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BEFORE THE ARIZONA CORPORATION COMMISSION

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DOCKET NO. W-01445A-11-0310

STAFF'S CLOSING BRIEF

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.

The Utilities Division staff ("Staff") of the Arizona Corporation Commission ("Commission") hereby files its Closing Brief in this matter. Staff urges the Commission to approve the Settlement Agreement filed on April 1, 2013 as the resolution for Phase 2 of this case. The Settlement Agreement proposes a ratemaking treatment that will allow the Arizona Water Company ("Company" or "AWC") to recover the costs of installing certain categories of replacement plant to serve existing connections. The agreement proposes a resolution to a ratemaking issue that would otherwise be addressed repeatedly over a series of closely spaced rate cases at significant additional expense to the ratepayers. The resolution proposed in the agreement serves the best interests of customers, the Company, and ultimately, the public interest.

I. IT IS UNDISPUTED THAT THE COMPANY IS REQUIRED TO UNDERTAKE A COMPREHENSIVE SERIES OF PLANT REPLACEMENT PROJECTS THROUGHOUT THE THREE SERVICE TERRITORIES THAT ARE COVERED BY THIS RATE CASE.

As one of the largest regulated water utilities in the state, AWC boasts a large network of water distribution infrastructure that is devoted to serving its 84,300 customers, approximately 33,700 of whom are located in the systems involved in the present rate case.¹ Much of that

¹ Phase 1 application at 1-2.

1 network of pipe is aging, beyond its useful life, or otherwise in need of replacement. For Example,
2 Mr. Schneider testified on behalf of the Company that many thousands of feet of pipe within its
3 Bisbee system date back at least to 1906, the earliest point at which the Company has records for that
4 system, and that it is probable that the pipe was put in service as far back as the 1800s.² Moreover,
5 the issue of failing infrastructure is not just limited to the Bisbee system.³ Further, the problem of
6 excessive water loss is not restricted to those areas.⁴

7 As the Company witness explained, the traditional remedy of patching leaks as they occur
8 does not necessarily address the issue of failing aged infrastructure.

9 So as we go in and replace a section of main, we're able to move large amounts of
10 water to the next restricted point, which then creates a pressure point at the next spot
11 where the pipe is corroded, which only causes another failure, which you make a
repair on, only to move the water to the next weak point, which causes a failure;⁵

12 As the Company illustrated in this case, the deteriorating nature of its extensive infrastructure
13 poses a unique and far from trivial challenge.⁶ Moreover, the Company has demonstrated the efforts
14 that it has used in an attempt to stay ahead of this problems by carrying out such measures as
15 replacing as much as a mile of water mains per year in one system alone.⁷

16 RUCO may argue that the Company should have anticipated and planned for these
17 replacement projects. In fact, that was the focus of Staff's position in Phase 1 of this proceeding.
18 Nevertheless, the record in this matter supports a finding that the Company's upcoming plant
19 replacement projects are extraordinary in scope. It is further undisputed that customers will benefit
20 from timely replacement of aged or inadequate plant in the form of decreased water losses, fewer
21 outages, and improved quality of service.

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24 ² Phase 1 tr. at 472.

25 ³ *Id.* at 482-483.

26 ⁴ *Id.* at 483-87.

27 ⁵ *Id.* at 500; *see also* tr. at 512 (explaining that some instances of pipe repair will cause pressure to
increase in the pipe leading to failure elsewhere on the pipe).

28 ⁶ *Id.* at 483-517.

⁷ *Id.* at 523.

1 **II. THE COMMISSION SHOULD NOT BE CONSTRAINED FROM DEVELOPING**
2 **NEW RATEMAKING MECHANISMS IN ORDER TO RESPOND TO ONGOING**
3 **REGULATORY CHALLENGES.**

4 The Commission—and the entities that it regulates—are often faced with new problems and
5 new challenges. Not all of them can be meaningfully addressed solely through a traditional rate case.
6 The Residential Utility Consumer Office (“RUCO”) seems to incorrectly suggest that the
7 Commission’s rate setting methods should be limited to those employed by the traditional, general
8 rate case as embodied by A.A.C. R14-2-103. Unfortunately, neither the world at large nor the world
9 of regulation is so static.

