

ORIGINAL

OPEN MEETING AGENDA I



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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION  
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7  
8 IN THE MATTER OF THE APPLICATION OF  
9 ARIZONA WATER COMPANY, AN ARIZONA  
10 CORPORATION, FOR A DETERMINATION  
11 OF THE FAIR VALUE OF ITS UTILITY  
12 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

NOTICE OF FILING

13  
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16  
17 The RESIDENTIAL UTILITY CONSUMER OFFICE ("RUCO") hereby provides notice of  
18 filing the Direct Settlement Testimony of Patrick J. Quinn and William A. Rigsby in opposition  
19 to the Settlement Agreement, in the above-referenced matter.

20 RESPECTFULLY SUBMITTED this 2nd day of April, 2013.

21 Arizona Corporation Commission

22 DOCKETED

23 APR 02 2013

24

DOCKETED BY

Daniel Pozefsky  
Chief Counsel

1 AN ORIGINAL AND THIRTEEN COPIES  
of the foregoing filed this 2nd day  
2 of April, 2013 with:

3 Docket Control  
Arizona Corporation Commission  
4 1200 West Washington  
Phoenix, Arizona 85007

5 COPIES of the foregoing hand delivered/  
6 mailed this 2nd day of April, 2013 to:

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ARIZONA WATER COMPANY  
DOCKET NO. W-01445A-11-0310

DIRECT SETTLEMENT TESTIMONY  
OF  
PATRICK J. QUINN  
IN  
OPPOSITION TO THE SETTLEMENT AGREEMENT

ON BEHALF OF  
THE  
RESIDENTIAL UTILITY CONSUMER OFFICE

APRIL 2, 2013

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**EXECUTIVE SUMMARY**

RUCO Director Patrick J. Quinn recommends that the Arizona Corporation Commission (“ACC” or “Commission”) reject the proposed settlement agreement on Arizona Water Company Eastern Group rate case which adopts a System Improvement Betterment (“SIB”) mechanism.

1 **INTRODUCTION**

2 **Q. Please state your name, occupation, and business address.**

3 A. My Name is Patrick J. Quinn. I am the Director of the Residential Utility  
4 Consumer Office ("RUCO") located at 1110 W. Washington, Suite 220,  
5 Phoenix, Arizona 85007.

6

7 **Q. Have you filed any prior testimony in this case on behalf of RUCO?**

8 A. No.

9

10 **Q. What is the purpose of your testimony in this proceeding?**

11 A. The purpose of my testimony is to present RUCO's reasons for opposing  
12 a System Improvement Benefit mechanism ("SIB") which was developed  
13 through a settlement process that was ordered by the Arizona Corporation  
14 Commission ("ACC" or "Commission") in Decision No. 73736, dated  
15 February 20, 2013. The SIB was adopted in the proposed settlement  
16 agreement ("Settlement Agreement") that was filed with the Commission  
17 on April 1, 2013. My testimony will address the public interest issues  
18 associated with the SIB mechanism and explain why the Settlement  
19 Agreement should not be approved by the Commission.

20

21

22 ...

23

1 **Q. Is RUCO a signatory to the Settlement Agreement that is the subject**  
2 **of this phase of the proceeding?**

3 A. No. RUCO is not a signatory to the Settlement Agreement.

4

5 **Q. Will RUCO offer a witness who will address the specific problems**  
6 **with the SIB mechanism being proposed in this phase of the**  
7 **proceeding?**

8 A. Yes. Those aspects will be addressed by RUCO William A. Rigsby,  
9 RUCO's Chief of Accounting and Rates.

10

11 **Q. How is your testimony organized?**

12 A. My testimony contains two parts, the introduction that I've just presented  
13 and a section on the SIB mechanism that has been adopted in the  
14 Settlement Agreement.

15

16 **SYSTEM IMPROVEMENT BETTERMENT MECHANISM**

17 **Q. Were you involved in the Settlement Agreement negotiations?**

18 A. Yes.

19

20 **Q. Did you sign the Settlement Agreement?**

21 A. No.

22

23

1 **Q. Why not?**

2 A. While there were many parts of the Settlement Agreement that were well  
3 thought out and many compromises were agreed to, in the final  
4 document there are still areas that RUCO believes are not fully addressed.  
5 There are some protections for the rate payer like a cap on annual SIB  
6 charges; however the only real financial benefit for the residential  
7 consumer is the efficiency credit equal to 5.00 percent of the SIB  
8 surcharge cap. This credit and other benefits were insufficient to offset  
9 what the residential consumer would be giving up if RUCO signed the  
10 agreement. Therefore I could not sign the Agreement because I believed  
11 it was not in the best interest of the residential consumer.

12

13 **Q. What makes the Settlement Agreement unacceptable?**

14 A. The original idea of a SIB surcharge was to allow a company to recover  
15 the cost of replacing fully depreciated facilities between rate cases when  
16 those facilities through no fault of the company failed and/or were  
17 operating inefficiently. In this Agreement the definition of what facilities  
18 would qualify for a SIB surcharge expanded beyond the original intent of  
19 the SIB.

20 There should be language in the Settlement which does not limit the  
21 Commission but allows the Commission to consider the circumstances of  
22 each case when considering a SIB surcharge. This is important, as now  
23 the Agreement creates perverse incentives. For example, under section

1           6.3, the Agreement provides that all a utility needs to qualify for the SIB is  
2           to meet one of the numerous criteria. If a utility has an eight percent water  
3           loss, the utility may create circumstances that allow a greater water loss to  
4           meet the eligibility. Another example would include the circumstances of  
5           this case. In the ROO, the Judge was concerned with the Company's  
6           payment of dividends over the years when it could have used the money  
7           to address its infrastructure needs. Under the Agreement concerns such  
8           as this are not part of the eligibility criteria.

9  
10          Perhaps RUCO's greatest concern is its belief that when a company  
11          qualifies for a SIB surcharge that the company shifts risk to the consumer  
12          and therefore the authorized return on equity ("ROE") should be adjusted  
13          downward. While it was not possible to make the ROE argument in this  
14          case, RUCO did not want to limit its ability to argue that in future cases  
15          since this Agreement may be used as a template in future filings.

16          Also RUCO by signing this agreement would have given up its rights to  
17          challenge the legality of the SIB mechanism in the future. These were the  
18          main reasons RUCO chose not to sign.

