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BOB STUMP, Chairman  
GARY PIERCE  
BRENDA BURNS  
BOB BURNS  
SUSAN BITTER SMITH

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2013 APR 29 P 4:00

AZ CORP COMMISSION  
DOCKET CONTROL

BEFORE THE ARIZONA CORPORATION COMMISSION

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

Bryan Cave LLP  
Two North Central Avenue, Suite 2200  
Phoenix, Arizona 85004-4406  
(602) 364-7000

ARIZONA WATER COMPANY'S

PHASE 2 POST-HEARING BRIEF

Arizona Corporation Commission  
**DOCKETED**

APR 29 2013

DOCKETED BY

Bryan Cave LLP  
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**Pre-Filed Testimony**

**Hearing Exhibit**

Testimony of Joel M. Reiker

A-2

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**GLOBAL WATER COMPANY'S  
PHASE 2 PRE-FILED TESTIMONY**

**Pre-Filed Testimony**

**Hearing Exhibit**

Testimony of Ron Fleming

Global - 1

Testimony of Paul Walker

Global - 2

**ARIZONA INVESTMENT COUNCIL'S  
PHASE 2 PRE-FILED TESTIMONY**

**Pre-Filed Testimony**

**Hearing Exhibit**

Testimony of Gary Yaquinito

AIC-1

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**EPCOR WATER ARIZONA, INC.'S**

**PHASE 2 PRE-FILED TESTIMONY**

**Pre-Filed Testimony**

**Hearing Exhibit**

Direct Testimony of Thomas M. Broderick

EPCOR - 1

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**RIO RICO UTILITIES, INC.'S  
PHASE 2 PRE-FILED TESTIMONY**

**Pre-Filed Testimony**

**Hearing Exhibit**

Direct Testimony of Greg Sorensen

RRUI - 1

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**ARIZONA CORPORATION COMMISSION STAFF'S  
PHASE 2 PRE-FILED TESTIMONY**

**Pre-Filed Testimony**

**Hearing Exhibit**

Testimony of Steven M. Olea

S - 1

Bryan Cave LLP  
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**RESIDENTIAL UTILITY CONSUMER OFFICE'S  
PHASE 2 PRE-FILED TESTIMONY**

**Pre-Filed Testimony**

**Hearing Exhibit**

Direct Testimony of Patrick J. Quinn

RUCO – 11

Direct Testimony of William A. Rigsby

RUCO – 12

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1 **I. INTRODUCTION**

2 On August 5, 2011, Arizona Water Company (“Arizona Water Company” or “the  
3 Company”) filed an application for a determination of the fair value of its utility plant and  
4 property, and for adjustments to its rates and charges for utility service furnished by its  
5 Eastern Group of water systems, including its Superstition (Apache Junction, Superior and  
6 Miami), Cochise (Bisbee and Sierra Vista), San Manuel, Oracle, SaddleBrooke Ranch and  
7 Winkleman water systems. At its Open Meeting on February 12, 2013, the Commission  
8 discussed and approved a Recommended Opinion and Order regarding the Company’s  
9 application with certain amendments, including setting procedural deadlines for further  
10 consideration of the Company’s proposed Distribution System Improvement Charge  
11 (“DSIC”).

12 On February 20, 2013, the Commission issued Decision No. 73736, which resolved  
13 all aspects of the rate proceedings. Instead of authorizing a DSIC mechanism, the  
14 Commission stated its support for such a mechanism, and provided for the reopening of  
15 intervention for the limited purpose of taking up the Company’s DSIC proposal and other  
16 DSIC-like proposals Commission Staff may wish to introduce:

17 Although we will not authorize a DSIC herein, today, we are supportive  
18 of the DSIC type mechanism and therefore we will leave this Docket open to  
19 allow the parties the opportunity to enter into discussions regarding AWC’s  
20 DSIC proposal and other DSIC like proposals Staff may wish to introduce.

21 In order to allow other parties that may be interested in this issue the  
22 ability to have input, we will allow such parties the opportunity to request late  
23 intervention in this Docket for the specific and limited purpose of participating  
24 in proceedings addressing the two proposals referenced in the previous  
25 paragraph.

26 [Decision No. 73736 dated February 20, 2013, p. 104, l. 22 – p. 105, l. 3]. No party filed a  
27 motion for reconsideration and the Decision became final in all respects on March 12, 2013  
28 pursuant to A.R.S. § 40-253.

1 This proceeding has been designated as “Phase 2” of the Docket<sup>1</sup> and provides for the  
2 specific and limited consideration of DSIC or DSIC-like proposals as the Commission  
3 directed. Pursuant to the Commission’s February 21, 2013 Procedural Order, the following  
4 additional entities intervened in Phase 2 for this purpose:

- 5 • Global Water – Palo Verde Utilities Company, Global Water – Santa Cruz  
6 Water Company, Valencia Water Company – Town Division, Valencia Water  
7 Company – Greater Buckeye Division, Water Utility of Greater Tonopah,  
8 Willow Valley Water Co. and Water Utility of Northern Scottsdale  
(collectively, “Global Utilities”)
- 9 • EPCOR Water Arizona, Inc. (“EPCOR”)
- 10 • Rio Rico Utilities, Inc. dba Liberty Utilities (“RRUI”)
- 11 • The Water Utility Association of Arizona (“WUAA”)
- 12 • Arizona Investment Council (“AIC”)
- 13 • City of Globe (“Globe”)

14 The Arizona Corporation Commission Utilities Division (“Staff”) filed a notice of  
15 settlement discussions on February 21, 2013, setting settlement discussions in the Phase 2  
16 Proceedings for March 4, 2013. All parties save for Kathie Wyatt, an early intervenor in  
17 Phase 1 of the case, appeared and participated in settlement discussions on March 4. As set  
18 forth in more detail below, a settlement was reached between Arizona Water Company,  
19 Staff, the Global Utilities, EPCOR, RRUI, WUAA and AIC (the “Signatory Parties”). The  
20 Residential Utility Consumer Office (“RUCO”) and Globe participated in the settlement  
21 discussions but did not sign the Settlement Agreement [Phase 2 (“P-2”), Ex. A-1].

22 Pre-filed testimony in Phase 2 was submitted on April 2, 2013, and the matter  
23 proceeded to hearings on April 8 and 11, 2013. By Procedural Order dated April 4, 2013,  
24 the evidentiary record created in the underlying Phase 1 proceeding is incorporated into the  
25 Phase 2 hearing and this Post-Hearing Brief (and will be specifically designated as such).

---

27  
28 <sup>1</sup> See Procedural Order docketed February 21, 2013.