10 The Commission has made use of its ratemaking authority to approve novel mechanisms to
11 respond to a variety of challenges. When the Environmental Protection Agency issued revised
12 arsenic contamination standards, water utilities throughout Arizona as well as the Commission were
13 presented with an extraordinary challenge as to how to pay for the heavily capital intensive treatment
14 measures necessary to meet the new standards. The Arsenic Cost Recovery Mechanism (“ACRM”),
15 a regulatory device employed by many Arizona water utilities, was developed in response to these
16 standards and in a rate case involving Arizona Water Company. *See generally* Docket No.
17 W-01445A-00-0962. In fact, RUCO participated in the proceedings that led to the development of
18 the ACRM which is a streamlined cost recovery mechanism to deal with the high capital cost of
19 bringing water utilities’ service into compliance with acceptable standards. *See* Decision No. 66400
20 (October 14, 2003).

21 The courts have upheld the Commission’s ability to establish renewable portfolio standards on
22 the basis of the impact that energy resource diversity has on the rates paid by utility ratepayers.
23 *Miller v. Arizona Corp. Comm'n*, 227 Ariz. 21, 27, 251 P.3d 400, 406 (App. 2011), rev. denied Sept.
24 20, 2011.

25 As these cases demonstrate, the Commission’s ratemaking authority is far from narrow and
26 provides the Commission with a variety of regulatory tools.
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1 **III. THE PROPOSED SIB COMPORTS WITH THE ARIZONA CONSTITUTION.**

2 The SIB as developed and proposed in the agreement is consistent with the requirements of
3 the Arizona Constitution. However, RUCO will likely claim that the proposed SIB is inconsistent
4 with the fair value provision of the Arizona Constitution. In an earlier brief filed in this matter,
5 RUCO stated that:

6 [t]he Arizona Constitution protects consumers by generally requiring that the
7 Commission only change a utility's rates in conjunction with making a finding of the
8 fair value of a utility's property. However, Arizona courts recognize that, in limited
9 circumstances, the Commission may engage in rate making without ascertaining a
10 utility's rate base.⁸

11 Staff does not disagree with these general principles, but the SIB proposed in the agreement
12 provides ample opportunity for the Commission to ascertain Arizona Water's fair value rate base, and
13 thereby comply with the requirements of the Arizona Constitution.

14 Section 7 of the agreement specifically requires the Company to provide a schedule (Schedule
15 D) as part of the filing package every time that it seeks Commission authorization to enact a SIB
16 surcharge. This information will enable the Commission to update the fair value rate base finding
17 and to determine the impact of the revenues (with the addition of the proposed SIB surcharge) on the
18 Company's fair value rate of return. The SIB surcharge cannot go into effect without a Commission
19 order, and the agreement further provides that the Commission may terminate the SIB at any time.⁹

20 RUCO cannot convincingly claim that the SIB is *per se* inconsistent with the Constitution's
21 fair value requirements, because the proposed SIB expressly requires the Company to provide
22 updated rate base information. To argue that the proposed SIB will not comply with the Constitution
23 implies that the Commission will ignore this information and will not use it "to aid it in the proper
24 discharge of its duties" See Ariz. Const. art XV, § 14. It is not reasonable to assume that the
25 Commission will not act in accordance with the Constitution as to its future ratesetting; instead, the
26 opposite should be presumed.

27 ⁸ Phase 1 RUCO Br. at 11.

28 ⁹ Phase 2 – DSIC Settlement Agreement (hereafter referred to as "SA"), Section 10.01.

1 RUCO may also argue that the Commission may not determine a Company's fair value rate
2 base by relying on a recent fair value finding (from a recent rate case) as a starting point and then
3 updating that finding with new information. However, the Commission has wide discretion to decide
4 the method that it will use to determine fair value. As our Supreme Court has recognized, "the
5 commission in exercising its rate-making power of necessity has a range of legislative discretion . . ."
6 *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 154, 294 P.2d 378, 384 (1956).

7 In the present case, the proposed SIB would provide a means for the Commission to update
8 the Company's fair value rate base and thereby to implement a series of step increases. This
9 ratemaking mechanism is designed to allow the Company to undertake its substantial replacement
10 program without having to resort to a repeated series of rate cases. *See Arizona Corp. Comm'n v.*
11 *Ariz. Pub. Serv. Co.*, 113 Ariz. 368, 371, 555 P.2d 326, 329 (1976) (noting that a "constant series of
12 rate hearings" does not serve the public interest). General rate cases can be time consuming and
13 costly, both for the Company and for ratepayers, who pay for the costs of the rate case in rates.