19

20       **Q. Does your silence on any other issues, matters or findings**  
21       **addressed in the testimony of the parties who support the SIB**  
22       **mechanism constitute your acceptance of the Company's positions**  
23       **on such issues, matters or findings?**

24       **A. No, it does not.**

1

2 **Q. Does this conclude your testimony on the proposed SIB**  
3 **mechanism?**

4 **A. Yes, it does.**

ARIZONA WATER COMPANY  
DOCKET NO. W-01445A-11-0310

DIRECT SETTLEMENT TESTIMONY  
OF  
WILLIAM A. RIGSBY  
IN  
OPPOSITION TO THE SETTLEMENT AGREEMENT

ON BEHALF OF  
THE  
RESIDENTIAL UTILITY CONSUMER OFFICE

APRIL 2, 2013

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EXHIBIT 1 – Staff’s Opening Brief Filed on June 26, 2012

EXHIBIT 2 – Staff’s Reply/Closing Brief Filed on July 11, 2012

EXHIBIT 3 – RUCO’s Opening Brief Filed on June 26, 2012

EXHIBIT 4 – RUCO’s Reply Brief Filed on July 11, 2012

**EXECUTIVE SUMMARY**

RUCO Chief of Accounting and Rates, William Rigsby, recommends that the Arizona Corporation Commission (“ACC” or “Commission”) reject the proposed settlement agreement on Arizona Water Company Eastern Group rate case which adopts a System Improvement Betterment (“SIB”) mechanism.

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1 **INTRODUCTION**

2 **Q. Please state your name, occupation, and business address.**

3 A. My Name is William A. Rigsby. I am the Chief of Accounting and Rates  
4 for the Residential Utility Consumer Office ("RUCO") located at 1110 W.  
5 Washington, Suite 220, Phoenix, Arizona 85007.

6  
7 **Q. Have you filed any prior testimony in this case on behalf of RUCO?**

8 A. Yes, I filed direct and surrebuttal testimony presenting RUCO's  
9 recommendations on cost of capital and on the Company's request for a  
10 Distribution System Improvement Charge ("DSIC") mechanism in Phase 1  
11 of this proceeding.

12  
13 **Q. Is RUCO a signatory to the proposed settlement agreement that is  
14 the subject of this phase of the proceeding?**

15 A. No. RUCO is not a signatory to the proposed settlement agreement  
16 ("Settlement Agreement").

17  
18 **Q. Please state the purpose of your testimony.**

19 A. The purpose of my testimony is to present RUCO's reasons for opposing  
20 a System Improvement Benefit mechanism ("SIB") which was developed  
21 through a settlement process that was ordered by the Arizona Corporation  
22 Commission ("ACC" or "Commission") in Decision No. 73736, dated  
23 February 20, 2013. The SIB was adopted in the Settlement Agreement

1 that was filed with the Commission on April 1, 2013. My testimony will  
2 address RUCO's concerns with the proposed SIB and why RUCO  
3 believes the Settlement Agreement should not be approved by the  
4 Commission.

5

6 **Q. Will RUCO offer a policy witness who will address the public interest**  
7 **issues in this phase of the proceeding?**

8 A. Yes. The public interest issues in this matter will be addressed by RUCO  
9 Director Patrick J. Quinn who is also filing direct testimony on the  
10 Settlement Agreement.

11

12 **Q. How is your testimony organized?**

13 A. My testimony contains three parts: the introduction that I've just presented;  
14 a section on the background of this proceeding, and a section on the SIB  
15 that has been adopted in the Settlement Agreement.

16

17 **BACKGROUND**

18 **Q. What is the background of this proceeding?**

19 A. On August 5, 2011, AWC filed an application with the Commission  
20 requesting a permanent rate increase for the Company's Eastern Group  
21 systems. In addition to the requested rate increase, AWC sought  
22 approval of a DSIC mechanism that would allow the Company to

1 implement annual surcharges to recover the costs of specific plant items  
2 placed into service between general rate case proceedings.

3  
4 During what is now being referred to as Phase 1 of this proceeding, expert  
5 witnesses for both ACC Staff and RUCO testified against the DSIC  
6 mechanism and recommended that the Commission reject it. After  
7 weighing the evidence presented in the case, the Administrative Law  
8 Judge assigned to hear the matter issued a Recommended Opinion and  
9 Order ("ROO") on Wednesday, January 30, 2013. The Administrative Law  
10 Judge adopted ACC Staff's and RUCO's positions and recommended that  
11 the Commission deny AWC's request for a DSIC.

12  
13 At the Regular Open Meeting held on Tuesday, February 12, 2013, the  
14 Commission voted 5-0 to adopt an amended ROO that approved an  
15 increase in rates for AWC's Eastern Group Systems, but left the docket  
16 open for the purpose of allowing the Company, ACC Staff, RUCO and  
17 other interested parties to engage in settlement discussions for the  
18 purpose of developing a DSIC-like mechanism. Decision No. 73736,  
19 dated February 20, 2013, ordered a procedural schedule that would result  
20 in a tentative vote on a settlement agreement reached by any of the  
21 parties to the case.

22

1 Settlement talks were conducted on Monday, March 4, 2013 immediately  
2 following a Procedural Conference on the Phase 2 procedural schedule  
3 and the admission of the City of Globe as an intervenor in the proceeding.  
4 Participants in the settlement meetings included AWC, ACC Staff, RUCO,  
5 On February 13, 2013, Rio Rico Utilities, Inc. dba Liberty Utilities ("Liberty  
6 Utilities"), EPCOR Water Arizona, Inc., Global Water – Palo Verde Utilities  
7 Company, Santa Cruz Water Company, Valencia Water Company – Town  
8 Division, Valencia Water Company – Greater Buckeye Division, Water  
9 Utility of Greater Tonopah, Willow Valley Water Co. and Water Utility of  
10 Northern Scottsdale ("collectively the Global Utilities"), the Water Utility  
11 Association of Arizona ("WUAA"), whose representative was not in  
12 attendance, the Arizona Investment Council ("AIC"), and the City of Globe.  
13 At the conclusion of the settlement meeting, an agreement in principle had  
14 been reached on the SIB mechanism which was to be reduced to writing  
15 and reviewed by settling parties.

16  
17 After three weeks of revisions to the first draft of the Settlement  
18 Agreement, a final draft, which adopts the SIB mechanism, was approved  
19 on Monday, March 25, 2013. The signatories to the Settlement  
20 Agreement include AWC, ACC Staff, Global Water, EPCOR Water  
21 Arizona Inc., Liberty Utilities, WUAA, and AIC. On Monday, April 1, 2013,  
22 a copy of the Settlement Agreement was filed with the Commission.

1 **Q. Was RUCO a signatory to the Settlement Agreement?**

2 A. No. RUCO chose not to sign the Settlement Agreement because of its  
3 concerns with the SIB mechanism that was developed by the signatories.

4  
5 **Q. Does RUCO believe that the Agreement itself is a good Agreement?**

6 A. Legal and Policy considerations aside, the Agreement viewed alone has a  
7 lot of good points. There are still areas that the Agreement does not cover  
8 or covers inadequately that RUCO believes must be addressed if the  
9 Commission intends to approve a SIB mechanism.

10

11 **Q. What areas need to be addressed?**

12 A. First, the Settlement Agreement does not exclude improvements for fire  
13 flow in the surcharge. The Commission has determined that utilities  
14 should not recover improvements for fire flow. (See the Youngtown case  
15 – Decision No. 70351, dated May 16, 2008). Under the terms of the  
16 Settlement Agreement there is nothing from stopping a utility from running  
17 fire flow improvements through the surcharge. It is a contract and there  
18 should be a provision which directly addresses this issue so that there is  
19 no question in the future.