1 **II. THE SIB MECHANISM<sup>2</sup> SET FORTH IN THE SETTLEMENT**  
2 **AGREEMENT SHOULD BE ADOPTED**

3 **A. The Settlement Procedure Was Open and Involved a Vigorous**  
4 **Negotiation Resulting In an Agreement That Is In The Public Interest.**

5 The record is clear that the settlement process was open, transparent and inclusive of  
6 all parties—including Staff, the Company and RUCO as well as the Intervenors. First, the  
7 Signatory Parties agreed “that the negotiation process undertaken in this matter was open,  
8 transparent and inclusive of all Signatory Parties, with each such party having an equal  
9 opportunity to participate. All Signatory Parties attended and actively participated in the  
10 settlement discussions.” [P-2, Ex. A-1 at para. 1.7]. No one party received everything they  
11 wanted; instead, the parties agreed upon a conceptual compromise that when viewed as a  
12 whole, was in the public interest and in the best interests of all parties. [P-2, Ex. A-2,  
13 Reiker Prefiled Testimony at p. 6, ll. 6-9; Phase 2 Transcript (“P-2 Tr.”) at p. 42, ll. 8-16].  
14 Second, witnesses for the parties confirmed that the process was designed to maximize  
15 productive negotiations, was “very vigorous,” and involved “fully vetted” and “hotly  
16 contested” issues. [P-2 Tr. at p. 153, ll. 11 – p. 154, l. 16 (Walker); p. 200, l. 22 – p. 202, l.  
17 17 (Broderick)]. Mr. Broderick, EPCOR’s Director of Rates with more than 25 years of  
18 experience in the international and Arizona electric and water utility industry, testified that  
19 this was a historic exercise in compromise negotiations among different companies and  
20 constituencies. [P-2 Tr. at p. 203, ll. 18 – p. 205, l. 14; P-2 Ex. EPCOR-1, Broderick  
21 Prefiled Testimony at p. 3, l. 21 – p. 4, l. 5 (“This is the first time I have seen a large  
22 segment of the water industry come together and speak, for the most part, with one voice  
23 throughout the Phase 2 process in support of another water company, AWC.... No doubt  
24 this will enable an evolution of the SIB mechanism through time to the continuing  
25 betterment of the public interest.”)]

26 <sup>2</sup> “SIB” is the acronym for “System Improvement Benefits.” [P-2 Tr. at p. 58, ll. 2-3]. It is  
27 similar in purpose and function to the Company’s proposed DSIC, but contains several  
28 additional compromise provisions. It is a “DSIC-like” mechanism as called for by the  
Commission.

1           The process involved three separate formal negotiation sessions spanning a period of  
2 weeks and covering multiple hours involving the Company, Staff and RUCO, with two of  
3 the three sessions including many of the Intervenors [P-2 Tr. at p. 48, l. 5 – p. 52, l. 15].  
4 Staff believed the settlement discussions were “transparent, candid, professional and open to  
5 all parties in this docket. All Parties were allowed to openly express their views and  
6 opinions on all issues.” [P-2 Ex. S-1, Olea Prefiled Testimony at p. 9, l. 25]. RUCO’s  
7 witnesses testified that many parts of the Settlement Agreement were well thought out and  
8 that many compromises were agreed to [P-2 Ex. RUCO-11, Quinn Prefiled Testimony at p.  
9 3, ll. 2-3; P-2 Tr. at p. 393 at ll. 4-20] and that “the Agreement viewed alone has a lot of  
10 good points.” [P-2 Ex. RUCO-12, Rigsby Prefiled Testimony at p. 5, ll. 6-7; *see also* P-2 Tr.  
11 at p. 472, ll. 9 – p. 473, l. 4 (“As far as the events that produced the work product, I would  
12 say that there was quite a bit of effort into that.”)]. RUCO participated vigorously and  
13 completely right up to very end, when it announced it would not be a Signatory Party. As  
14 such, the Settlement Agreement and the SIB Mechanism itself are the product of substantial  
15 compromise for the benefit of the consumers and the public interest (and of course Staff  
16 both vigorously negotiated and signed the Settlement Agreement), even though RUCO  
17 ended up not being a Signatory Party.

18           As Utilities Division Director Steve Olea testified, “Yes, in Staff’s opinion, the  
19 Agreement is fair, balanced and in the public interest” and “I believe the Settlement  
20 Agreement is in the public interest.” [P-2 Ex. S-1 at p. 9, l. 25; p. 11 at ll. 11-12]. Staff  
21 reached that conclusion based on the fact that the SIB Mechanism allows Arizona Water  
22 Company to make plant investments to improve service to existing customers in a way that  
23 will lessen rate shock by allowing smaller, more incremental rate increases to cover those  
24 costs. [*Id.* at p. 10, ll. 1-6]. In addition, “because of the five percent efficiency credit, the  
25 SIB rate increases that will be granted to AWC are actually less than otherwise would have  
26 been granted.” [*Id.* at ll. 6-8]. Mr. Olea accurately summarized the advantages to the public  
27 interest in adopting the SIB Mechanism in this case:  
28

1 The primary goal of Staff in this matter, as in all proceedings before the  
2 Commission, *is to protect the public interest by making recommendations that*  
3 *are just, fair and reasonable for both the ratepayers and the Company. Staff*  
4 *believes it has accomplished this objective* by reviewing the facts presented  
5 and making the appropriate recommendations to the Commission for its  
6 consideration. Staff believes that the proposed settlement balances the  
interests of AWC and its ratepayers, by ensuring that the Company will have  
the tools and financial health to provide safe, adequate and reliable service,  
while complying with Commission requirements at just and reasonable rates.

7 [*Id.* at p. 10, ll. 11-18 (emphasis added)].

8 **B. The SIB Mechanism Agreed to by the Signatory Parties.**

9 The provisions of the proposed SIB Mechanism are set forth in the Settlement  
10 Agreement, P-2 Ex. A-1, and its associated exhibits and tables. The SIB Mechanism  
11 represents significant further compromise from the DSIC mechanism as originally proposed  
12 by Arizona Water Company and then refined during the course of the Phase I proceedings.  
13 The SIB Mechanism appropriately balances the interests of the Company, its customers, and  
14 the public interest. Its key provisions include:

- 15 • Commission Pre-Approval of SIB-Eligible Projects – All of the infrastructure  
16 replacement projects contemplated for SIB recovery must be reviewed by Staff  
17 and approved by the Commission prior to the Company filing for recovery of the  
18 capital costs associated with such projects. The specific projects the Company  
19 proposes for SIB treatment in this proceeding are listed in SIB Plant Table I,  
20 attached to the Settlement Agreement, P-2 Ex. A-1, as Exhibit A, and Staff has  
21 already reviewed and approved those projects. [P-2 Ex. A-2 at p. 11, ll. 1-6]. All  
22 of the Commission-approved projects that are included in a SIB surcharge filing  
23 must be completed and placed in service prior to the SIB surcharge going into  
24 effect. If circumstances require the Company to add a qualifying project to the  
25 list of SIB-eligible projects, it may seek Commission approval to add such project  
26 to the list. Additionally, Section 4.8 of the Settlement Agreement requires the  
27 Company to file a report with the Commission every six months summarizing the  
28 status of all SIB eligible projects.

