readily available to investors and are routinely considered by them in making investment decisions."[54] Staff agrees that investors have access to a multitude of sources for making their investment decisions beyond even those utilized by the Company. However, Staff relied on Value Line as a source for its growth estimates for the reason that among investors the Value Line Investment Survey is well respected.[55] In addition, more than any other investment publication of its kind, it is readily available in public libraries across the country. More importantly for the purposes of this case Value Line Investment Survey provides a uniform 5-year projection for both DPS and EPS for each company it follows.[56] This ultimately ensures uniformity in the time horizon over which Staff makes growth projections for each of the sample utility companies.[57] The Company cannot make this claim because Zacks and Reuters do not report the data for all of the utilities that the Company used in it sample group.[58]

Third, in addressing the accuracy of analysts' forecasts, the Company contends that "Dr. Zepp countered with specific studies conclusively demonstrating that analysts' forecasts for EPS for utilities are not biased and that they have done a remarkably good job of forecasting EPS for utilities."[59] Specifically, Dr. Zepp refers to four studies and a discussion of Gordon, Gordon, and Gould in support of this contention.[60] However, Staff has overwhelmingly demonstrated based on the record in this case that the majority of studies, including the Dreman and Seigal studies, show that analysts' forecast are consistently inaccurate, and overly optimistic.[61]

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[53] Zepp Rebuttal Test., Ex. A-32 at 16; *see generally* TMZ-2.
[54] AWC's Cl. Br. at 37.
[55] Cassidy Surreb. Test., Ex. S-6 at 7.
[56] *Id.*
[57] *Id.*
[58] Zepp Rebuttal Test., Ex. A-33, TMZ-2, table 7.
[59] AWC's Cl. Br. at 37.
[60] Zepp Rebuttal Test., Ex. A-33 at 25.
[61] Cassidy Dir. Test., Ex. Ex. S-5 at 36-37.

Fourth, the Company again takes issue with Mr. Cassidy's choice of spot prices, arguing that they were shown to be biased and resulted in a skewing of dividend yields too low.[62] Importantly, the Company does not take issue with the use of spot prices conceptually, and appears to take issue with Mr. Cassidy's choice of February 1, 2012 to determine spot prices. However, the Company fails to acknowledge that Staff, unlike the Company, updated its cost of capital analyses as part of surrebuttal testimony, and utilized an updated spot price as of April 25, 2012 in its DCF analyses.[63]

Fifth, the Company criticizes Mr. Cassidy and makes the assertion that analysts should never use a proxy for the risk free rate in a CAPM analysis that is lower than that of the long-term Treasury rate because evidence suggests that even long-term treasury rates may understate the required return on zero beta assets.[64] First, Staff utilized the 30-year Treasury bond as a surrogate for the risk free rate in its current market risk premium CAPM cost of equity estimation.[65] Staff did so because the market risk premium in its current market risk premium CAPM model was DCF-derived,[66] and because the constant-growth DCF model assumes dividend growth (g) to be infinite,[67] use of the long-term 30-year Treasury note as the risk free rate was deemed appropriate. Second, and contrary to the Company's assertion, intrinsic to the CAPM is the assumption that it involves a single holding period.[68] Because most investors consider the intermediate time frame (5-10 years) to be a more appropriate investment horizon,[69] Staff uses the average of three (5-, 7-, and 10-year) intermediate-term U.S. Treasury securities' spot rates as a surrogate for the risk-free rate in its historical market risk premium CAPM cost of equity estimation.[70] Staff's use of an intermediate term proxy for the risk-free rate is appropriate, as it allows for an estimation of the cost of equity over the investor's holding period.

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[62] AWC's Cl. Br. at 38.
[63] Cassidy Surreb. Test., Ex. S-6, JAC-7.
[64] AWC's Cl. Br. at 38.
[65] Cassidy Dir. Test., Ex. S-5 at 28.
[66] *Id.* at 29.
[67] *Id.* at 15.
[68] *Id.* at 27 fn 9.
[69] Frank K. Reilly and Keith C. Brown, Investment Analysis and Portfolio Management 439 South-Western 2003.
[70] *Id.* at 28.