20

21 Second, the eligibility requirements could result in perverse incentives.

22 For example, to be eligible for a SIB, a Company need only experience  
23 water loss for the system that exceeds ten percent (Settlement Agreement

1 Section 6.3.1). A utility that is experiencing only eight or nine percent  
2 water loss and does not meet eligibility under the other criteria would have  
3 incentive to take action which brings its water loss above the criteria.  
4 Inappropriate conduct or malfeasance in that case would be awarded by  
5 the approval of a SIB mechanism. There should be language in the  
6 Settlement which does not limit the Commission but allows the  
7 Commission to consider the circumstances of the case when considering  
8 a SIB.

9

10 Third, the Settlement Agreement does not address what will happen to the  
11 SIB beyond the next general rate case. The understanding is that the  
12 Company will have to apply for a new SIB but it is not stated in the  
13 Settlement.

14

15 Fourth, an earnings test requirement would protect the ratepayers better  
16 than a Schedule D filing which would show the impact of the SIB plant on  
17 FVRB (Settlement Agreement Section 7.17).

18

19 **SYSTEM IMPROVEMENT BETTERMENT MECHANISM**

20 **Q. Have you reviewed the Settlement Agreement that adopts the SIB**  
21 **mechanism?**

22 **A. Yes.**

23

1 **Q. Please describe the SIB mechanism.**

2 A. The SIB mechanism will allow AWC to implement a surcharge on the  
3 Company's ratepayers that will allow AWC to recover a return on, and a  
4 return of the capital costs of certain eligible utility plant items that are  
5 placed into service between general rate case proceedings.

6

7 **Q. When would the SIB surcharge go into effect?**

8 A. The Settlement Agreement requires ACC Staff to promptly process AWC's  
9 request and docket any Staff recommendations to the Commission within  
10 thirty days after AWC has filed its request for an SIB surcharge. If there is  
11 no objection to AWC's request, the request shall be placed on an open  
12 meeting agenda at the earliest practical date for approval by ACC  
13 Commissioners. If AWC's SIB filing is approved by the Commissioners,  
14 AWC will begin recovering the SIB related costs through a surcharge  
15 placed on the Company's ratepayers.

16

17 **Q. How will the SIB mechanism operate if the Settlement Agreement is**  
18 **approved by the ACC?**

19 A. Under the terms of the Settlement Agreement, AWC will be able to, within  
20 twelve months from the date of the ACC's final decision on the Company's  
21 general rate case application, file a request with the Commission to  
22 implement the SIB surcharge to be collected from AWC's ratepayers.  
23 AWC would be able to file for additional SIB surcharges in subsequent

1 years as long as the surcharges do not exceed a 5 percent cap of total  
2 authorized revenues. AWC would be required to file a rate case after five  
3 years after the prior rate case in which the SIB mechanism was approved.  
4

5 **Q. What criteria must be met before eligible plant items can be placed**  
6 **into service and be granted cost recovery under the SIB mechanism?**

7 **A.** Under the terms of the Settlement Agreement, AWC would first have to  
8 meet one of the following criteria prior to requesting cost recovery of  
9 eligible plant items. The three conditions are as follows:

- 10  
11 1. Water loss for the system exceeds ten (10) percent, as  
12 calculated by the following formula:

13  
14 
$$\frac{(\text{Volume of Water Produced} - (\text{Volume of Water Sold} + \text{Volume of Water Put to Beneficial Use}))}{(\text{Volume of Water Produced})}$$
  
15 If the Volume of  
16 Water Put to Beneficial Use is not metered, it shall  
17 be established in a reliable, verifiable manner;  
18  
19

- 20 2. Water Utility plant assets have remained in service beyond  
21 their useful service lives (based on that system's authorized  
22 utility plant depreciation rates) and are in need of  
23 replacement due to being worn out or in a deteriorating  
24 condition through no fault of the Company; and,  
25

- 26 3. Any other engineering, operational or financial justification  
27 supporting the need for a plant asset replacement, other  
28 than AWC's negligence or improper maintenance, including,  
29 but not limited to:

30  
31 Any other engineering, operational or financial  
32 justification supporting the need for a plant asset  
33 replacement, other than utility negligence or improper  
34 maintenance, including, but not limited to:  
35

36 A documented increasing level of repairs to, or  
37 failures of, an asset justifying its replacement prior to

1 reaching the end of its useful service life (e.g. black  
2 poly pipe);  
3

4 Meter replacements for systems that have  
5 implemented a meter testing and maintenance  
6 program in compliance with A.A.C. R14-2-408 (E);  
7

8 Meters replaced in a system for the purpose of  
9 complying with the U.S. Environmental Protection  
10 Agency's Reduction of Lead in Drinking Water Act of  
11 2010;  
12

13 Assets that are required to be moved, replaced or  
14 abandoned by a governmental agency or political  
15 subdivision if AWC can show that it has made a good  
16 faith effort to seek reimbursement for all or part of the  
17 costs incurred.  
18

19  
20 **Q. What types of plant items would be eligible for cost recovery under**  
21 **the SIB?**

22 **A.** Distribution system items that must be classified in the following plant  
23 categories:

- 24 • Transmission and Distribution Mains;
- 25
- 26 • Fire Mains;
- 27
- 28 • Services, including Service Connections;
- 29
- 30 • Valves and Valve Structures;
- 31
- 32 • Meters and Meter Installations;
- 33
- 34 • Hydrants  
35

36 In addition to the plant categories listed above, AWC may also include a  
37 request to modify or add projects. The Settlement Agreement contains a  
38 provision that allows AWC to provide a proposed order for Commission

1 consideration that would list such projects. Under the Settlement  
2 Agreement, ACC Staff and RUCO would have thirty days to object to the  
3 projects that AWC is seeking.

4  
5 **Q. Does RUCO agree with the SIB mechanism?**

6 **A. No.**

7  
8 **Q. Please explain why RUCO does not agree with the SIB mechanism.**

9 **A.** RUCO does not agree with the SIB mechanism for several reasons. First,  
10 and perhaps most important, the SIB shifts risk from the Company to  
11 ratepayers adequate financial consideration to the ratepayers. Second,  
12 RUCO believes that the SIB is not legal in Arizona. Third, there are a  
13 number of flaws with the SIB as proposed. Fourth, the SIB is not in the  
14 public interest.

15  
16 **Q. Please elaborate on each of the four reasons stated above beginning  
17 with RUCO's view that the SIB shifts risk from the Company to  
18 ratepayers.**

19 **A.** In RUCO's view, the SIB mechanism reduces regulatory lag for AWC  
20 because the Company will not have to wait until new rates go into effect to  
21 recover a return on SIB eligible plant or the depreciation expense  
22 associated with it. However, any actual cost savings, such as lower  
23 operating and maintenance expense, attributable to the new plant are not

1 captured by the mechanism and flowed through to ratepayers. Unlike a  
2 typical adjustor mechanism for purchased fuel or natural gas which  
3 operates on a two way street basis by flowing both increases and  
4 decreases in costs to ratepayers the SIB operates on a one way street  
5 basis and only provides cost recovery to AWC. Ratepayers on the other  
6 hand see no actual cost savings that might be realized and will no longer  
7 benefit from the rate stability that exists under the present ratemaking  
8 procedure.