- 1 • SIB Project Eligibility Criteria – Only those projects completed for the purpose of  
2 maintaining or improving existing customer service and reliability, integrity and  
3 safety are eligible for SIB treatment. Projects designed purely to extend existing  
4 facilities or expand capacity to serve new customers are not eligible for SIB  
5 treatment.
- 6 • Costs Eligible for SIB Recovery – The project costs that are eligible for SIB  
7 surcharge recovery are limited to the pre-tax rate of return on investment and  
8 depreciation expense associated with SIB-eligible projects. The rate of return,  
9 depreciation rate, and tax multiplier are equal to those approved by the  
10 Commission in the Company’s most recent general rate case – in this case  
11 Decision No. 73736 docketed February 20, 2013. The calculation of the SIB  
12 surcharge will also take into account any related plant retirements.
- 13 • Efficiency Credit – A credit equal to five percent of the SIB surcharge will be  
14 given back to customers in the form of a SIB efficiency credit.
- 15 • SIB Surcharge Cap – The amount to be collected from each SIB surcharge is  
16 capped annually at five percent of the revenue requirement authorized in the  
17 Company’s most recent general rate case.
- 18 • SIB Surcharge Rate Design – The SIB surcharge will be a fixed monthly  
19 surcharge presented on customers’ bills as a SIB fixed surcharge and SIB  
20 efficiency credit as two separate line-items. The surcharge will increase with  
21 meter size based on the flow capacity of the meter.
- 22 • Commission Approval of SIB Surcharge – Each SIB surcharge filing must be  
23 approved by the Commission prior to the Company implementing such surcharge.  
24 To this end, the Company will include a proposed order for the Commission’s  
25 consideration with each SIB surcharge filing. When the Company files a SIB  
26 surcharge, Staff and RUCO have 30 days to review the filing and, if no objection  
27 is raised, the surcharge will be placed on an open meeting agenda at the earliest  
28

1 practicable date. No surcharge can be implemented until objections are addressed  
2 and the Commission approves such surcharge.

- 3 • Number of SIB Surcharge Filings Allowed Between General Rate Cases – The  
4 Company may file up to five SIB surcharges for each of its ratemaking systems  
5 between general rate cases, with the initial filing being no sooner than 12 months  
6 after the date of the Commission’s decision in each ratemaking system’s most  
7 recent general rate case. The Company may file no more than one SIB surcharge  
8 every 12 months for each ratemaking system. Additionally, the Company must  
9 file its next general rate case application no later than five years after its most  
10 recent general rate case, and any SIB surcharges that are then in effect will end  
11 and the associated costs will be included in the base rates approved by the  
12 Commission in that proceeding.
- 13 • Annual SIB True-up – For each 12-month period that a SIB surcharge is in effect,  
14 the Company will reconcile the revenue collected with the SIB revenue  
15 authorized for that period. Any over- or under-collected SIB surcharge revenues  
16 will be refunded, or collected, as appropriate over the subsequent 12-month  
17 period.
- 18 • Public Notice – At least 30 days prior to a SIB surcharge becoming effective, the  
19 Company will provide public notice in the form of a billing insert or customer  
20 letter that summarizes the amount of the SIB surcharge, SIB efficiency credit, any  
21 true-up, as well as a summary of the projects included in the surcharge and their  
22 associated cost.

23 [P-2 Ex. A-2 at p. 8, l. 20 – p. 10, l. 28; P-2 Tr. p. 54, l. 7 – p. 62, l. 5; P-2 Ex. A-1]

24 **C. Arizona Water Company, Staff and the Signatory Intervenors**  
25 **Demonstrated That A SIB Mechanism Is Justified In This Case and In**  
26 **Future Cases Under Appropriate Circumstances.**

27 As set forth in the record in both Phases 1 and 2, for most of the last two decades, the  
28 Company has not been able to recover its cost of service, despite diligent efforts to contain  
costs and increase efficiencies. [Phase 1 (“P-1”) Ex. A-10 at p. 5, l. 18 - 6, l. 22; P-1 Tr. at

1 p. 332, ll. 7-18] In the Phase 2 proceedings, Mr. Reiker testified that Arizona Water  
2 Company has not been able to recover its cost of service for 16 years in a row, resulting in  
3 the Company's shareholders subsidizing the cost of providing public utility water service to  
4 the extent of \$41 million—and still counting—since 1996. [P-2 Tr. at p. 63, l. 22 – p. 64, l.  
5 4]. This fact has resulted in the filing of serial rate cases as the Company sought to recover  
6 its actual cost of providing service. [P-1 Tr. at p. 333, l. 22 – p. 335, l. 2]. The evidence  
7 remains uncontroverted that the Company's shareholders have subsidized the cost of service  
8 and financed necessary infrastructure improvements with little, if any, realistic probability  
9 of fully recovering the costs of doing so. [*Id.*]. This has contributed to the situation set  
10 forth in depth in the Phase 1 record in which the Company's Eastern Group infrastructure is  
11 at, or is rapidly approaching, the end of its useful life, but the Company is unable to finance  
12 all of the massive and critical utility plant improvements and replacements that are  
13 necessary. [P-1 Tr. at p. 329, ll. 17-23; p. 370, ll. 12-15].

14 The impact of these problems affect the customers as well as the Company. The  
15 record shows that thousands of line breaks are occurring every year in these systems. [*See*  
16 P-1 Exs. A-11, A-12, A-13, A-14, A-15 and A-36 (annual water leaks by system since  
17 2006); P-1 Ex. A.-28 at FKS-13, Apps. 9.1-9.2.3]. While the Company is fully cognizant of  
18 its duty to provide safe and reliable service to its customers (and fully complies with that  
19 duty), current ratemaking practice prevents critically needed utility plant improvements. [P-  
20 1 Tr. at p. 329, l. 24 – p. 331, l. 1; p. 588, l. 18 – p. 589, l. 18]. This is the appropriate case  
21 for the Commission to adopt the "Best Practice" recommended by the National Association  
22 of Regulatory Utility Commissioners ("NARUC") [P-1 Exs. A-1 at p. 16, A-9 at p. 12 and  
23 JDH-3, Ex. F] by implementing the SIB Mechanism as agreed to by the Signatory Parties.

24 Phase 1 established that the Company's Eastern Group contains approximately 3.5  
25 million lineal feet (over 600 miles) of water mains and over 33,000 service connections.  
26 [Water Loss Reduction Report at 7, 18; P-1 Tr. at p. 212, ll. 16-17; p. 471, ll. 11-15]. The  
27 Company's analysis of that infrastructure identified approximately 371,000 lineal feet of  
28 mains (as well as the 4,915 service connections attached to those mains) and 3,850

1 additional failing plastic service connections that need to be replaced in the next ten years.  
2 [P-1 Exs. A-10 at p. 8, ll. 4-15; A-28 at pp. 35, 81, ll. 12-25; Water Loss Reduction Report,  
3 App. 9.4]. At current capital expenditure levels, (limited as they are by chronic deficiencies  
4 in cost recovery and earnings), these specific replacements, which are only a portion of the  
5 existing infrastructure that needs to be replaced, would take over *fifty years* to replace. [P-1  
6 Ex. A-9 at p. 14, ll. 13-20]. In the meantime, the remaining infrastructure facilities will  
7 continue to age beyond the end of their useful lives before the Company is able to replace  
8 them, resulting in even greater infrastructure failures, water losses and costs going forward.  
9 [See P-1 Exs. A-10 at p. 8, ll. 11-15; A-28 at pp. 36, ll. 18-25; p. 81, ll. 22-25; Tr. at p. 401,  
10 ll. 7-16, p. 522, l. 13-p. 524, l. 14]. The Company's Water Loss Reduction Report examined  
11 in depth during Phase 1 conclusively demonstrated—undisputed by Staff or RUCO—that  
12 the Bisbee, Miami, Oracle, Superior and Apache Junction systems all require significant,  
13 immediate investment in replacement infrastructure in order to reduce water losses. Even  
14 the Staff Engineering witness agreed during Phase 1 that the Company's repair cost  
15 estimates and projected time frame for repairs were reasonable and justified. [P-1 Ex. S-1,  
16 Ex. KS, Stukov Direct at p. 36].