Finally, the Company incorrectly alleges that "Mr. Cassidy's testimony did not support or justify his ignoring the expected additional risk of Arizona Water Company based on its smaller size and unique characteristics."[71] The Company further claims that "Mr. Cassidy did not comment about the list of Company-specific risks built into Dr. Zepp and Ms. Ahern's analysis."[72] The Company's allegations are baseless. Staff's position is that the size of a company, in this case AWC, does not warrant recognition of a risk premium.[73] Stated another way the firm size phenomenon does not exist for regulated utilities.[74] Further, it is Staff's position that all companies have firm-specific risks.[75] However, firm-specific risk does not affect cost of equity because an investor can eliminate those risks through diversification.[76] In other words investors who choose not to diversify cannot be expected to be compensated for unique company risks through an increase to the cost of equity.[77]

The other aspect of risk that should not be overlooked, is that in Decision No. 71845, the last Arizona Water Company rate case that included the Eastern Group, the Commission opined that Arizona Water had not demonstrated that in that case that its risk is significantly greater compared to other comparable companies or that its risks had increased substantially since its last rate case.[78] Looking at this case through that lens the Company has not demonstrated that its risk is "*significantly greater* compared to other *comparable* companies." Further, the Company has not shown that its risks have increased substantially since its last rate case. The Company asserts that the massive construction program facing the Eastern Group, and its small size are two "very very important factors that indicate it's more risky and it needs a risk premium."[79] However, it does not appear that the size of the Eastern Group has changed significantly since the last rate case, and further, the Company was facing a similar infrastructure problem in that prior case.[80] Therefore, Staff continues

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[71] AWC's Cl. Br. at 38.
[72] *Id.*
[73] Cassidy Dir. Test., Ex. S-5 at 43.
[74] *Id.*
[75] *Id.*
[76] *Id.* at 13.
[77] *Id.*
[78] Dec. No. 71845 at 39.
[79] Tr. at 899.
[80] Dec. No. 71845 at 33-34.

to recommend denial of the Company's request for an upward risk adjustment to the cost of equity of 90 basis points.

IV. DISTRIBUTION SYSTEM IMPROVEMENT CHARGE.

Staff continues to oppose a Distribution System Improvement Charge ("DSIC"). Staff's alternative proposal for a Sustainable Water Loss Improvement Program ("SWIP") would be more appropriate, as detailed in its Opening Brief.

A. Inability to Earn Authorized Rate of Return Does Not Warrant a DSIC.

In support of its request for a DSIC, AWC makes much of its failure to earn its authorized rate of return, or to recover its cost of service for 15 years.[81] While Staff has not audited this Company's past performance and cannot verify its assertions in that regard, Staff does note that the Company has continued to pay, and even increase, dividends to shareholders.[82]

Moreover, it is important to remember that a utility is entitled to a *reasonable opportunity* to earn its full rate of return, not a guarantee that it will earn its full rate of return.[83] AWC has the burden of proving that it did not have a reasonable opportunity to earn its fair rate of return.[84] This could include evidence that the opportunity to earn its rate of return was different for AWC than it has been for other water utilities in Arizona.

The only evidence the Company presented, other than its mere assertion, was that during one year – the 2010 test year- it was unable to earn its 7.87 per cent rate of return, earning only a 4.73 per cent rate of return.[85] This evidence is insufficient to establish that the financial conditions AWC faces are any different than those faced by any other water utility in Arizona. Even if such evidence had bee presented, there is no basis for increasing a company's overall rate of return because it did not earn its previously authorized rate of return.

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[81] AWC's Cl. Br. at 5.
[82] Tr. at 154-55.
[83] *Bluefield,* 262 U.S. at 692.
[84] *Id.*
[85] AWC's Cl. Br. at 5.

AWC further suggests that a DSIC is needed to address failures in Arizona's rate-setting process.[86] Yet again, AWC presents no evidence to support such a failure, such as utilities filing bankruptcies or failing to provide safe, reliable and adequate service to its customers.

B. No Extraordinary Circumstances Exist Which Would Warrant a DSIC.

Staff has no basis on which to dispute AWC's claimed need to replace aging infrastructure in this case, and generally supports the same. However, Staff has not conducted an in-depth assessment of that proposed by AWC in this rate case and has not determined prudency in a legal or technical sense.

In its Closing Brief, AWC states that Staff has deemed the projects proposed by the Company to be prudent.[87] Staff disagrees. Staff Engineer Katrin Stukov was asked at hearing whether, generally speaking, replacement of infrastructure before the end of its life would be prudent, and she answered affirmatively.[88] And in her pre-filed Direct Testimony, she indicated that the proposed infrastructure replacements in the Eastern Group's systems that have water loss above 10 per cent were reasonable and appropriate, although she specifically stated that this did not constitute a "used and useful" determination.[89] Ms Stukov adopted her testimony at hearing[90] and further testified as follows:

> **Q.** [by Mr. Lutz] … referring to your direct testimony, in your review of that report, you at least with respect to the company's Miami system and Bisbee system and Oracle system, you determined that the proposed plant facilities, the proposed replacements that the company was making in those systems that were identified in Mr. Schneider's report, that those were reasonable and appropriate, correct?
>
> **A.** That is correct.[91]