9  
10 **Q. What is regulatory lag?**

11 A. Regulatory lag is the time that it takes for a utility to recover the costs of  
12 plant additions placed into service between general rate case proceedings  
13 through new rates.

14  
15 **Q. Please explain how regulatory lag works to the benefit of both**  
16 **utilities, such as AWC, and ratepayers.**

17 A. In my direct testimony I cited a report authored by Ken Costello of the  
18 National Regulatory Research Institute who stated that mechanisms such  
19 as the proposed SIB "undercut the positive effects of regulatory lag on a  
20 utility's costs." According to Mr. Costello, "economic theory predicts that  
21 the longer the regulatory lag, the more a utility has to control its costs."  
22 Regulatory lag acts as a surrogate for the competitive pressures that force  
23 unregulated companies to keep their costs low. Under this scenario, both

1 utilities and ratepayers see the benefits that come from higher earnings  
2 and lower rates.

3

4 **Q. Doesn't the SIB incorporate a 5.00 percent efficiency credit to**  
5 **recognize the types of cost savings that you noted above?**

6 A. Yes, it does.

7

8 **Q. Didn't RUCO state in its underlying testimony that it could accept an**  
9 **operations & maintenance expense offset of 15.00 percent?**

10 A. Yes. RUCO did state that. However, that is not what the Settlement  
11 Agreement provides and RUCO would also have to consider the terms of  
12 any proposal.

13

14 **Q. Why does RUCO believe that the SIB mechanism is not legal in**  
15 **Arizona?**

16 A. Of course, this question suggests a legal analysis. I am not an attorney  
17 and not testifying as one. RUCO presented its legal analysis regarding  
18 the Company's proposed DSIC in its Briefs in this docket. While the SIB  
19 here is not the same as the Company's proposed DSIC, the underlying  
20 legal objections are for the most part the same. The legal points regarding  
21 the DSIC, and similarly the SIB, are attached in the relevant portions of  
22 RUCO and ACC Staff's Briefs (the relevant excerpts are attached as  
23 Exhibits 1 through 4).

1 **Q. From a layman's perspective, can you summarize the legal**  
2 **argument?**

3 A. Again, I would defer to the attorneys for the legal interpretation but the  
4 controversy centers on Arizona's fair value requirement and RUCO's  
5 belief that the SIB violates the Constitutional requirement of finding fair  
6 value when establishing rates. Perhaps Staff, who also believed the  
7 Company's proposed DSIC was unconstitutional (See Staff Opening Brief  
8 at page 26), summed it up best when it said "The DSIC in this case does  
9 far more than simply pass on increasing and decreasing costs to AWC. It  
10 allows surcharges based on the cost of the new plant, effectively  
11 increasing the fair value rate base without any determination by the  
12 Commission of what that fair value is." (Staff Reply Brief at 22).

13  
14 **Q. Does the SIB increase the fair value rate base without any**  
15 **determination by the Commission of what fair value is?**

16 A. Yes. The Company will be able to file for the SIB surcharge no more than  
17 five times between rate case decisions (Settlement Agreement, section  
18 4.4). The Commission will ultimately consider and then may approve each  
19 surcharge filing. The Commission, however, will not be making a new  
20 FVRB finding as part of each surcharge filing.

21

22 ...

23

1 **Q. What will be the result of the Commission's findings?**

2 A. Among other things, the result will be rates based on a fair value finding  
3 for a period different than the period in which the Company's operating  
4 expenses were incurred.

5  
6 **Q. Are there other aspects to the legal argument that you have not**  
7 **discussed?**

8 A. Yes. Again I would refer the reader to the Briefs submitted by both  
9 RUCO and ACC Staff on the legality of the DSIC. RUCO believes that the  
10 SIB has not overcome the legal hurdles raised by ACC Staff and RUCO in  
11 their respective Briefs. While it is true that the SIB mechanism would be  
12 authorized by the ACC in a general rate case proceeding, the SIB  
13 mechanism would recover new plant placed into service in the years  
14 between general rate case proceedings. Because a SIB surcharge could  
15 be established within thirty days of the Company's request, the same level  
16 of scrutiny that occurs in a general rate case proceeding would not exist to  
17 insure that a real finding of fair value is accomplished. Furthermore, the  
18 SIB surcharge would represent piecemeal ratemaking since it would only  
19 recover capital expenditures associated with the type of plant items that a  
20 regulated water utility, such as AWC, would replace under normal  
21 circumstances and seek rate base treatment for in a general rate case  
22 proceeding.

23

1 For a more detailed explanation of why RUCO believes that a DSIC-like  
2 mechanism such as the SIB is not legal in Arizona, see the excerpts of  
3 RUCO's and ACC Staff's Briefs that are attached as exhibits. While I am  
4 not an attorney I cannot vouch for the legal arguments but I provide the  
5 exhibits only to present the Commission with a better understanding of  
6 RUCO's legal position.

7

8 **Q. Does RUCO believe that the SIB appears to be a template for future**  
9 **cases?**

10 A. Yes. RUCO believes that the SIB appears to be a template for future rate  
11 cases. The circumstances of each case are different and providing  
12 specific eligibility requirements is one of the flaws of the Settlement  
13 Agreement as it leaves the Commission no flexibility to consider the  
14 circumstances of each case.

15

16 **Q. Please discuss some of the other flaws with the proposed SIB.**

17 A. The 5.00 percent efficiency credit is inadequate to compensate ratepayers  
18 for the shift in risk. The Commission awarded AWC a higher cost of  
19 common equity because of the infrastructure issue presented in the  
20 Company's rate application. Now the Commission is considering a SIB to  
21 address the same infrastructure issue. In exchange, the only financial  
22 benefit to the Company's ratepayers is the 5.00 percent efficiency credit.

1 RUCO believes that the Settlement Agreement is woefully inadequate  
2 here, at the ratepayer's expense.

3  
4 In RUCO's view, none of the plant items are extraordinary in nature and  
5 none of the plant is being replaced under extraordinary circumstances,  
6 such as a government mandate. In addition to the failure of taking into  
7 consideration all of the ratemaking elements that are reflected in rates  
8 approved by the Commission in a general rate case proceeding, the SIB  
9 has been tied to the Commission's policy of keeping water loss under  
10 10.00 percent. While this might seem laudable, given the fact that much  
11 of Arizona is in an arid climate, the SIB could have the unintended effect  
12 of encouraging utilities to exceed the 10.00 percent threshold just to  
13 qualify for a SIB surcharge in order to get faster recovery of routine plant  
14 additions. As noted earlier, the short period of time in which the request  
15 for a SIB surcharge is filed and the time it is approved circumvents a  
16 proper regulatory review for prudence and reasonableness.