17 During Phase 2, RUCO questioned why the Company's proposed replacements were  
18 not part of the Company's ongoing efforts to provide safe, reliable and adequate service to  
19 its customers. However, the record demonstrates that the Company regularly replaces  
20 failing infrastructure. [P-1 Exs. A-9 at p. 14, ll. 13-20; A-28 at p. 43, l. 18 – p. 49, l. 23; *see*  
21 *also* Tr. at p. 533, ll. 18-24; p. 614, ll. 9-25]. The Company has a rigorous water loss  
22 reduction program that actively seeks to detect water losses and replace infrastructure that  
23 can no longer be repaired. [See P-1 Ex. A-28 at p. 43, l. 18 – p. 49, l. 23]. Because large  
24 portions of its infrastructure are now at or beyond their useful service lives, those ongoing  
25 efforts are not sufficient to replace that infrastructure, and a SIB Mechanism is necessary.  
26 [*Id.*; P-1 Ex. A-9 at p. 14, l. 4 – p. 16, l. 1; Water Loss Reduction Report at p. 42 (current  
27 replacement levels for Superstition division would need to triple just to stay even with  
28 replacement needs related to aging infrastructure); P-1 Tr. at p. 535, ll. 6-19]. The age of

1 the Company's infrastructure and the increasing frequency of leaks and breaks means that  
2 the infrastructure is failing faster than it can be replaced given the resources available to the  
3 Company. [P-1 Ex. A-29 at p. 6, l. 3 – p. 8, l. 5; Water Loss Reduction Report at pp. 42, 57  
4 (at current replacement levels it would take 640 years to replace existing infrastructure in  
5 Superstition division); P-1 Tr. at p. 533, ll. 21-24]. The Company demonstrated in Phase I  
6 that the scale of the needed replacement program dwarfs the resources available to the  
7 Company, rendering the Company's ongoing replacement efforts under current rates  
8 inadequate.<sup>3</sup> [See P-1 Exs. A-9 at p. 15, l. 13 – p. 16, l. 1; A-29, FKS-RB8 (Company's  
9 Water Loss Reduction Plan)].

10 In Phases 1 and now 2, RUCO presented no credible evidence that a SIB Mechanism  
11 is not fully justified under the circumstances presented here. RUCO presented no evidence  
12 in either Phases 1 or 2 disputing the impending water infrastructure replacement crisis  
13 facing the Company and its customers.

14 In addition to the overwhelming and pressing size of the problem facing the  
15 Company, the financial burden and challenges to the Company are just as imposing. The  
16 Company's proposed infrastructure replacement plan presented in Phase 1 would require the  
17 expenditure of approximately \$67 million over the next ten years. [P-1 Exs. A-9 at p. 14, l.  
18 11 - p. 15, l. 12; A-28 at pp. 73, ll. 1-18; p. 81, ll. 10-25; P-1 Tr. at p. 555, l. 23 – p. 556, l.  
19 2]. That estimated expenditure, which does not include any increase in construction costs  
20 over that period, nearly doubles the amount the Company had to spend to comply with the  
21 federal arsenic removal standards and represents a more than 500 percent increase over the  
22 amount of plant the Company replaced in the last decade. [P-1 Ex. A-10, Harris Rebuttal at  
23 \_\_\_\_\_

24 <sup>3</sup> As in Phase 1, RUCO suggested in its testimony and questioning of the Company's  
25 witness that it was incumbent on the Company to replace the now-failing infrastructure prior  
26 to it reaching the end of its useful life in order to avoid the circumstances now requiring a  
27 SIB Mechanism. This suggestion ignores the fact that such expenditures would have been  
28 objected to and likely disallowed as imprudent by RUCO, if not Staff as well. [See P-1 Tr.  
at p. 602, l. 23 – p. 603, l. 1 (Staff considers replacing infrastructure prior to the end of its  
useful life to be imprudent)].

1 p. 4, l. 20 – p. 5, l. 7]. Those sizable arsenic plant costs were considered extraordinary by  
2 Staff, RUCO and the Commission. [See Decision No. 66400; P-1 Ex. A-10 at p. 5, ll. 11-  
3 17]. As Company witness Joseph Harris explained in Phase 1, spending \$67 million over  
4 the next ten years is an extraordinary expenditure which the Company does not have the  
5 resources to fund. [P-1 Ex. A-9 at p. 15, l. 13 – p. 16, l. 2; P-1 Tr. at p. 370, ll. 7-15].

6 Despite the fact that the Company has been unable to earn its authorized rate of  
7 return over the last 16 years, the Company's shareholders recently infused over \$10 million  
8 in equity into the Company. [P-1 Tr. at p. 332, ll. 7-18.] As stated above, the Company's  
9 shareholders have provided subsidies totaling \$41 million, and counting, since 1996. Even  
10 if the Company were able to internally finance the necessary replacements, which it cannot,  
11 the Company has established that its ability to refinance multiple short-term projects  
12 through the issuance of additional long-term bonds has been severely compromised by the  
13 Company's weakened financial state. [P-1 Tr. at p. 365, l. 10 – p. 371, l. 23]. As explored  
14 in detail in Phase 1, the Company's bond indenture prohibits the Company from issuing any  
15 bonds when the Company's earnings before interest and taxes are not equal to at least two  
16 times the outstanding interest payment requirements. [P-1 Tr. at p. 368, l. 8 - p. 369, l. 1].  
17 The Company's bond indenture also prevents the Company from issuing bonds that cause  
18 its equity ratio to dip below 35 percent of its overall capital structure. [P-1 Tr. at p. 369, l.  
19 23 – p. 370, l. 6]. Theoretically, the Company might be able to issue approximately \$7  
20 million in additional long-term bonds at this time, which is only a small fraction of the \$67  
21 million of infrastructure replacements that are needed. [P-1 Tr. at p. 370, ll. 7-15]. Such a  
22 bond issuance would be impracticable, however, as bond lenders are typically interested in  
23 issuances of at least \$15 million. [P-1 Tr. at p. 366, ll. 9-17]. In addition, when the  
24 Company last issued bonds, only two of five potential bond lenders made offers on the  
25 Company's private placement offering. [P-1 Tr. at p. 367, ll. 12-18]. Further, both of those  
26 bond lenders required the Company to pay a risk premium due to the Company's weak  
27 financial condition. [P-1 Tr. at p. 371, pp. 15-23]. Absent the ability to recover  
28 infrastructure-related costs in a timely manner through the agreed SIB Mechanism, the

1 Company has conclusively demonstrated that it cannot finance the needed replacement  
2 infrastructure.

3 The agreed SIB Mechanism provides credit support that should assist the Company  
4 in attracting capital to construct the necessary improvements. As the Company's witnesses  
5 pointed out in Phase 1, water utilities are the most capital intensive utilities. [P-1 Exs. A-1  
6 at p. 10, ll. 16-18; A-34 at p. 7, l. 11 ("because the water ... industry is much more capital-  
7 intensive than [other utility] industries, the investment required to produce a dollar of  
8 revenue is greater")]. As a result, water utilities often do not generate positive free cash  
9 flow. [*Id.* at p. 8, ll. 23-24 (quoting Standard & Poor's article)]. The infrastructure needs  
10 facing the Company will require significant additional sources of financing. [P-1 Tr. at p.  
11 272, l. 1 – p. 273, l. 5; p. 381, ll. 2-20; p. 398, l. 25 – p. 394, l. 6; p. 423, ll. 14-18]. By  
12 partially mitigating regulatory lag and providing additional stability to cash flows, the  
13 agreed SIB Mechanism helps support a utility's credit quality, bond rating, and "enhances  
14 [its] ability to attract necessary new capital." [P-1 Ex. A-34 at p. 21, l. 23 – p. 22, l. 1; p. 26,  
15 ll. 3-8; *see also* P-1 Tr. at p. 329, l. 17 – p. 332, l. 18.] As Company expert witness Pauline  
16 Ahern explained in her Phase 1 testimony, the major credit rating agencies view a  
17 mechanism such as a SIB (her testimony was in the context of a DSIC) as credit supportive,  
18 which is a significant justification for implementation of the agreed SIB Mechanism. [P-1  
19 Ex. A-34 at pp. 22-26; *see also* P-2 Ex. A-2 at p. 12, ll. 3-9].