Citing this testimony, AWC states "in other words, Staff has reviewed the projects the Company has deemed necessary and agrees that those projects are reasonable and prudent."[92] This misstates Staff's position. The concepts of prudency and used and useful are addressed by the rules

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[86] *Id.* at 28-29.
[87] *Id.* at 11.
[88] Tr. at 603.
[89] Stukov Dir. Test., Ex. S-1, att. KS at 36.
[90] Tr. at 599-601.
[91] *Id.* at 603.
[92] AWC's Cl. Br. at 11.

under which the Commission operates.[93] Under those definitions, 'prudency' is not merely another word for 'appropriate' and carries with it much more than mere appropriateness. In fact, it is quite clear from Ms. Stukov's engineering report that she had not made a prudency determination.

It is Staff's position that infrastructure replacement such as that proposed by the Company in this case not only is not extraordinary, but is among the most ordinary types of expense a utility will face. As detailed in Staff's Opening Brief, from the time a system is built, or in this case, purchased, there is an inherent awareness that plant will wear out and must be replaced. The Company itself acknowledges that it "regularly" replaces failing infrastructure.[94]

In addition, even if these circumstances were deemed "extraordinary," that alone does not justify a DSIC. AWC asserts that neither Staff nor RUCO presents any evidence that the impending infrastructure crisis does not warrant a DSIC, other than the article entitled "The Distribution System Improvement Charge: A Rip-Off for Consumers," published on the website of Food and Water and Watch which was included in Mr. Michlik's pre-filed testimony.[95] Although this report was the subject of much criticism due to the purported agenda of the organization which published it, it should be noted that the report itself relied upon data and commentary in the decisions of other state commissions; from publications including the *Trenton Times*, the *Philadelphia Inquirer*, and *Water Sense*; and from reports from the National Regulatory Research Institute, the National Association of Water Companies and even a white paper from American Water Company. Simply because the Company disapproves of what it believes the organization to promote does not mean that the information cited by that organization lacks merit.

Also required for an adjustor type mechanism, such as a DSIC, is that the utility is unable to fund the necessary expenditures. The Company asserts that it cannot do so, but has presented little evidence to that effect. To support its assertion, the Company cites only Staff's recommendation to reject the amount of financing the Company sought in its 2008 financing application in Docket No. W-01445A-08-0607. No evidence of any other attempts to fund infrastructure was provided.

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93 A.A.C. R14-2-103(A).

94 AWC's Cl. Br. at 11, citing Exs. A-9 at 14, A-28 at 43, 49; *see also* Tr. at 533, 614.

95 AWC's Cl. Br. at 13; Michlik Surreb. Test., Ex. S-4, att. A.

Although the Company asserts wide support for DSICs among other states, it should be noted that only 11 out of 50 have adopted DSIC mechanisms[96] in the 16 years since the first was adopted.[97] This hardly suggests resounding approval of the mechanism. Other states have rejected DSICs, such as West Virginia in Case No. 10-0920-W-42T before its Public Utilities Commission. Contrary to AWC's assertion, that Commission did not reject the DSIC merely because it did not want to effect a rate increase.[98] Many of the Staff's issues in that case reflect the concerns of Staff here, that a DSIC: "(i) deprives the Commission of "regulatory lag" as a tool to prevent [the utility] from spending imprudently on physical plant, (ii) violates the matching principle, [and] (iii) constitutes single issue ratemaking."[99] Although the Commission was sympathetic to the company's plight, it was 'skeptical' of the DSIC which the company and its customers would likely consider an automatic and additional rate increase.[100] In rejecting the DSIC, that Commission also expressed the following concerns:

> ...the Commission is troubled by the recurring WVAWC [the utility in the case] claim that its periodic investment between rate cases erodes any meaningful opportunity to earn its authorized ROR. We are also concerned that granting the DSIC petition will create a permanent structure for quarterly rate increases with the attendant litigation for the foreseeable future.[101]

The West Virginia PUC was clearly concerned with more than a disinclination to increase rates.

<u>C. AWC Has Not Established That a DSIC Is Required In Order to Attract Capital Or That It Would Achieve That Goal If Adopted.</u>

AWC acknowledges that the only genuine reason it is seeking a DSIC is to obtain financing and internally generate funds through the retained earnings of shareholders necessary to finance the proposed infrastructure replacement.[102] Whether a DSIC would accomplish these goals is speculative, as the Company has presented minimal evidence to support its theory. As previously noted, the only evidence that the Company presented to support its claim that the Company either cannot fund the infrastructure replacement or is unable to obtain financing therefor, other than the opinion of the AWC employees who testified herein, is the outcome of the Company's 2008 financing application.

