# ARIZONANS FOR RESPONSIBLE



July 30, 2012



Chairman Gary Pierce
Bob Stump, Commissioner
Sandra Kennedy, Commissioner
Paul Newman, Commissioner
Brenda Burns, Commissioner
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

In re: Docket No. W-00000C-06-~~0146~~ 0149

Dear Chairman and Commissioners:

In the past two years, several economic policies toward water companies have been changed by the Commission, and as a result rate cases have become less costly for customers, rate increases are much less than they have been in the past, and there is a growing interest in solving Arizona's longer-term water challenges. Those challenges are well known: attracting capital investment into Arizona, replacing aging infrastructure, linking water systems to improve water quality and ensure long-term supply availability, and the continuing need to consolidate the water industry (13 years after the Commission declared that there was a need to consolidate the sector, it has grown ever more dispersed with nearly 400 water and wastewater systems – mostly small, rural, and financially and/or hydrologically challenged).

Those known problems confront an almost endless litany of broader economic ills: unemployment, housing, and cost of living increases that have drained Arizonans' confidence, wealth, and cash. It is imperative that the Commission and the water sector work together to identify the best long-term options for dealing with Arizona's water challenges.

Responsible Water is hopeful, because we believe that most of the problems Arizona faces in the water sector were caused by policy, and to quote a famous memo: "Having been produced by government policy, they can be redressed by a change in policy."[1]

---

[1] Economic Strategy for the Reagan Administration, a Nov. 16, 1980 memo to President-elect Ronald Reagan from his Coordinating Committee on Economic Policy

5025 North Central Avenue, Phoenix, Arizona 85012
(602) 703-4205

The challenges we still face in the Arizona water sector are the "unseen" and "unforeseen" effects of prior decisions; virtually all of which predate the history of anyone at the Commission – whether on Staff or in the Wing. For example, the decision to rely on historic costs and to preclude future costs, even knowable costs; has long been "Exhibit 1" in the argument that Arizona has a difficult regulatory climate for investors. Another was the decision to believe in the "Efficient Market Hypothesis" and its reliance on complex models in the vain hope of avoiding risk, downturns, and economic volatility. The entire world is literally in the continuing grasp of the EMH's failure – and the nonstop tinkering with the EMH's models, notably the Capital Asset Pricing Model or CAPM, is further proof of its fundamental error. Markets can be irrational and policy should recognize that fact rather than try to develop a complicated model to negate it.

Changing the historic test year is a political improbability, and this paper will only address that which is solvable, economically, politically, environmentally, and socially.

We believe that what Arizona needs to do is this: ***Create an economic culture that encourages investment in water solutions that are economically and environmentally sound over the long term.***

> *"The need for a long-term point of view is essential to allow for the time, the coherence, and the predictability so necessary for success. This long-term view is as important for day-to-day problem solving as for the making of large policy decisions. Most decisions in government are made in the process of responding to problems of the moment. The danger is that this daily firefighting can lead the policy-maker farther and farther from his goals.*
>
> *A clear sense of guiding strategy makes it possible to move in the desired direction in the unending process of contending with issues of the day. Many failures of government can be traced to an attempt to solve problems piecemeal... Measures adopted to deal with one problem will inevitably have effects on others. It is as important to recognize these interrelationships as it is to recognize the individual problems themselves."*[2]

**<u>Challenge One: Adopt policies on plant replacement and repairs that reduce the challenge of operating in a historic test year state.</u>**

The Commission often refuses to include post-test year plant into water and wastewater rates. This is in stark contrast to ACC decisions allowing about $700 million in post-test year plant and acquisitions into APS' rates since 2009. Furthermore, the Commission steadfastly opposes infrastructure adjustment mechanisms like the Distribution System Improvement Charge (DSIC).

The result of the no-post-test-year plant policy and the no-DSIC policy is that water companies must put all improvements into one-year capital expenditure plans and then file rate applications that seek to recover all that plant in one fell swoop. Again, this contrasts mightily with the Commission's provision of Transmission Cost Adjustors, Purchased Power and Gas Adjustors, Renewable Energy Adjustors, Energy Efficiency Adjustors, and Distribution Cost Adjustors that are provided routinely to electric and gas utilities.

---

[2] <u>Economic Strategy for the Reagan Administration</u>

Those adjustor mechanisms and post-test year plant allowances smooth out rate increases for Arizona's electricity customers and avoid "rate shock"; and they allow those utilities to better manage their capital costs by engaging in smaller, routine investments rather than packing all such investments into test years.

- The Commission should begin allowing DSICs for water and wastewater companies; and should allow post-test year plant that is proven to be used and useful before the Decision in the case.[3]

## Challenge Two: Minimize rate volatility and rate shock.

The Commission sometimes sets rates that minimize the fixed cost recovery by enacting basic service charges that provide only a small portion of revenues; other times the Commission sets the basic service charge at a reasonable level. But in nearly all cases, the Commission then uses a three-tier inclining block rate design that shifts consumptive fees to the highest use customers – the intent is to signal those customers to reduce their water use. But when they do reduce their water use, the impact on the company's revenues is profound, the highest-use customers reduce consumption and revenues plummet.

While it is true that those customers do react to the massive price signal they receive, and conservation results, the unseen effect is that their reaction eliminates the company's ability to recover the revenues required to run the utility system and a rate case becomes necessary (which will cost all customers).