20 Finally, the SIB Mechanism will help enable Arizona Water Company to recover its  
21 cost of service. [P-2 Tr. at p. 64, ll. 5-12]. It will reduce regulatory lag for the most critical  
22 types of capital projects – the replacement of aging and failing infrastructure. [P-2 Ex. A-2  
23 at p. 22, l. 23 – p. 3]. However, while the SIB Mechanism will serve to reduce regulatory  
24 lag, it will not eliminate it, resulting in the Company continuing to under-recover its cost of  
25 providing utility service. [*Id.* at p. 13, l. 27 – p. 14, l. 2]. As a result of the five percent  
26 efficiency credit negotiated by Staff and RUCO, the effective return on common equity the  
27 Company would be authorized to earn on SIB-eligible projects is only 9.68 percent—87  
28 basis points lower than what the Commission already determined the Company's cost of

1 equity to be in Decision No. 73736. [P-2 Tr. at p. 232, l. 6 – p. 233, l. 17 and P-2 Ex. A-3  
2 (assuming alternative calculation schedule reflecting adjustment for income tax reduction is  
3 adopted by the Commission)]. Still, the SIB Mechanism is a significant move in the right  
4 direction toward addressing these critical infrastructure issues.

5 **D. The Agreed SIB Mechanism Is In the Best Interests of the Customers.**

6 The agreed SIB Mechanism, like the Arsenic Cost Recovery Mechanism (“ACRM”)  
7 previously approved by the Commission and now in place for several years in the Arizona  
8 water utility industry, would provide significant benefits to customers at a minimal cost, by  
9 permitting the Company to replace and upgrade its aging infrastructure in a timely and  
10 efficient manner, while providing more gradual and smaller rate impacts on those  
11 customers. [P-1 Exs. A-5 at p. 4, l. 9 – p. 5, l. 16 (actual experience in Pennsylvania shows  
12 benefits to ratepayers); A-34 at p. 26, l. 9 – p. 27, l. 25]. Under the Company’s proposal, the  
13 Company would begin replacing only those portions of its aging infrastructure identified in  
14 the Company’s Water Loss Reduction Report, which is undisputed by Staff or RUCO, and  
15 as identified and approved in SIB Plant Table 1. [P-2 Ex. A-1 at Ex. A; P-1 Exs. A-9 at p.  
16 17, l. 4 – p. 20, l. 3; A-28, Tab FKS-13]. Those projects are limited to replacements of  
17 existing infrastructure serving current customer accounts, such as mains, service lines,  
18 hydrants and meters. [P-1 Ex. A-9 at p. 17, ll. 7-17; Water Loss Reduction Report, App. 9.4  
19 (recommended projects); P-2 Tr. at p. 72, l. 1 – p. 73, l. 7; p. 127, l. 3 – p. 128, l. 11].

20 RUCO asserted in Phases 1 and 2 that the DSIC, then the SIB Mechanism, would  
21 “shift risks” to ratepayers. RUCO’s assertions are in conflict with and are not supported by  
22 any evidence in the record (as opposed to record evidence to the contrary as provided by  
23 Arizona Water Company). As the Commission is aware, in the absence of a SIB  
24 Mechanism, a utility cannot recover costs associated with replacement infrastructure until  
25 after such plant is included in rate base as part of the utility’s next general rate case. This  
26 lag in recovery is not beneficial to either the utility or its customers. [P-1 Exs. A-5, Ahern  
27 Rejoinder at p. 5, ll. 7-19, A-34, Ahern Rebuttal at p. 6, ll. 10-15]. For utilities, regulatory  
28 lag increases borrowing costs and undercuts their ability to actually earn their authorized

1 return. [See *id.* at p. 6, ll. 10-23]. This results in higher costs to customers as the higher  
2 borrowing costs are included in future rates and the utility is forced to file more frequent  
3 rate cases to attempt to recoup its cost of service. [*Id.*] Regulatory lag also forces utilities to  
4 time their capital expenditures to coincide with rate cases to minimize the negative impacts  
5 of regulatory lag on the utility.<sup>4</sup>

6 The agreed SIB Mechanism will provide partial cost recovery to support investment  
7 in the infrastructure replaced by the Company. Such cost recovery will also be credit  
8 supportive, allowing the Company to attract the capital necessary to accelerate its  
9 infrastructure replacement program on more favorable terms, which is a key benefit to the  
10 customers. [P-1 Ex. A-34 at p. 21, l. 23 – p. 22, l. 1, p. 26, ll. 3-8; P-1 Tr. at p. 329, l. 17 –  
11 p. 332, l. 18]. Instead of shifting risks to customers, as RUCO argues, the agreed SIB  
12 Mechanism creates long-term benefits for customers. It will also more closely match the  
13 customers benefiting from replaced infrastructure with those paying the rates associated  
14 with such infrastructure, a principal generally espoused by RUCO.

15 The SIB Mechanism also promotes rate stability by providing for smaller, more  
16 regularly-timed increases, as opposed to much larger increases that frequently occur absent  
17 such a mechanism. [P-2 Ex. A-2 at p. 12, l. 26 – p. 13, l. 1; P-2 Tr. at p. 64, l. 15 – p. 65, l.  
18 3]. As Mr. Olea testified, “So it’s kind of like the FRAM commercial, you can pay me now  
19 or you can pay me later. This is later.” [P-2 Tr. at p. 303, ll. 14-16]. RUCO Director  
20 Patrick Quinn also agreed that rate gradualism benefits consumers. [P-2 Tr. at p. 453, l. 23  
21 – p. 454, l. 13]. Another benefit is that allowing the utility a better chance to recover its cost  
22 of providing service results in a healthier company that is able to serve its customers. Mr.  
23 Olea recognized that a SIB Mechanism benefits both the utility and the consumer, “because  
24 you’re going to make sure that you keep providing proper and adequate service. It is true  
25

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26 <sup>4</sup> Unfortunately, the agreed SIB Mechanism does not eliminate regulatory lag; it only  
27 partially mitigates some of its negative effects. Even with a SIB Mechanism in place, the  
28 replaced plant is not included in rate base until after the utility’s next general rate case.

1 that the companies have to do that regardless, but if you can assist the companies to do that  
2 and making sure that. . .every time somebody turns on the spigot, water comes out, that it's  
3 safe water, then I think that's not just a benefit to the company, but it's a benefit to the  
4 ratepayers." [*Id.* at p. 304, ll. 14-22]. Mr. Quinn agreed: "I think what benefits the  
5 consumers is, you have to have a healthy company." [*Id.* at p. 423, ll. 19-20]. In addition,  
6 because the Company operates in a rising-cost industry, delaying infrastructure replacement  
7 projects causes costs to be higher than if the Company were able to undertake them sooner.  
8 The SIB Mechanism thus helps to mitigate rising operational and maintenance costs, in  
9 addition to the five percent efficiency credit built into the SIB surcharge as a benefit to  
10 consumers. [*Id.* at p. 13, ll. 1-10; P-2 Tr. at p. 6, ll. 4-15].