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[96] Tr. at 1011-12.
[97] Ahern Rebuttal Test., Ex. A-34, PMA-4.
[98] AWC's Cl. Br. at 13.
[99] Order, W. Va. PSC, Case No. 10-0920 – W-42T (April 18, 2011) at 6.
[100] *Id.* at 7.
[101] *Id.*
[102] Tr. at 398-99.

There the Company sought approval of a new loan agreement for a line of credit up to $30,000,000. With the new debt, the Company's capital structure would have been 17.2 per cent short term debt, 42.9 per cent long term debt and only 39.9 per cent equity. Given that capital structure, Commission Staff did not recommend approval of the requested amount of financing and the Company ultimately withdrew its application.[103] The Company did not consult with a banker or lender to confirm whether financing would be available with or without the DSIC.[104]

Nor has the Company presented evidence that a DSIC would enable it to attract capital. First, this is a closely-held corporation. Although there appear to be several layers of ownership, ultimately the Company is family owned.[105] Thus it is unlikely that new investors can be expected to contribute funding. That funding is expected to be obtained by a combination of retained earnings and debt financing, but the Company has not provided the Commission with any specifics. The Company has only indicated that 'a fair amount' of the funding will come from debt.[106] Yet any additional debt incurred by the Company will negatively impact its capital structure.[107] While a DSIC may make the Company more attractive to lenders, the resulting change in the capital structure may well place the Company in the same position it was in the 2008 financing case: having a capital structure which will not support approval of the financing.

The Company admits that it has not conducted any calculations in this regard, [108] and has presented none which would indicate that a method of funding the project could be developed that would enable the Company to balance the DSIC revenues, shareholder contributions and decrease in the equity component of its capital structure in such a manner that it could obtain financing. Nor is there any indication of the portion of funding that will come from shareholders, or any indication of the willingness of the Board to authorize any such contribution.

That a DSIC will allow AWC in this case to attract capital is, at best, speculative. It is troubling that a utility comes before the Commission proposing an unprecedented mechanism for

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[103] *Id.* at 371; AWC's Cl. Br. at 15.
[104] *Id.* at 425
[105] *Id.* at 181.
[106] *Id.* at 423.
[107] Tr. at 370-71.
[108] *Id.* at 398.

what will be perceived as a means of increasing rates between rate cases without providing some specific evidence of whether or in what manner that DSIC will enable the Company to achieve its goal of attracting capital to fund infrastructure replacement.

D. If a DSIC Is Approved, Staff's Recommendations for the Mechanics of the DSIC Should Be Adopted.

In its Closing Brief, AWC sets forth the most comprehensive description of the mechanics of its proposed DSIC to date. Much of this is based on testimony at hearing rather than on pre-filed testimony and exhibits, supporting Staff's criticism that a well-planned, thoroughly considered mechanism has not been presented. Certainly such detail would have been helpful to the parties and to the Administrative Law Judge prior to hearing.

Several of the conditions requested by Staff continue to be opposed by the Company. These include a proposed credit for operating and maintenance expense cost reductions that can be expected as a result of infrastructure replacement and tying the DSIC to water loss. The Company acknowledges that there will be expected savings to O&M expenses, but that these will be minimal in early years and suggests that, if a credit is given, it should be based on a rational per unit cost.[109] Based on discussions with the Company, Staff is concerned that the calculation of credits based on a per-unit cost would be so great that they could exceed the amount of any credit to be allowed.[110] While savings may be reduced at the outset, they can be expected to increase over time. Staff's conservative 10 percent credit will allow variation in savings to even-out over time and leave 90 percent for recovery that would not occur absent a DSIC.

Staff also continues to support allowing any DSIC which may be approved only in those systems where water loss exceeds 10 per cent. That was the Commission's apparent condition based on its orders in Decision No. 71845. In addition, the need for water loss reduction as a basis for a DSIC constitutes more of an extraordinary circumstance than infrastructure replacement. Given that a DSIC is untested in Arizona, and has not been thoroughly developed as a methodology, it would be more appropriate to limit the scope and dimension of such a mechanism on a first-time basis.

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[109] AWC's Cl. Br. at 21.
[110] *Id.* at 21-22.