14 In *Arizona Community Action Assoc. v. Ariz. Corp. Comm'n*, 123 Ariz. 228, 599 P.2d 184
15 (1979), the court upheld step rate increases based on subsequent additions to the company's plant.
16 Specifically, the company was granted a six percent rate increase in year 1; in years 2 and 3, the
17 company was permitted to increase its rates by a maximum of five percent per year, if certain
18 conditions were met. For the step 2 increase, the company was permitted to increase its rates by the
19 lesser of either five percent of gross operating revenues or a revenue deficiency,

20 calculated by first totaling (1) *the amount of electric properties placed in service*
21 *since the prior rate increase*, (2) construction work in progress for the preceding
22 calendar year for any plant for which construction work in progress had previously
been included in rate base, and (3) construction work in progress during the preceding
calendar year for plants scheduled to go into service within two years.

23 123 Ariz. at 229, 599 P.2d at 185 (emphasis added). The sum of these amounts was then to be
24 multiplied by the rate of return on electric plant authorized by the Commission. The court upheld this
25 portion of the Commission's order, stating,

26 The Commission stated in the decision under attack that it . . . would initiate
27 innovative procedures in an attempt to deal promptly and equitably with increasingly
28 complex regulatory matters. At the Step I hearing, the Commission fulfilled the

1 constitutional requirements of art. 15, §§ 3, 14, which mandate a finding of the fair
2 value of all property at the time of fixing a rate.

3 The court further indicated that it did not “find fault” with the Commission’s efforts to avoid a
4 “constant series of extended rate hearings” 123 Ariz. at 231, 599 P.2d at 187. Finally, the court
5 noted that the Commission’s order in the rate case “resulted in a determination of fair value [,]” and
6 that further adjustments *between rate cases* “were adequate to maintain a reasonable compliance with
7 the constitutional requirements *if used only for a limited period of time.*” *Id.* (emphasis added).

8 The SIB proposed in the agreement has been developed in the context of a full rate case in
9 which the Commission has determined the Company’s fair value rate base and approved the specific
10 plant projects to be included in the SIB. The SIB will be limited to projects that replace plant used to
11 serve existing connections. The SIB further provides for the retirement (removal from rate base) of
12 the plant that has been replaced. Therefore, the new plant will not generate a new revenue stream.

13 The amount to be collected by each SIB surcharge is capped at five percent of the revenue
14 requirement established in Decision No. 73736, Phase 1 of Docket No. W-01445A-11-0310. These
15 amounts are subject to true-up, either in the annual SIB filings or in the Company’s next full rate
16 case. Finally, the Company is required to file a full rate case by August 31, 2016, with a test year
17 ending December 31, 2015. These features serve to ensure that the resulting rates will be just and
18 reasonable and that the SIB will be used only for a limited period of time.

19 Opponents of the SIB may argue that the step increase mechanism in *Community Action* was
20 ultimately set aside by the court. While this is ultimately true, it is important to note that the court did
21 not find fault with the step increases *per se*; instead it found that the step increase was triggered solely
22 on a percentage of return on common equity, which fell largely within the Company’s control. For
23 this reason, it could not be the “sole criterion” for triggering the step increase. 123 Ariz. at 231, 599
24 P.2d at 187.

25 The SIB, however, differs from the step increase mechanism in *Community Action* in that
26 there is no earnings test, nor is there any “test” subject to control by the Company. In fact, there is no
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1 guarantee that the Commission will authorize each step increase, and the agreement expressly
2 recognizes that the Commission may suspend the SIB mechanism.

3 Each annual SIB surcharge requires Commission approval in order to take effect. And the
4 Company is required to provide information with each SIB filing that will allow the Commission to
5 determine the impact of the new plant on the Company's fair value rate base and to consider the
6 resulting impact on the Company's rate of return. Arizona case law does not require more.

7 RUCO may argue that the SIB is an example of "single issue ratemaking" and that such an
8 approach is prohibited by *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 578 P.2d 612 (App. 1978).
9 That case, however, focuses upon the requirements of Article XV, section 14 of the Arizona
10 Constitution, which pertain to determining fair value rate base:

11 "We . . . hold that the Commission was without authority to increase the rate without
12 any consideration of the overall impact of that rate increase upon the return of . . . [the
13 utility], and without, as specifically required by our law, a determination of . . . [the
utility's] rate base."