11 **E. The SIB Mechanism Addresses Separate Issues and Should Not Be**  
12 **Linked to a Utility's Cost of Capital and Rate of Return on Equity**  
13 **("ROE").**

14 As demonstrated above, Arizona Water Company made its case in both Phases 1 and  
15 2 for the implementation of the agreed SIB Mechanism. However, the benefits of the  
16 negotiated and compromised SIB Mechanism become meaningful only to the extent that  
17 Arizona Water Company's awarded cost of equity, which is 10.55 percent in this case,<sup>5</sup> is  
18 reflected in its rates. Stated differently, the Commission should not authorize a utility a SIB  
19 Mechanism (which already includes a five percent efficiency credit), then subtract the  
20 benefits of the SIB Mechanism by also reducing the Company's authorized ROE. As Ms.  
21 Ahern testified during Phase 1 on this point, it is especially important to authorize a DSIC-  
22 type mechanism in conjunction with a sufficient ROE to enable the Company to raise the  
23 capital required to undertake the capital expenditures required while maintaining its  
24 financial integrity. [P-1 Ex. A-34 at p. 29, ll. 17-20].

25  
26  
27 <sup>5</sup> Decision No. 73736 (February 20, 2013) at p. 61, ll. 9-11, with no party moving for  
28 rehearing thereafter under A.R.S. § 40-253.

1 Ms. Ahern explained that DSIC mechanisms, if all else is equal and/or effective, will  
2 reduce the volatility of cash flows; however, such a reduction is a small, single factor that  
3 affects the investor in making their pricing decisions but does not affect the investor's  
4 expected return on equity. [P-1 Tr. at p. 997, l. 19 – p. 998, l. 3]. Ms. Ahern also testified  
5 that of the 11 states that have adopted DSIC like mechanisms, *not a single one* had reduced  
6 the utility's ROE because of the existence of a DSIC. [*Id.* at ll. 4-9]. She testified that the  
7 perceived benefits of enhancement of credit quality of this nature may result in a higher  
8 bond rating, but does not translate directly to a reduction in common equity risk. [P-1 Tr. at  
9 p. 999, l. 18 – p. 1000, l. 14; p. 1001, l. 21 – p. 1002, l. 22; p. 1006, ll. 8-16; p. 1015, l. 16 –  
10 p. 1016, l. 7].

11 Mr. Olea's testimony is clear that ROE and the SIB Mechanism are entirely different  
12 issues:

13 [W]hat we're saying is, for Arizona Water's 10.55, you don't have to  
14 look at that, the way the SIB is set up with the efficiency credit. If you set up  
15 the SIB the same way for other companies, then those two items will be  
16 separate. The ROE would be separate from the SIB, because you've already  
17 taken something in account.

18 \* \* \*

19 Q. [By Counsel for RUCO]: So as we move forward, Mr. Olea,  
20 and we look at SIB surcharge applications in the future, is it your testimony  
21 that as long as there's an efficiency credit, then Staff will be – Staff won't  
22 concern itself with the return on equity as it relates to the investment issue?

23 A. That's what I'm saying.

24 \* \* \*

25 Q. Do you believe, to the extent that the 5 percent efficiency credit  
26 is a benefit to ratepayers, that the benefit is negated by the higher 10.55  
27 percent ROE awarded by the Commission?

28 A. No.

Q. Why not?

A. Because I think that the risk is what the risk is on that company,  
and the fact that they now have a mechanism or would have a mechanism to

1 address part of that, you know, part of their infrastructure needs, doesn't  
2 change that. That risk still is what it is.

3 Q. Do you think the company's ROE in this case should be a  
4 consideration when evaluating the SIB?

5 A. No. As I stated earlier, as long as you have some type of credit  
6 in their in the SIB, then no. If you didn't have that, which is why I totally  
7 agree with the way the ROO was written, it says that the DSIC that the  
8 company had, and that's why they didn't get the DSIC.

9 [P-2 Tr. at p. 272, ll. 12-18; p. 272, l. 23 – p. 273, l. 3; p. 275, l. 23 – p. 276, l. 15].

10 Mr. Olea also addressed specific Commissioner questions on this point that were  
11 posed to him by ALJ Nodes:

12 Q. [By Judge Nodes] And the final question from Commissioner  
13 Burns' office is, if in a rate case the cost of equity incorporates investor risk,  
14 then wouldn't the inclusion of a DSIC-type mechanism for the purpose of rate  
15 gradualism mitigate some of that risk?

16 A. Can you say that again?

17 Q. I think she means if a DSIC is granted for purposes of rate  
18 gradualism, would the approval of such a mechanism mitigate some of the, I  
19 suppose, financial risk that is associated with whatever position that company  
20 is in?

21 A. And I think my answer to that would be, is that the way that we  
22 have set up with SIB with the efficiency credit and with all of the protections  
23 in here to make sure that it's only plant that really needs to be replaced, with  
24 all the checks in it, and because the amount of plant that's being replaced,  
25 especially in the case of Arizona Water Company, is very small compared to  
26 their total plant, then I think, as I stated earlier, that really shouldn't come into  
27 play with the ROE. The ROE is set up on, you know, whatever the risk is, and  
28 the SIB is separate in Staff's mind.

I know that as far as tying any type of DSIC mechanism to ROE, that  
has been the argument from the day one since DSIC has first been done in  
Pennsylvania, which was quite a few years ago. And as far as I know, I think  
the SIB is the only one that I know of that I've read about, and, you know, I  
don't, obviously, know all the DSIC mechanisms in all the states, but the SIB  
is the only one that has this kind of – some kind of credit in it for the

1 customers, and that's the one thing Staff was really pushing for that was  
2 different from the DSIC that was filed by Arizona Water.

3 Q. But in your mind, even though the Commission specifically  
4 indicated that it was granting a higher ROE than it might otherwise have  
5 granted due to the infrastructure replacement needs that had been identified  
6 during the case, you don't believe that there should be any lowering of the  
7 ROE in this case given the fact that you're now recommending a SIB  
8 mechanism be approved, which seemingly is intended to recognize the same  
9 type of infrastructure replacement needs?

10 A. Correct, we are not recommending that the ROE be changed  
11 from what's in the order that's out there now, even with the SIB.

12 [*Id.* at p. 317, l. 13 – p. 319, l. 7]. Mr. Olea also testified that he was unaware of any  
13 instances where the Commission has ever increased an ROE to account for actions it took  
14 that resulted in worsening the effects of regulatory lag, such as elimination of purchased  
15 power adjustors or purchased water adjusters. [*Id.* at p. 349, l.25 – p. 350, l. 15].