AWC also opposes requiring refunds of surcharges in the event water loss is not reduced. What would satisfy the water loss reduction has not been established. However, Staff's assessment thereof would likely take into consideration that a reduction in one section of a system might partially offset incremental losses in another resulting in a net increase in water loss. Should the Company be granted this rare opportunity to effectively increase rates between rate cases, it should be able to assure that the purpose for which the DSIC is required is accomplished. Further, even though recovery of infrastructure costs through the DSIC may be denied if there is no reduction in water loss, the Company would be able to seek recovery of those costs within the context of subsequent rate increase.

Staff continues to support its position in its Opening Brief regarding the conditions to be included in any DSIC. Despite the further clarifications of the mechanics of the DSIC in AWC's brief, some elements require further clarification. First, Staff would be required to review and respond only to the initial filing; remaining filings would be adopted if Staff did not oppose or make other recommendations. However, all annual surcharges would be subject to true-up in the next rate case, where a prudency review would be conducted. Any refunds due to any over-collection due to improperly computed DSICs would not be limited to calculation or accounting-type errors but would include substantive bases such as prudency.

Second, a DSIC would not automatically continue in perpetuity. At each future rate case, a determination would be made as to whether the DSIC was still appropriate. If the DSIC does continue, the surcharge would be reset to zero.

E. The DSIC, as Proposed, Violates the Arizona Constitution.

A DSIC-type mechanism has not been addressed judicially in Arizona. However, based upon existing case law, Staff does not believe that a DSIC, per se, would violate the Arizona Constitution so long as its methodology meets the constitutional mandate.[111] Staff is concerned that the DISC as proposed by AWC does not meet that mandate. As AWC states in its Brief, Arizona's Supreme Court has noted, in *U.S. West vs. Arizona Corporation Commission*[112] (U.S.West II), it is judicial

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[111] *Arizona Corp. Comm'n v. Arizona Pub. Serv. Co.,* 113 Ariz. 368, 555 P.2d 326 (1976); Arizona Cmt'y Action Ass'n, 123 Ariz. 228, 599 P.2d 184 (1979).

[112] *U.S. West Communications, Inc. v. Arizona Corp. Comm'n,* 201 Ariz. 242, 245-46, 34 P.2d 351, 354-55 2001).

interpretation of Arizona's Constitution that requires that the finding of fair value be used in a formula wherein a rate of return is applied to that fair value to determine rates.[113] As such, the requirement could be judicially modified, which the Court did in that case. That modification does not apply to this matter, however.

U.S. West II was the result of a lawsuit filed by a local non-competitive telephone service provider against the Commission in which U.S. West challenged the Commission's method of setting rates for competitive local exchange carriers (CLECs). The Commission had not determined fair value before setting rates for the reason that the CLECs operated in a competitive rather than monopolistic environment. The Supreme Court determined that the Arizona Constitution made mandatory that the Commission determine fair value for the purpose of setting rates. As it was the judiciary which interpreted that mandate to determine the fair value and calculate a reasonable rate of return thereon, the judiciary could re-evaluate it as well.

In doing so, the Court affirmed that the Constitution mandated the finding of fair value and that "when a monopoly exists, the rate of return method is proper."[114] It is only when the rate case concerns a competitive utility that the rate of reform method is inappropriate.[115] In this case, AWC has monopoly status. Therefore, the rate of return methodology still applies.

At the same time, Arizona case law acknowledges that the Commission has a great deal of discretion in setting rates, and can utilize a variety of methodologies as long as the method used complies with the Constitutional mandate.[116] The Commission can consider matters subsequent to the historic test year,[117] including construction projects contracted for and commenced during the test year[118] and construction work in progress but not yet in service,[119] subject to the constitutional mandate. The Commission may also engage in rate-making without first determining fair value rate base under circumstances limited to interim rates and automatic adjustment clauses.[120] In addition,

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[113] *Id.*
[114] *Id.*, 201 Ariz. at 246, 34 P.2d at 355.
[115] *Id.*
[116] *Arizona Pub. Serv. Co.*, 113 Ariz. at 371, 555 P.2d at 329.
[117] *Id.*
[118] *Id.*
[119] *Arizona Cmt'y Action Ass'n,* 123 Ariz. at 230, 599 P.2d at 186.
[120] *Residential Util. Consumer Office v. Arizona Corp. Comm'n,* 199 Ariz. 588, 20 P.2d 1169 (App. 2011).

with the adoption of new federal drinking water standards for arsenic, which would cause water utilities to construct and operate new arsenic treatment facilities, the Commission approved an Arsenic Cost Recovery Mechanism to enable water utilities to meet its requirements.[121] Such mechanisms are in place throughout Arizona and none has been constitutionally challenged. All of these indicate that a DSIC can be adopted, subject to the constitutional mandate.