17  
18 The settlement also does not specifically address the issue of fire flow  
19 upgrades that have been problematic in the past. Finally, there is no  
20 reason to believe that AWC would not be able to ensure safe and reliable  
21 water service or achieve cost recovery absent the SIB. Therefore, there is  
22 no need for the Commission to adopt a special surcharge for routine plant  
23 additions.

1 **Q. Please explain why RUCO believes the SIB mechanism is not in the**  
2 **public interest.**

3 A. My direct testimony contains a resolution adopted by National Association  
4 of State Utility Advocates (“NASUCA”) in 1999 that states a number of  
5 reasons why the SIB mechanism is not in the public interest. In addition to  
6 the reasons I’ve cited in my testimony, NASUCA’s Ad Hoc Water  
7 Committee stated that rate stability is reduced and proper price signals are  
8 distorted by frequent rate increases. According to the NASUCA  
9 resolution, no convincing evidence has been shown to support the claim  
10 that the frequency of rate case proceedings is reduced by mechanisms  
11 such as the SIB. NASUCA’s findings are consistent with the recent  
12 findings of the Regulatory Affairs and Public Advocacy (“RAPA”) section of  
13 the Alaska Attorney General’s Office. RAPA found that, among other  
14 things, that a review of ten states that have implemented some sort of  
15 DSIC-type mechanism, there does not appear to be support for the  
16 conclusion that DSIC adoption reduces rate case frequency.<sup>1</sup>  
17 Furthermore, special incentives are not needed in order ensure adequate  
18 water quality, pressure, and a proper reduction of service interruptions. In  
19 NASUCA’s view, SIB-like mechanisms can inappropriately reward water  
20 companies that have imprudently fallen behind in infrastructure  
21 improvements. Finally, the NASUCA resolution expressed the belief that it  
22 is inappropriate to tilt the regulatory balance against consumers and shift

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<sup>1</sup> See RUCO’s Closing Brief at 8-10.

1           business risk away from water companies simply for the purpose of  
2           creating an incentive for those companies to fulfill their basic obligation to  
3           provide safe and adequate service.

4

5           For the various reasons cited above, RUCO believes that the Commission  
6           should reject the proposed SIB mechanism.

7

8   **Q.   Does your silence on any other issues, matters or findings**  
9           **addressed in the testimony of the parties who support the SIB**  
10           **mechanism constitute your acceptance of the Company's positions**  
11           **on such issues, matters or findings?**

12   **A.   No, it does not.**

13

14   **Q.   Does this conclude your testimony on the proposed SIB**  
15           **mechanism?**

16   **A.   Yes, it does.**

# **EXHIBIT 1**

**ORIGINAL**

**BEFORE THE ARIZONA CORPORATION**

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**COMMISSIONERS**

GARY PIERCE - Chairman  
BOB STUMP  
SANDRA D. KENNEDY  
PAUL NEWMAN  
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

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**STAFF'S OPENING BRIEF**

**June 26, 2012**

Arizona Corporation Commission  
**DOCKETED**  
JUN 26 2012

DOCKETED  
*JM*

Bridget Humphrey, Attorney  
Wesley C. Van Cleve, Attorney  
Legal Division  
Arizona Corporation Commission  
1200 West Washington Street  
Phoenix, Arizona 85007  
(602) 542-3402

- 1 a) Maintenance of appropriate supporting records to correlate depreciation and  
2 cost of money deferrals with the associated plant;
- 3 b) Demonstration during its relevant rate case(s) (see condition No. 7) that the  
4 plant replacements contributed to a reduction in water loss; and
- 5 c) Whole or partial disallowances for deficiencies in "a" or "b;" and

6 7. Amortization of the allowed (i.e., net of any disallowances) combined depreciation  
7 and cost of money deferrals over 10 years and monthly application of cost of money on  
8 allowed amounts not yet recovered. The purpose of this provision is to provide a continuous,  
9 10-year incentive for the Company to reduce its water loss. Thus, the Company must continue  
10 to meet conditions "6a" and "6b" in each rate case over the 10-year amortization period to  
11 continue recovering the deferral amortizations. Terminates before 24 months if rates become  
12 effective that include the qualified plant in rate base in the 24-month period.

13 The benefit of the SWIP is that it permits the Company to retain all the financial benefits of  
14 the new plant, such as depreciation, until the next rate case is filed, without creating an imbalance in  
15 the principles of historical test year and regulatory lag.

16 C. The Commission should deny AWC's proposal to implement a Distribution  
17 System Improvement Charge (DSIC) in this case.

18 1. **Constitutionality of the DSIC.**

19 a. **DSICs in General.**

20 Arizona's Constitution requires the Commission to determine the fair value of a utility's  
21 property in order to set just and reasonable rates.<sup>205</sup> Rates cannot be said to be just and reasonable if  
22 they fail to produce a reasonable rate of return or if they produce revenue which exceeds the  
23 authorized rate of return.<sup>206</sup> This, of course, is what is evaluated in a full rate case. However, there are  
24 clearly circumstances under which rates may be adjusted outside of a rate case. The Commission has  
25 long allowed cost adjustor mechanisms which allow utilities to pass on to customers changes in  
26 certain specific volatile costs outside of the utility's control, such as purchased power costs. The  
27 Commission has also authorized ACRM which allow a utility to recover the costs of added plant  
28 required to meet new federal requirements reducing allowed arsenic levels. An ACRM is very limited  
in terms of the scope of what is included and the duration of the mechanisms. By their nature and the

<sup>205</sup> Ariz. Const. art. 15, §14.

<sup>206</sup> *Scates v. Arizona Corp Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616 (App.1978).

1 nature of the costs being recovered, they tend to be of short duration. Rather than changing rates, per  
2 se, they add costs on to current rates, which does effectively raise rates.<sup>207</sup>

3 However, rate adjustors outside of a rate case are the exception rather than the rule and very  
4 limited in what they can do. The Arizona Court of Appeals has determined that, while exceptional  
5 situations may occur which justify a partial rate adjustment without requiring full rate cases, such an  
6 adjustment cannot be made without the Commission determining the rate base and considering the  
7 overall impact of that adjustment on the rate of return.<sup>208</sup> Therefore, where exceptional circumstances  
8 exist, and a mechanism for a future rate adjustment is adopted in the context of a rate case as part of a  
9 utility's rate structure and if that mechanism meets the constitutional requirements that rate base is  
10 determined and the overall impact on the rate of return prescribed, that mechanism will not violate  
11 the Arizona Constitution.

12 **b. AWC's Proposed DSIC.**

13 The question in this case then becomes whether the DSIC as proposed by AWC complies with  
14 the constitutional mandates. It is Staff's position that it does not.