16 It is also significant that RUCO presented no evidence whatsoever of what an  
17 appropriate adjustment to ROE would be as a result of the SIB mechanism, a fact that was  
18 confirmed both by Mr. Quinn [*Id.* at p. 427, ll. 14-19] and Mr. Rigsby [*Id.* at p. 487, ll. 16-  
19 20; p. 488, l. 6 – p. 489, l. 1], and presented no studies to support its theory about reduction  
20 to ROE where there was a DSIC-type mechanism. [*Id.* at p. 489, ll. 2-7]. Finally, Global  
21 Water witness Paul Walker testified that to take the SIB Mechanism and its provision of  
22 timely recovery on replacement investments, capped at five percent per year, and then  
23 conclude that the entire investment in the Company should also be reduced, “is  
24 unsupported on the facts.” [P-2 Ex. Global 2, Walker Prefiled Testimony at p. 6, ll. 1-3].  
25 Mr. Walker testified that invested capital in traditional rate base does not have annualized  
26 changes, the ROE does not change when the market goes into chaos, and the return of and  
27 on a utility's rate base investment is completely unaffected by the allowance of costs for  
28 repairing aging plant. [*Id.* at ll. 3-6]. He also noted, as did other witnesses, that if the price  
of using a SIB Mechanism were a company-wide ROE reduction, there would be a severe  
risk that utilities would not use the SIB Mechanism because the cost to investors would be  
too great, erasing all of the benefits of the mechanism. [*Id.* at ll. 8-14].

1 In summary, the awarded ROE helps the Company continue its long-standing  
2 replacement and maintenance program. But, it will not provide sufficient revenues to lessen  
3 the infrastructure crisis facing the Company, which is an entirely separate issue, as  
4 demonstrated in Phases 1 and 2. The agreed SIB Mechanism helps to address this problem,  
5 but should play no role in determining the appropriate return on equity for a water utility  
6 company (or specifically the Company's ROE previously awarded in this case), and the  
7 Commission should reject RUCO's attempts to link the two issues. As Mr. Olea testified,  
8 with the SIB Mechanism already containing the functional equivalent of a reduction in ROE  
9 for SIB-eligible projects, a company's overall risk "still is what it is."

10 **F. The SIB Mechanism Complies with the Arizona Constitution, Arizona**  
11 **Statutes, Commission Regulations and Procedures and Arizona Case**  
12 **Law.**

13 The Arizona Supreme Court's interpretation of the state Constitution requires the  
14 Commission to find and utilize the "fair value" of a utility's plant and property as its rate  
15 base when setting rates and charges for utility service. *Simms v. Round Valley Light &*  
16 *Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956); *but see US West Communications,*  
17 *Inc. v. Arizona Corp. Comm'n*, 201 Ariz. 242, 245-46, 34 P.3d 351, 354-55 (2001)  
18 (recognizing that only judicial interpretation, not the Arizona Constitution itself, requires  
19 rate base to equate to fair value and holding that in certain circumstances this is not  
20 required). Nonetheless, as the legislative body given the plenary power under the Arizona  
21 Constitution to set rates, the Commission has substantial discretion to adopt methodologies  
22 and approaches necessary to address particular issues, such as the looming infrastructure  
23 crisis facing Arizona's investor owned water utilities. *See Arizona Corp. Comm'n v.*  
24 *Arizona Pub. Serv. Co.*, 113 Ariz. 368, 370, 555 P.2d 326, 328 (1976); *see also, e.g., Qwest*  
25 *Corp. v. Kelly*, 204 Ariz. 25, 30, 59 P.3d 789, 794 (App. 2002) (Commission has exclusive  
26 power to set rates, extending to enactment of rules and regulations that are necessary for that  
27 purpose). In *Arizona Public Service Company*, the Arizona Supreme Court stated that:  
28

1           The Corporation Commission in its discretion can adopt any of  
2           the various approaches used by public utility regulative bodies in  
3           considering plant under construction as long as the method  
4           complies with the constitutional mandate [for finding fair value]  
          and is not arbitrary and unreasonable.

5           113 Ariz. at 371, 555 P.2d at 329. In that case, the Supreme Court addressed the inclusion  
6           of construction work in progress (“CWIP”) in the determination of fair value. In the course  
7           of criticizing an opinion of the Arizona Attorney General opining that the Commission  
8           could not consider plant under construction at the end of the historical test year in setting  
9           rates, the Court further noted:

10           From the foregoing, it is obvious that the Commission in its  
11           discretion can consider matters subsequent to the historic year,  
12           bearing in mind that all parties are entitled to a reasonable  
13           opportunity to rebut evidence presented. ... We would not  
14           presume to instruct the Commission as to how it should exercise  
15           its legislative functions. However, it appears to be in the public  
          interest to have stability in the rate structure within the bounds  
          of fairness and equity rather than a constant series of rate  
          hearings.

16           *Id.* (citation omitted).

17           Subsequent decisions of the Arizona Supreme Court have approved methodologies  
18           analogous to the agreed SIB Mechanism in this case. In *Arizona Cmty. Action Ass’n v.*  
19           *Arizona Corp. Comm’n*, 123 Ariz. 228, 599 P.2d 184 (1979), the Supreme Court approved a  
20           methodology under which Arizona Public Service Company (“APS”) was authorized to  
21           automatically increase its rates in two consecutive years if certain conditions were met.  
22           Specifically, APS was authorized to increase its rates in the two years following the  
23           Commission’s decision if the return on its common stock fell below a certain level. In  
24           discussing the Commission’s proposed automatic step increases, the Court stated:

25           In view of *Arizona Corporation Commission v. Arizona Public*  
26           *Service, supra*, we find entirely reasonable that portion of the  
27           Commission’s decision allowing the inclusion of construction  
28           work in progress to go on line within two years from the  
          effective date of the Step II increase. Nor do we find fault with

1 the Commission's attempt to comply with our indication in  
2 *Arizona Corporation Commission v. Arizona Public Service,*  
3 *supra*, that a constant series of extended rate hearings are not  
4 necessary to protect the public interest. The hearing culminating  
5 in the order of August 1, 1977, resulted in a determination of fair  
6 value. The adjustments ordered by the Commission in adding  
7 the CWIP to that determination of fair value were adequate to  
8 maintain a reasonable compliance with the constitutional  
9 requirements if used only for a limited period of time.  
10 Adjustments obviously would be made after a full hearing  
11 [using] a test year ending December 31, 1978, as provided in the  
12 contested order.

13 *Id.* at 230-31, 599 P.2d at 186-87.

14 Similarly, in *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 578 P.2d 612 (App.  
15 1978), the Arizona Court of Appeals noted that in exceptional circumstances, such as those  
16 presented here, the Commission may adjust rates outside the general rate case setting.  
17 While holding that the Commission lacked the authority to authorize an increase in a  
18 telephone provider's charges for the installation, movement or change of telephone service  
19 where the Commission refused to consider the impacts such increases would have on the  
20 utility's rate of return and overall financial condition, the Court noted:

21 The Commission here ... failed to make any examination  
22 whatsoever of the company's financial condition, and to make  
23 any determination of whether the increase would affect the  
24 utility's rate of return. There may well be exceptional situations  
25 in which the Commission may authorize partial rate increases  
26 without requiring entirely new submissions. We do not decide  
27 in this case, for example, whether the Commission could have  
28 referred to previous submissions with some updating or whether  
it could have accepted summary financial information.

118 Ariz. at 537, 578 P.2d at 618. Consistent with the earlier decisions of the Arizona  
Supreme Court, the *Scates* court recognized that the Commission has considerable  
legislative discretion under Article 15 of the Arizona Constitution to address unique and  
changing circumstances. *See also, e.g., Phelps Dodge Corp. v. Arizona Elec. Power Coop.*,  
207 Ariz. 95, 83 P.3d 573 (App. 2004) (recognizing Commission has authority to set range  
of rates).