In *Arizona Community Action Association v. Arizona Corporation Commission,*[122] where the Court allowed the inclusion of plant under construction, it rejected the utility's methodology used to determine the increase. To the extent that an increase was based solely on the company's common equity falling below a certain level, and given that the company had the ability to influence the return on equity, this methodology would be beneficial only to shareholders and was not constitutional.[123] In *Scates v. Arizona Corp Commission*, the Court determined that the Commission did not have the authority to increase rates without first considering the impact of the overall rate of return on rate base.[124]

The proposed DSIC in this case is neither an interim rate nor an adjustor mechanism. An interim rate is a rate which is authorized pending the establishment of a permanent rate.[125] Interim rates may only be ordered where an emergency exists, the utility posts a bond to assure payment of refunds and where it is followed by a rate case in which fair value will be determined, usually within a specified period of time.[126] While a bond could be required to satisfy that requirement in this case, the other two criteria are not met. There has been no assertion that an emergency exists in this case, nor does it. The deterioration of infrastructure is a slow process and complete or major failures in the system are not imminent; there is no immediate threat to the Company's ability to provide services to the ratepayors. Nor is this a temporary order pending a rate hearing. This is the rate hearing.

Adjustor clauses are initially adopted as a part of a rate case and made part of the overall rate structure.[127] In that respect, the proposed DSIC meets these requirements. However, an adjustor

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[121] Garfield Dir. Test., Ex. A-1at 22.
[122] *Arizona Community Action Ass'n v Arizona Corp. Comm'n* 123 Ariz. 228, 599 P.2d 184(1979).
[123] *Id.* at 231, 599 P.2d at 187.
[124] *Id.*
[125] *Scates v. Arizona Corp Comm'n,* 118 Ariz. 531, 535, 578 P.2d 612, 616 (App. 1978).
[126] *Id.*
[127] *Residential Util. Consumer Office,* 199 Ariz. at 591, 20 P.2d at 1172; *Scates,* 118 Ariz. at 535, 578 P.2d at 616.

clause is designed to allow a utility to increase or decrease rates by passing on to customers increases or decreases in specific and easily segregated costs, such as the cost of fuel or purchased water.[128] Rather than changing the utility's overall rate of return, an adjustor mechanism allows the authorized rate of return to be maintained.[129] The DSIC in this case does far more than simply pass on increasing and decreasing costs to AWC. It allows surcharges based on the cost of new plant, effectively increasing the fair value rate base without any determination by the Commission of what that fair value is.

Although the DSIC is similar to an ACRM, there are distinctions which raise questions about its constitutionality. Both allow a utility to seek periodic rate increases outside of a rate case based on the cost of certain added plant specified in the rate case which authorized the mechanism.[130] Many of the procedures by which the annual increase will be sought are also similar, but are not the subject of constitutionality.

In contrast to the proposed DSIC, an ACRM has been fully developed and was only approved after about two years of study by the various interested parties.[131] An ACRM is more limited in scope than the DSIC: it is in place for one plant only and is limited to two instances in which a surcharge or increase can occur, step one occurring when the plant goes into service and step two at a later date to recover the additional capital expenditures.[132] In addition, when the ACRM is authorized, a specific date for filing a next rate case is set, at which time a true up would occur.[133] These latter two distinctions are most concerning.

Unlike an ACRM, a DSIC allows for more immediate recovery not of a single plant or item, but for on-going infrastructure structure replacement over at least a decade. This is somewhat ameliorated by AWC's agreement that the projects included in a DSIC would be limited to those non-revenue producing projects itemized in the DSIC Study docketed in the 2008 rate case and submitted

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[128] *Id.*
[129] *Id.*
[130] *Id.* at 1173; *Scates,* 118 Ariz. at 535, 578 P.2d at 616.
[131] Ex. A-41.
[132] Tr. at 1423.
[133] *Id.* at 1428-31.

with the Company's pre-filed testimony.[134] Whether this is sufficient to meet the constitutional mandate is unknown.

Also, as noted, the Company would not be required to file a rate case by any specific date under a DSIC. The Company asserts that the maximum annual cap and lifetime maximum cap would incentivize the Company to file a rate case without such a mandate.[135] While Staff agrees to an extent, the possibility remains that, even the though maximum cap is reached, the Company could simply leave the surcharge in place for an extended period of time without a true up for prudency occurring, possibly resulting in over-recovery of costs. Again, whether the Company's proposal for resolving this matter is sufficient cannot yet be determined.