15 *i. The DSIC as proposed does not contain sufficient detail to*  
16 *assure that it meets the constitutional requirements.*

17 If the constitutionality of a DSIC depends on its terms, then it is critical that the DSIC provide  
18 sufficient information for the Commission to make that decision. As was noted during the hearing  
19 herein, 'the devil is in the details.'<sup>209</sup> Yet few details have been provided here. The entire DSIC plan,  
20 as set forth by AWC in its DSIC Study filed in the 2008 rate case<sup>210</sup> fits on a single sheet of paper,  
21 excluding the list of required schedules.<sup>211</sup> The plan provides only minimal details as to how the  
22 DSIC would be implemented. The plan contains no details as to the extent or nature of Staff's  
23 evaluation of the new plant, or its prudence. There is no requirement that Staff evaluate the overall  
24 impact of the rate increase. The plan does not address any change in operating expenses that may  
25 have resulted from the new plant, such as efficiencies in the system. And there is no provision for a

26 <sup>207</sup> Tr, 1439-41.

27 <sup>208</sup> *Scates*, 118 Ariz. at 533, 578 P.2d at 614.

28 <sup>209</sup> Tr. at 438.

<sup>210</sup> Harris Dir. Test., Ex. A-9, att. A.

<sup>211</sup> Harris Dir. Test., Ex. A-9, att. A at 7-9.



1 Company has some control over the rate of deterioration, by performing routine repairs and  
2 maintenance. By their own admission, they cut maintenance expenses 'to the bone' in 2008.<sup>216</sup> Staff  
3 has expressed concern that this has caused a more rapid deterioration of plant.<sup>217</sup> To a significant  
4 extent, the circumstances in which AWC now finds itself are of its own making. The customer should  
5 not be required to bear the burden of the Company's decisions.

6 **iii. The scope of the DSIC is so broad that the overall impact of**  
7 **the rate adjustment on the rate of return cannot be evaluated**  
8 **without a full rate case.**

9 AWC's proposed DSIC does not merely permit it to recover its costs of replacing  
10 infrastructure by passing those costs on to the customer. What the Company has proposed is that,  
11 rather than including a mechanism to recover costs, any new plant that is added will be included in  
12 rate base and will be used to calculate rates in the future.<sup>218</sup> This is far more comprehensive than  
13 simply recovering costs. It is a new determination of rate base and it allows the Company to earn a  
14 return on that plant. The adjustor or surcharge will not end, but will continue for the life of the asset  
15 in question. Nor will the revenue generated be used to to acquire the added plant or pay the cost of  
16 the added plant. The revenue will be treated as income.<sup>219</sup> It is Staff's position that in adding plant to  
17 rate base and earning a return thereon rather than simply recovering the costs incurred this DSIC  
18 crosses over from the realm of an adjustor mechanism into a rate case.

19 **2. Even if the proposed DSIC does not violate the Arizona constitution, it**  
20 **should not be adopted as it stands.**

21 **a. A DSIC Alters balance of regulatory lag and is inconsistent with**  
22 **Arizona's use of a historic test year in setting rates.**

23 Although the Company asserts that a DSIC is not contrary to the concept of regulatory lag,<sup>220</sup>  
24 in its discussions of its proposed DSIC it concedes that a DSIC 'mitigates'<sup>221</sup> or 'reduces'<sup>222</sup>  
25 regulatory lag and that denying a DSIC will perpetuate the negative impact of regulatory lag.<sup>223</sup>

26 <sup>216</sup> Tr. at 133-34.

27 <sup>217</sup> Michlik Dir. Test., Ex. S-3 at 21-22.

28 <sup>218</sup> Tr. at 151-53.

<sup>219</sup> *Id.*

<sup>220</sup> Reiker Rebuttal Test., Ex. A-4 at 6.

<sup>221</sup> *Id.*

<sup>222</sup> *Id.*

<sup>223</sup> Test., Ex. A-34, Ex. PMA 9- at 2.

# **EXHIBIT 2**

**ORIGINAL**

**BEFORE THE ARIZONA CORPORATION COMMISSION**  
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**COMMISSIONERS**

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

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AZ CORP COMMISSION  
DOCKET CONTROL

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

DOCKETED BY *LM*

**STAFF'S REPLY/CLOSING BRIEF**

**JULY 11, 2012**

Bridget A. Humphrey, Attorney  
Wesley C. Van Cleve, Attorney  
Legal Division  
Arizona Corporation Commission  
1200 West Washington Street  
Phoenix, AZ 85007  
(602) 542-3402

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

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

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

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

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

27 <sup>111</sup> *Arizona Corp. Comm'n v. Arizona Pub. Serv. Co.*, 113 Ariz. 368, 555 P.2d 326 (1976); *Arizona Cmt'y Action Ass'n*,  
28 123 Ariz. 228, 599 P.2d 184 (1979).

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

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

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

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

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

24

25 <sup>113</sup> *Id.*

26 <sup>114</sup> *Id.*, 201 Ariz. at 246, 34 P.2d at 355.

27 <sup>115</sup> *Id.*

28 <sup>116</sup> *Arizona Pub. Serv. Co.*, 113 Ariz. at 371, 555 P.2d at 329.

<sup>117</sup> *Id.*

<sup>118</sup> *Id.*

<sup>119</sup> *Arizona Cmt'y Action Ass'n*, 123 Ariz. at 230, 599 P.2d at 186.

<sup>120</sup> *Residential Util. Consumer Office v. Arizona Corp. Comm'n*, 199 Ariz. 588, 20 P.2d 1169 (App. 2011).

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

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

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

23 Adjustor clauses are initially adopted as a part of a rate case and made part of the overall rate  
24 structure.<sup>127</sup> In that respect, the proposed DSIC meets these requirements. However, an adjustor

25 \_\_\_\_\_  
<sup>121</sup> Garfield Dir. Test., Ex. A-1at 22.

26 <sup>122</sup> *Arizona Community Action Ass'n v Arizona Corp. Comm'n* 123 Ariz. 228, 599 P.2d 184(1979).

27 <sup>123</sup> *Id.* at 231, 599 P.2d at 187.

28 <sup>124</sup> *Id.*

<sup>125</sup> *Scates v. Arizona Corp Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616 (App. 1978).

<sup>126</sup> *Id.*

<sup>127</sup> *Residential Util. Consumer Office*, 199 Ariz. at 591, 20 P.2d at 1172; *Scates*, 118 Ariz. at 535, 578 P.2d at 616.

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

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

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

20         Unlike an ACRM, a DSIC allows for more immediate recovery not of a single plant or item,  
21 but for on-going infrastructure structure replacement over at least a decade. This is somewhat  
22 ameliorated by AWC's agreement that the projects included in a DSIC would be limited to those non-  
23 revenue producing projects itemized in the DSIC Study docketed in the 2008 rate case and submitted  
24  
25

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26 <sup>128</sup> *Id.*

27 <sup>129</sup> *Id.*

28 <sup>130</sup> *Id.* at 1173; *Scates*, 118 Ariz. at 535, 578 P.2d at 616.

<sup>131</sup> Ex. A-41.

<sup>132</sup> Tr. at 1423.

<sup>133</sup> *Id.* at 1428-31.