1 The agreed SIB Mechanism is entirely consistent with these court decisions and  
2 Arizona law. The SIB surcharge will be based on specific, readily-identifiable, quantifiable  
3 and justified additions—pre-approved by Commission Staff—to those systems'  
4 infrastructure. The Company will be required to file annual summary schedules  
5 demonstrating the actual cost of constructing that infrastructure, with supporting  
6 documentation and information permitting the Commission to determine how the proposed  
7 surcharges would impact the rate of return for each affected system., just like the increases  
8 for CWIP that were found reasonable in *Arizona Community Action*. While approving the  
9 CWIP increases in *Arizona Community Action*, the Arizona Supreme Court recognized that  
10 a constant series of extended rate hearings are not necessary to protect the public interest  
11 (123 Ariz. at 230-231; 599 P.2d at 186-187). However, because of the five percent annual  
12 revenue cap, the limit of five SIB surcharge filings between rate cases, and the requirement  
13 to file a future rate case, under the SIB Mechanism the Company must ultimately seek  
14 Commission approval to recover 100 percent of the costs associated with these  
15 infrastructure investments. The SIB Mechanism protections, including numerous built-in  
16 notices, checks and approvals negotiated into the Settlement Agreement, serve the public  
17 interest, and result in an eventual true-up and determination of fair value for the new SIB  
18 plant approved through the agreed SIB Mechanism. As a result, the SIB mechanism  
19 contained in the Settlement Agreement and agreed upon by the Signatory Parties—which  
20 was carefully vetted by Staff's counsel as well as legal counsel for the Company and  
21 Intervenors during negotiations—is constitutionally permissible and consistent in every  
22 respect with Arizona law.

23 Another issue explored in the Phase 2 hearing related to whether utilities such as  
24 Arizona Water Company were legally required to set aside money in a depreciation fund for  
25 subsequent replacement of plant. *See* A.R.S. § 40-222. Mr. Olea, who is approaching his  
26 30 year anniversary as an employee of the Commission, confirmed from his perspective and  
27 as Utilities Division Director that the Commission has never prescribed or adopted rules or  
28 regulations requiring utilities to establish such a fund. [P-2 Tr. at p. 246, l. 17 - p. 247, l.

1 22]. Although Mr. Olea recognized the Commission may have the power to provide for  
2 such a “set aside” fund, it has not done so in the past. [*Id.* at 322, ll. 6-12]. In fact, the  
3 governing regulation on depreciation, R14-2-102 (marked as Ex. Global-3), provides for the  
4 opposite result: “depreciation” is defined as an accounting process “which will permit the  
5 recovery of the *original cost* of an asset less its net salvage over the service life,” R14-2-  
6 102(A)(3)(emphasis supplied), or in other words, the recovery of the *original cost* of plant  
7 less its salvage value, and nothing more. Further, as Mr. Reiker explained in his testimony,  
8 the water utility industry in general, and Arizona Water Company specifically, have  
9 extremely low depreciation rates. This means that the depreciation expense associated with  
10 utility plant that is currently in service is literally pennies on the dollar compared to the  
11 replacements that need to be made: “And that’s one of the problems, that’s one of the cash  
12 flow issues we face, because we don’t collect the magnitude of depreciation expense that  
13 your telecoms, your energies [companies] collect, to use that cash flow to fund ongoing  
14 replacements. And that’s why the whole rate of return part is important, too. We need a  
15 sufficient rate of return as well.” [P-2 Tr. at p. 77, ll. 11-17].

16 Accordingly, Mr. Olea recognized that if the Commission wished to direct utilities to  
17 collect such replacement funds as an item of depreciation, the utility’s revenue requirement  
18 would have to be increased:

19 Q. [By Judge Nodes]: But if, in fact, the company has been collecting  
20 through rates a certain amount of depreciation expense from ratepayers,  
21 shouldn’t that money that’s actually being recovered through rates over time  
22 be used for replacement of infrastructure?

23 A. If they were actually given enough revenue to put that money aside,  
24 yes; but usually, you know, at least the way I’ve seen it done here, is that the  
25 expense of depreciation is basically just considered part of cash flow, and you  
26 use your cash flow to pay your everyday expenses, and it’s not money that  
27 you put aside.

28 Q. ....[W]ould it be unreasonable for the Commission to require that the  
companies track and maintain separate depreciation reserve accounts and  
show that that money that’s collected for depreciation expense has been

1 exhausted for infrastructure replacement projects prior to qualifying for the  
2 SIB kicking in?

3 A. Well, and I guess I'll approach it a different way. That if you're going  
4 to require companies to use their depreciation and put it aside to then take care  
5 of plant replacements in the future, I think you would have to increase the  
6 revenue requirement, because now they can't use that money to pay expenses  
7 that they were doing otherwise.

8 And if you did that, you would raise the rates to increase the revenue to  
9 allow the depreciation, that mon[ey] to be actually used as an actual reserve;  
10 then you create the reserve fund. Then you wouldn't need the SIB. But you  
11 would probably end up in the same place as far as rates, because now you  
12 have the extra revenue, that's actually being done with the SIB, to be put aside  
13 to put the plant replacements in that they're doing with the SIB. So you would  
14 end up rate-wise in the same place.

15 \* \* \*

16 And that has not been done, because the Commission has only granted  
17 enough revenue, that included that expense of depreciation, to where the  
18 companies had to use that expense of depreciation that they got to pay regular  
19 expenses and not save it for plant. They never had enough money to, you  
20 know, put that aside.

21 \* \* \*

22 Again, I think if you did, if you required companies to put money aside  
23 for depreciation and use that for plant replacement, you wouldn't need the  
24 SIB. So you wouldn't do both. Because if you did both, in my mind you  
25 would be hitting the customers twice for the same piece of plant.

26 [Id. at p. p. 322, l. 21 - p. 323, l. 6; p. 323, l. 11 - p. 324, l. 7; p. 324, l. 22 - p. 325, l. 3; p.  
27 326, ll. 6-11].

28 In summary, depreciation expense as currently defined and used in Commission  
practice provides for the utility's recovery of the *original cost* it has invested in plant (minus  
salvage value). It does not, above and beyond that return of rate base, provide extra monies  
to fund new plant replacements at potentially hundreds of times the cost of the plant that is  
being replaced (and RUCO and Staff, as stated above, would likely oppose such charges).  
A utility is entitled to recovery of its investment (depreciation as defined in R14-2-

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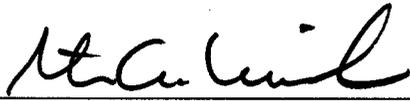
1 102(A)(3)) and *on* its investment (ROE), and the SIB Mechanism does not add to recovery  
2 of original plant that is provided for by depreciation.

3 **III. CONCLUSION**

4 Based on the conscientious efforts of the Signature Parties in settlement of this  
5 matter, the historic significance of the Settlement Agreement between Commission Staff,  
6 the Company, and other major water utilities in the state concerning this important and  
7 beneficial rate innovation, and for the other reasons stated in the Phase 1 briefing and this  
8 Phase 2 Post-Hearing Brief, Arizona Water Company submits that the Commission should  
9 approve the agreed SIB Mechanism as set forth in the Settlement Agreement for the  
10 Company's Eastern Group systems, and should adopt its use as a template in future rate  
11 proceedings where appropriate.

12 RESPECTFULLY SUBMITTED this 29th day of April, 2013.

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