The conditions proposed by Staff would further reduce any risk of violating the Arizona Constitution. For instance, while an ACRM is limited to a single project, it is not entirely clear that the DSIC would be similarly limited. Mr. Fox testified that he understood that a DSIC would be limited to a specific system, rather than to multiple systems,[136] but it is not clear whether the Company agrees. Limiting a DSIC to systems with water loss exceeding 10 per cent would clarify this. In addition, the clarification that a true-up at the next rate case would evaluate all surcharges subsequent to the decision herein, regardless of any annual or interim approvals by the Commission, would help assure the constitutionality of the DSIC.

V. RATE CONSOLIDATION AND RATE DESIGN.

A. Full Consolidation of the SaddleBrooke Ranch and Oracle Systems Would Result in Higher Rates for SaddleBrooke Ranch Customers and Should Be Denied at This Time.

The Company asserts that Staff's argument that consolidation would have adverse impacts on SaddleBrooke Ranch customers is incorrect and that Staff offered no testimony or specifics about any such adverse impacts.[137] Instead, argues the Company, the results of Staff's non-consolidation of SaddleBrooke Ranch would result in a revenue increase for that system of $126,586, or 108.10

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[134] *Id.* at 1434.
[135] Harris Dir. Test., Ex. A-9, att. A.
[136] AWC's Cl. Br. at 20.
[137] Tr. at 1450.

percent on a standalone basis, suggesting that it is non-consolidation which would have an adverse impact.[138]

Staff has recommended a revenue increase of $126,586, or 108.10 percent for SaddleBrooke Ranch.[139] Staff has *not* taken the position at any time in this case that the customers of SaddleBrooke Ranch should bear the full burden of the instant rate increase. Staff does not support full consolidation at this time because significant differences exist in the rate schedules.[140] However, Staff has repeatedly stated that it supports eventual consolidation of rates over the various systems, moving toward the goal of full consolidation by gradually bringing the rates of the various systems, including Oracle and SaddleBrooke Ranch, closer together.[141]

Staff's rate design accomplishes this goal by maintaining separate rate schedules for each system, but reducing the differences in the schedules.[142] The result is standalone rates with subsidization across systems, which is a necessary characteristic of a system moving toward consolidation. In this case, Staff's rate design gradually reduces rate differences among the systems by setting the same commodity rates for Oracle and SaddleBrooke Ranch, but different minimum (customer) rates.[143] Specifically, the Saddlebrooke customer charge under both alternatives 1 and 2 of Staff's rate design is $1.93 less than the corresponding customer charge for Oracle.[144] Therefore, the Company's contention that moving to consolidation would adversely impact Saddlebrooke is erroneous; under Staff's rate design, consolidation would mean an increase in minimum rates for SaddleBrooke Ranch.

Similarly, Staff's recommendation reduces the rate differences among systems by relying on cross-subsidization of the SaddleBrooke Ranch system by the Superstition system. The Company correctly notes in its Brief[145] that the rate design for the SaddleBrooke Ranch understates its revenue requirement by approximately $70,000. AWC's description of this $70,000 as a shortfall would

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[138] *Id.*
[139] Staff's Final Schedules JMM-1 (SaddleBrooke Ranch System).
[140] Erdwurm Dir. Test., Ex. S-7 at 2-3; Erdwurm Surreb. Test., Ex. S-8 at 3-4; Tr. at 1384-85.
[141] *Id.*
[142] *Id.;* Tr at 1388-89.
[143] *Id.*
[144] Staff's Final Schedules DBE-1(Alt.1) at 5 (Oracle), 6 (SaddleBrooke); DBE-3 (Alt. 2) at 5 (Oracle), 6 (SaddleBrooke).
[145] AWC's Cl. Br. at 54.

suggest that it was an error on the part of Staff, which is incorrect. It is an intentional aspect of Staff's rate design. At the hearing herein, Mr. Erdwurm explained that his revenue allocation was deliberate and not solely driven by revenue requirements for individual systems in its Eastern Group.[146] That testimony made clear that, as these systems move toward consolidation, individual system revenue requirements will become less important and with full consolidation, irrelevant. Mr. Erdwurm's rate design placed a great deal of focus on customer impacts and "gradualism" in rate changes. Addressing customer impact requires the analyst to be flexible and avoid dogmatic adherence to the system impacts. Given the Commissioners' demonstrated concerns about customer impacts in various proceedings, Staff's approach to revenue allocation is most reasonable.

B. Staff's Allocation of Revenues to the Fixed Basic Service Charge Balances the Desire of the Company to Achieve Revenue Stability With the Goal Of Promoting the Efficient Use of Scarce Resources.