- The Commission should set a minimum ratio of 50% of required revenues from the basic service charge, and 50% of required revenues from consumptive charges. The Commission should concurrently establish multiple tiers in rate design, thus ensuring that only the highest use customers see the highest price, and ensuring that demand reductions in that highest tier do not immediately result in under-earnings that drive a new rate case filing.

## Challenge Three: Implement and provide economies of scope and scale to reduce costs.

Rates should be consolidated across systems and areas. If APS's rates were set like water rates, Central Phoenix would have rock-bottom prices and developments built during the past ten years would have some of the highest prices in the nation. Rate cases would be a nightmare in which communities were pitted against communities, and each customer class fought against each other in a political effort to shift costs. In short, it would be exactly what is seen in water company rate cases.

- The Commission should support rate consolidation and should delineate the circumstances in which rate consolidation is preferred.

---

[3] Note: We agree with Staff's concern over the potential complexity of administering numerous DSICs and will publish a second paper that details the ways in which that process can be made more workable.

**<u>Challenge Four: Use all available sources of financing to consolidate the water sector.</u>**

There are only three ways to finance consolidation:

- Shareholders pay – in which case they will buy systems that return investment quickly,
- Customers pay – through an increase to rate base that makes the acquirer whole,
- Developers pay – through voluntarily funding the acquisition in order to get a better level of service for their planned developments.

As noted, shareholder funded acquisitions will focus on scenarios with high likelihoods of returns. The Commission is averse to making existing customers pay for consolidation through an Acquisition Adjustment in all but the direst of situations. And currently, the Commission opposes allowing companies to use developer money to acquire and consolidate water systems.

The result is that the Commission's policy defaults to making the water company investors shoulder the acquisition premium (the market price of an acquisition that is above the rate base value of an acquisition.) This will rarely make economic sense, and explains why 13 years into a pro-consolidation policy, the industry is more segmented and more companies exist.

If a company uses developer money to fund an acquisition, the current policy assigns the water company's money to an unrecoverable cost (the acquisition premium) and the developer's money is assigned as a deduction to rate base. The perfect investment black hole is thereby created and acquisitions using developer money become an act of financial suicide.

- The Commission should declare that using voluntarily contributed developer money for acquisitions should have no effect on rate base, and the developer money should simply be treated as an offset to the acquisition premium.

---

What we have attempted to do here is to do more than simply develop a "wish list" – the reader will no doubt have noticed that <u>nowhere</u> in this document do we ask for higher returns on equity. Responsible Water believes that what is needed now, more than ever, is for a cooperative dialogue that focuses on the means and the ends necessary to enact a new strategy for Arizona's water future.

Collectively, our companies serve over 750,000 Arizonans in over sixty communities throughout our state. Each of those areas has specific challenges and opportunities – but we believe that the policies and the goals we have outlined here will benefit every community, and all of our customers.

Each of these proposed policies could be implemented without driving up rates and each policy will provide benefits to customers over the long term, but only if the Commission acts to adopt, implement, and measure these changes.

> *"Consistency in policy is critical to effectiveness. Individuals and business enterprises plan on a long-range basis. They need to have an environment in which they can conduct their affairs with confidence."*[4]

We respectfully request the opportunity to discuss these proposals and goals in greater detail with you, at your convenience.

Respectfully yours,

Paul Walker, Chairman
Arizonans for Responsible Water Policy

Cc: Ernest Johnson, Executive Director, ACC
Steve Olea, Director, Utilities Division
Elijah Abinah, Deputy Director, Utilities Division

[4] Economic Strategy for the Reagan Administration

# ATTACHMENT ONE – PROPOSED WATER STRATEGY FOR THE COMMISSION

Establish the Following Goals:

1. Consolidation of rates
   a. Rates should be consolidated across water systems. The larger the base of customers, the lower the impact on customers from a cost increase. The following facts justify rate consolidation:
      i. It is certain and inevitable that companies will see increased groundwater treatment costs. These arise from the Safe Drinking Water Act's requirement that the U.S. Environmental Protection Agency regularly establish new contaminants and lower allowable levels of naturally-occurring mineral in drinking water,
      ii. Wells run dry, and EPA rule changes can take working wells out of service – providing a larger customer base allows those costs to be spread out more broadly,
      iii. Larger customer bases increase the ability of companies to attract capital, whether from banks or investors.

2. Consolidation of the water industry to allow for economies of scope and scale – each of which are essential to keeping rates as low as possible and providing solutions to the challenges of:
   a. Increased CAP water costs arising from emissions control changes on the Navajo Generating Station, CAP and CAGRD costs will increase with those changes,
   b. Maximizing the use of renewable water supplies such as surface water and reclaimed water through the construction and operation of treatment plants and distribution infrastructure.

3. Rate design that encourages conservation, reduces "rate shock", and reduces the chance of rate design-created revenue erosion that leads to multiple rate cases.

4. Reducing rate case filings, minimizing the size of rate increases, and funding needed plant replacements and repairs on an as-needed basis.
   a. Many of Arizona's water and wastewater systems are now past their service lives; communities like Bisbee and Willow Valley face daunting infrastructure challenges.
   b. Many of Arizona's water and wastewater systems were poorly designed or improperly emplaced. As the industry consolidates those areas, programs of replacement and repair will be costly and those costs should be spread out over time to allow customers the chance to adjust to higher prices.
   c. Rate case filings are costly and time-consuming. Enacting well-designed adjustor mechanisms reduces the frequency and complexity of rate filings while also avoiding "rate shock" increases on customers.

Evaluate the Results

1. Schedule biennial workshops to analyze and assess progress toward each goal, and make changes as needed.