1 with the Company's pre-filed testimony.<sup>134</sup> Whether this is sufficient to meet the constitutional  
2 mandate is unknown.

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

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

18 **V. RATE CONSOLIDATION AND RATE DESIGN.**

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

22 The Company asserts that Staff's argument that consolidation would have adverse impacts on  
23 SaddleBrooke Ranch customers is incorrect and that Staff offered no testimony or specifics about any  
24 such adverse impacts.<sup>137</sup> Instead, argues the Company, the results of Staff's non-consolidation of  
25 SaddleBrooke Ranch would result in a revenue increase for that system of \$126,586, or 108.10  
26

27 <sup>134</sup> *Id.* at 1434.

<sup>135</sup> Harris Dir. Test., Ex. A-9, att. A.

28 <sup>136</sup> AWC's Cl. Br. at 20.

<sup>137</sup> Tr. at 1450.

# **EXHIBIT 3**

**ORIGINAL**

**BEFORE THE ARIZONA CORPORATION COMMISSION**

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ARIZONA CORPORATION COMMISSION  
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1  
2 GARY PIERCE  
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3 BOB STUMP  
COMMISSIONER  
4 SANDRA D. KENNEDY  
COMMISSIONER  
5 PAUL NEWMAN  
COMMISSIONER  
6 BRENDA BURNS  
COMMISSIONER

7  
8 IN THE MATTER OF THE APPLICATION OF  
ARIZONA WATER COMPANY, AN ARIZONA  
CORPORATION, FOR A DETERMINATION  
9 OF THE FAIR VALUE OF ITS UTILITY  
PLANT AND PROPERTY, AND FOR  
10 ADJUSTMENTS TO ITS RATES AND  
CHARGES FOR UTILITY SERVICE  
11 FURNISHED BY ITS EASTERN GROUP  
AND FOR CERTAIN RELATED  
12 APPROVALS.

Docket No. W-01445A-11-0310

Arizona Corporation Commission

**DOCKETED**

JUN 26 2012

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*JM*

13  
14 **RUCO'S OPENING BRIEF**

15  
16 **INTRODUCTION**

17 The Residential Utility Consumer Office ("RUCO") submits this Brief in response to  
18 Arizona Water Company's ("Arizona Water" or "AWC" or the Company") request that the  
19 Arizona Corporation Commission ("Commission") authorize a rate increase of \$5,198,671 for its  
20 Eastern Group.

21 While the Company and RUCO are in agreement on many issues, there still remains in  
22 dispute a central issue which was the focus of much of the underlying hearing - the Company's  
23 request for a "Distribution System Improvement Charge" or "DSIC". The DSIC is a regulatory  
24 mechanism that allows the utility to recover its capital costs associated with non-revenue

1           **C.     THERE IS NO LEGAL BASIS FOR THE DSIC IN ARIZONA**

2           The Company requests recovery of routine plant improvements outside of a rate case.  
3 Even the Company admits the plant in question is routine. Transcript at 399-400. From the  
4 Company's perspective, it appears to be that the amount in question, which is undisputedly  
5 large, is not routine. Id. Given that there does not seem to be a dispute that the plant itself is  
6 routine, the question becomes whether extraordinary ratemaking to account for otherwise  
7 routine plant, even at a high cost, is legally permissible. And if legal, is the DSIC still  
8 appropriate under the circumstances of this case?

9                   **1.     THE DSIC IS NOT AN ADJUSTOR MECHANISM**

10           The Arizona Constitution protects consumers by generally requiring that the Commission  
11 only change a utility's rates in conjunction with making a finding of the fair value of the utility's  
12 property.<sup>13</sup> However, Arizona's courts recognize that, "in limited circumstances," the  
13 Commission may engage in rate making without ascertaining a utility's rate base.<sup>14</sup> One of  
14 those circumstances exists where the Commission has established an automatic adjustor  
15 mechanism. *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616;  
16 *Residential Util. Consumer Office v. Arizona Corp. Comm'n ("Rio Verde")*, 199 Ariz. 588, 591 ¶  
17 11, 20 P.3d 1169, 1172. An automatic adjustor mechanism permits rates to adjust up or down  
18 "in relation to fluctuations in certain, narrowly defined, operating expenses." *Scates* at 535, 616.  
19 An automatic adjustor permits a utility's rate of return to remain relatively constant despite  
20 fluctuations in the relevant expense. An automatic adjustor clause can only be implemented as  
21 part of a full rate hearing. *Rio Verde* at 592 ¶ 19, 1173, citing *Scates* at 535, 616.

22 \_\_\_\_\_  
23 <sup>13</sup> Arizona Constitution. Art. XV, § 14; *Simms v. Round Valley Light & Power Company*, 80 Ariz. 145, 151, 294 P.2d  
24 378, 382 (1956); see also *State v. Tucson Gas*, 15 Ariz. 294, 308; 138 P.781, 786 (1914); *Arizona Corporation  
Commission v. State ex rel. Woods*, 171 Ariz. 286, 295, 830 P.2d 807, 816 (1992).

1 The Commission has also defined adjustor mechanisms as applying to expenses that  
2 routinely fluctuate widely. In a prior decision in which it eliminated APS' fuel and power  
3 adjustor, the Commission stated:

4 The principle justification for a fuel adjustor is volatility in fuel prices. A  
5 fuel adjustor allows the Commission to approve changes in rates for a  
6 utility in response to volatile changes in fuel or purchased power  
prices without having to conduct a rate case. (Decision No. 56450,  
page 6, April 13, 1989).

7 The Commission went on to discuss the undesirability of such adjustors because they can  
8 cause piecemeal regulation that is inefficient and undesirable. *Id.* at 8. *See also Scates* at 534,  
9 615.

10 In the subject case, the DSIC clearly is not an adjustor mechanism – its purpose is not to  
11 account for fluctuating operating expenses. Its purpose is to allow for recovery of plant costs  
12 which increase rate base and thereby increase operating income. Unlike an adjustor, a DSIC  
13 does not allow for rates to adjust “in relation to fluctuations in certain, narrowly defined,  
14 operating expenses.”

15 Even if one could set aside the argument that Arizona's courts have only recognized  
16 adjustors for very limited operating expenses and not for operating income, the DSIC  
17 mechanism still would not qualify as an adjustor because the principal justification for the  
18 mechanism is not the volatility in the price of the plant. As explained, the concern here is the  
19 amount of the investment, and no case law parities the need for an adjustor mechanism with the  
20 magnitude of investment in plant. The DSIC is not an adjustor mechanism nor should the  
21 exception be expanded in any manner to treat it as such.