The Company proposes an allocation of 49% of residential revenues to the fixed basic service charge. Staff has submitted two alternate schedules, the second of which allocates allocates a larger portion of revenue to the fixed basic service charge than does Staff's first alternative. Either allocation is an acceptable balance between the goals of rate stability and efficient use of water.[147]

C. The Company's Proposed Adjustment to Billing Determinants Should Be Rejected, Except That For the Superstition-Commercial Customer Class.

As has been thoroughly discussed elsewhere, a regression analysis such as that relied upon by the Company in calculating its adjustment must be both robust and statistically significant in order to be known and measurable.[148] Staff evaluated the Company's analysis and concluded that, except for the Superstition Commercial class, the coefficients on which the Company's conclusions were based varied significantly when the analysis was conducted over varying time frames. Therefore the results were not known and measurable.[149]

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[146] Tr. at 1387-88.
[147] Erdwurm Surreb. Test., Ex. S-8, Executive Summary at 1.
[148] Erdwurm Surreb. Test., Ex. S-8 at 4-5.
[149] *Id.*

VI. RECOVERY OF INCREASED COSTS OF IMPLEMENTING BMPS.

In its Closing Brief, AWC states that it proposed that the increased cost of implementing the Best Management Practices ("BMP") ordered in Decision No. 71845 be authorized and approved for recovery in this proceeding and that neither Staff nor RUCO objected to this recovery.[150] AWC's position is not entirely clear. In Mr. Reiker's pre-filed Rebuttal Testimony, the Company's position was stated as follows:

> **Q. WHAT IS STAFF INCOME STATEMENT ADJUSTMENT NO. 5?**
>
> **A.** Staff Income Statement Adjustment No. 5 reverses the Company's pro forma adjustment (Income Statement Adjustment IS-14) to recognize the incremental cost of implementing additional Best Management Practices ("BMP") in the Superstition system, as ordered by the Commission in Decision No. 71845, dated August 24, 2010. Staff's adjustment reduces Administrative & General expense in the Superstition system by $6,850. Staff recommends that the Company be allowed to defer its BMP costs for consideration of recovery in a future rate case.
>
> **Q. DOES THE COMPANY ACCEPT STAFF'S ADJUSTMENT?**
>
> **A.** Yes, it does.[151]

This issue was not included on the Joint Disputed Issues Matrix submitted herein nor addressed at trial. It is Staff's position that if AWC intends that the BMPs be authorized and approved for recovery in its next rate case, then the parties are in agreement. To the extent AWC is seeking inclusion of such expenses in this case, Staff opposes the same and urges the adoption of Staff's adjustment to Administrative and General expense and the deferral of the Company's BMP costs for consideration in a future rate case.

VII. UNDISPUTED ISSUES.

Staff agrees that the following issues, as stated in AWC's Closing Brief, Have Been Resolved: Off Site Facilities Fees, Continuation of the ACRM, and inclusion of post test-year plant.

VIII. CONCLUSION.

The Company in this case is requesting a mechanism never before adopted in Arizona, a DSIC. That DSIC has not been fully or sufficiently developed in this case to withstand a test of its

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[150] AWC's Cl. Br. at 56.

[151] Reiker Rebuttal Test., Ex. A-4 at 21.

constitutionality. Nor has the Company met its burden by demonstrating any extraordinary circumstances which would warrant the Commission adopting a DSIC. Staff believes that the replace of infrastructure which the DSIC is designed to allow is among the most basic and routine expenses any utility faces and was entirely predictable. The Company has not demonstrated an emergency or impending inability to provide reliable service. Nor has it demonstrated that the Company is unable to raise capital to fund the project, or that a DSIC would enable it to attract the necessary capital.

In addition the Company is seeking treatment of things such as the cost of equity in a lead-lag study, where the Company admits it has never been included in the past and, in fact, was denied in its 2008 rate case. The Company is also seeking to include plant that was not in service during the test year or the 14 months thereafter, asserting that it is now in service. That it was used or useful during the test year has not been shown. Further the Company is seeking an adjustment to its actual test year pumping and transmission and distribution maintenance expenses by more than half of a million dollars, based on a regression analysis of dubious reliability, and a future projection of what those expenses will be in 2013 and 2014. Finally, the Company is seeking an overall rate of return of 9.72 percent based on a cost of equity of 12.5 per cent in the face of a continued economic downturn and with the proposal of a DSIC which will provide an early return on new plant. Staff believes the Company has failed to meet its overall burden in this case, and respectfully requests that the Commission adopt Staff's recommendations. This includes Staff's opposition to the DSIC proposed by the Company; however, if the Commission is inclined to adopt a DSIC, Staff's recommended conditions thereof should also be adopted.

RESPECTFULLY SUBMITTED this 11th day of July, 2012.

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