---

24 <sup>14</sup> *Residential Utility Consumer Office v. Arizona Corporation Commission*, 199 Ariz. 588, 591 ¶11, 20 P.3d

1           **2. THE COMPANY HAS NOT REQUESTED INTERIM RATES**

2           The only other circumstance where the Commission may engage in rate making without  
3           ascertaining a utility's rate base involves requests for interim rates.<sup>15</sup> The Commission's  
4           authority to establish interim rates is limited to circumstances in which 1) an emergency exists;  
5           2) a bond is posted guaranteeing a refund if interim rates are higher than final rates determined  
6           by the Commission; and 3) the Commission undertakes to determine final rates after making a  
7           finding of fair value.<sup>16</sup> The Arizona Attorney General has opined that an emergency exists when  
8           "sudden change brings hardship to a company, when a company is insolvent, or when the  
9           condition of the company is such that its ability to maintain service pending a formal rate  
10          determination is in serious doubt."<sup>17</sup>

11          The Company has not asserted an emergency nor requested interim rates. Regardless,  
12          and perhaps the reason why the Company has not asserted an emergency, is because the  
13          Company would not meet the legal criteria – there is no evidence of a sudden change that has  
14          brought hardship,<sup>18</sup> no insolvency issue, or evidence that the Company has an inability to  
15          maintain service in the interim or long term for that matter.

16          The provisions of Arizona's Constitution should be liberally construed to carry out the  
17          purposes for which they were adopted.<sup>19</sup> Conversely, exceptions to a constitutional  
18          requirement should be narrowly construed.<sup>20</sup> Essentially, the Commission should not use the  
19  
20

21          1169, 1172 (App. 2001).

22          <sup>15</sup> *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533-35, 578 P.2d 612, 614-16 (App. 1978).

23          <sup>16</sup> 199 Ariz. at 591, ¶12, citing *Scates*.

24          <sup>17</sup> 71-17 Opinion Arizona Attorney General at 50. (1971).

25          <sup>18</sup> The Company acknowledges that it has operated the Bisbee system for over 60 years and that much of the  
26          infrastructure is from the early 1900's. (Tr. At 400-401)

27          <sup>19</sup> *Laos v. Arnold*, 141 Ariz. 46, 685 P.2d 111 (1984).

28          <sup>20</sup> See *Spokane & I.E.R. Co. v. U.S.*, 241 U.S. 344, 350, 36 S.Ct. 668, 671 (1916) (an "elementary rule" that  
29          exceptions from a general policy embodied in the law should be strictly construed).

1 "emergency" exception or the adjustor mechanism exception liberally as an excuse to set aside  
2 the rule of finding fair value when setting rates.<sup>21</sup>

3 There is no exception or legal basis to establish a DSIC in Arizona. While other states  
4 may have DSICs or similar-type mechanisms, those states have different laws. The  
5 Commission cannot, nor should it overlook Arizona's fair value requirement when setting rates.  
6 Arizona's fair value requirement protects the ratepayer from "piecemeal" ratemaking which  
7 would be the result if the DSIC is approved. It also provides ratepayer's protection from unfair  
8 rates.

9 **D. SHOULD THE COMMISSION CONCLUDE THERE IS A LEGAL BASIS FOR  
10 THE DSIC, IMPLEMENTATION OF THE DSIC WOULD STILL BE INAPPROPRIATE IN THIS  
11 CASE**

12 In addition to those reasons already mentioned, there are many more reasons why the  
13 implementation of a DSIC would not be appropriate in Arizona. The National Association of  
14 State Utility Advocates ("NASUCA") issued a policy statement in 1991 discouraging state  
15 regulatory commissions from adopting DSICs and DSIC-type mechanisms. R-2. NASUCA's  
16 policy against such mechanisms includes the following:

- 17 • special incentives are not needed to ensure adequate water quality, pressure, and  
18 proper reduction of service interruptions,
- 19 • DSICs<sup>22</sup> can inappropriately reward water companies that have imprudently fallen  
20 behind in their infrastructure improvements

21  
22 <sup>21</sup> Arizona case law and the Attorney General Opinion 71-17 set forth the legal parameters within which the  
23 Commission should act when considering emergency rate relief.

24 <sup>22</sup> NASUCA refers to automatic adjustment mechanisms as the means for automatically increasing water rates, in  
this case the Company is proposing a DSIC as the means for automatically increasing rates – RUCO does not  
believe a DSIC is an automatic adjustment clause but regardless of the nomenclature the purpose is the same- to  
increase rates outside of a rate case.

# **EXHIBIT 4**

ORIGINAL

BEFORE THE ARIZONA CORPORATION

GARY PIERCE  
CHAIRMAN  
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COMMISSIONER  
SANDRA D. KENNEDY  
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PAUL NEWMAN  
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Arizona Corporation Commission

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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  
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FURNISHED BY ITS EASTERN GROUP  
AND FOR CERTAIN RELATED  
APPROVALS.

Docket No. W-01445A-11-0310

RUCO'S REPLY BRIEF

The Residential Utility Consumer Office ("RUCO") hereby files its Reply Brief on the matters raised in Arizona Water Company's ("Arizona Water" or "AWC" or the Company") and Staff's Opening Briefs.

I. THE DSIC

RUCO has addressed most of the arguments raised by the Company in support of the DSIC in its Opening Brief. To that extent, RUCO would incorporate by reference those arguments raised in its Opening Brief. RUCO Brief at 2-18. RUCO replies as follows to those points not addressed in RUCO's Opening Brief.

1           **B. The Company's legal analysis is misplaced.**

2           The Company concludes that the DSIC does not violate Arizona's Constitution based on  
3 the argument that the Commission has wide discretion when it comes to ratemaking. Company  
4 Brief at 23-26. RUCO does not take issue with the Company that the Commission has wide  
5 discretion when it comes to ratemaking. That wide discretion, however, is not without limits.

6           With regard to the specific and limited area of increasing rates outside of a rate case,  
7 which is what the DSIC does, the Commission's discretion is very limited. See *Scates, supra*.  
8 Arizona's courts recognize that, "in limited circumstances," the Commission may engage in rate  
9 making without ascertaining a utility's rate base. *Residential Utility Consumer Office v. Arizona*  
10 *Corporation Commission*, 199 Ariz. 588, 591 ¶11, 20 P.3d 1169, 1172 (App. 2001). The DSIC  
11 is not "consistent" with those limited circumstances for all of the reasons stated in RUCO's  
12 Opening Brief. See RUCO Opening Brief at 11-14. Arizona, unlike the other states with DSIC's  
13 or DSIC-like mechanisms, has a constitutionally mandated fair value requirement. The DSIC  
14 does not meet Arizona's fair value requirement nor does it qualify as an exception. There is no  
15 legal basis for the DSIC in Arizona.

16           **C. Other argument raised by the Company related to the DSIC.**

17           **1. The NASUCA Policy v. NARUC Policy v. The Food and Water Watch**  
18           **Article**

19           The Company argues that Staff and RUCO did not present credible evidence that a DSIC  
20 is not justified under the circumstances presented in the case. Company Brief at 12. In support  
21 of the Company's argument, the Company claims that NASUCA's Policy is "not relevant" on the  
22 issue of whether the DSIC is appropriate and that the Food and Water Watch Article is biased  
23 and not authoritative. Company Brief at 13. From the Company's perspective, the NARUC  
24