14 118 Ariz. at 537, 578 P.2d at 618. Article XV, section 14 is silent as to "single issue ratemaking."
15 Wherever that term may have originated, it is not contained in the Arizona Constitution.

16 The *Scates* court was careful to make it clear that a full rate case is *not* required for every
17 increase in rates. *Id.* The court noted that "[t]here may well be exceptional situations in which the
18 Commission may authorize partial rate increases without requiring" a full rate case. Therefore, the
19 case does not preclude the Commission from updating previous findings based upon new
20 information. *Id.*

21 In recognition of the *Scates* decision, the proposed SIB clearly requires the Company to
22 submit such information.¹⁰ There is no reason to presume that the Commission will not appropriately
23 consider this information when evaluating each SIB surcharge filing. Even if the Commission were
24 to fail to consider such information, the time for a challenge is *after* the Commission has acted. It is
25 inappropriate to assume that the Commission will fail in its future constitutional duties, especially
26 when the proposed SIB mechanism contains all the required ratemaking elements.

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28 ¹⁰ Phase 2 – DSIC SA, Section 7.

1 RUCO may argue that the proposed SIB would be improved if the annual filing information
2 were to incorporate an earnings test or other earnings related data.¹¹ However, an explicit earnings
3 test was perceived as a negative by the court in *Community Action*. Staff believes that the better
4 approach is to avoid the creation of a specific, formulaic test. Instead, whether to approve each
5 requested step increase should be left entirely to the Commission to evaluate at the time of each
6 annual filing, based upon the information available at that time. Arizona Water apparently
7 recognizes this feature of the proposed SIB:

8 Q. (By Mr. Hirsch): Is there any doubt in your mind, as one of the 18 architects of this
9 instrument, that if there is an objection, that Staff's expectations would be that the
10 SIB would not go forward and such proceedings as the Commission or Hearing
11 Division may order would ensue?

12 A. (By Mr. Olea): [T]hat's Staff's expectation¹²

13 When evaluating a SIB surcharge filing, the Commission would, of course, be free to request
14 any information that it needs, including information related to the Company's earnings. For that
15 matter, Staff, RUCO, or other interested parties could seek such information through discovery, and
16 then provide it to the Commission for its consideration. At the hearing, Company witness Reiker
17 acknowledged that the Company will be obligated to cooperate with the parties in their evaluation of
18 each SIB surcharge request.¹³ Nonetheless, if the Commission were to conclude that specific
19 earnings information should be included with each surcharge filing, Staff would not view that
20 addition as a material change.¹⁴

21 Finally, RUCO may argue that Staff has changed its position since the proceedings in Phase 1;
22 RUCO may further argue that the Commission should disregard Staff's legal arguments in Phase 2
23 and instead rely on Staff's arguments in Phase 1. Staff, however, believes that its positions in Phases
24 1 and 2 can be easily reconciled and are, in fact, completely consistent.

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26 ¹¹ Phase 2 – DSIC tr. at 280-8a.

27 ¹² *Id.* at 250.

28 ¹³ *Id.* at 59-80.

¹⁴ *Id.* at 281.

1 In Phase 1, Staff had two primary concerns with the Company's proposed DSIC: 1) the
2 Company's proposal was one-sided in that it provided benefits only to the Company and not to
3 ratepayers; and 2) the Company's DSIC proposal lacked the specific features that are necessary to
4 comply with Arizona law. As to the first concern, that has been addressed by the efficiency credit.¹⁵
5 As to the second concern, Staff believes that the proposed SIB incorporates the elements necessary to
6 comply with Arizona law concerning fair value rate base, step increases, and the corresponding
7 impact upon the rate of return.

8 In Phase 1, Staff *never* took the position that DSIC-type mechanisms are *per se* unlawful. The
9 following statement from Staff's closing brief in Phase 1 illustrates Staff's position:

10 [W]here exceptional circumstances exist, and a mechanism for a future rate
11 adjustment is *adopted in the context of a rate case* as part of a utility's rate structure
12 and if that mechanism *meets the constitutional requirements that rate base is*
determined and the overall impact on the rate of return prescribed, that mechanism
will not violate the Arizona Constitution.¹⁶

13 The proposed SIB complies with these requirements.

14 **IV. THE PROPOSED SIB PROVIDES AN EQUITABLE BALANCE BETWEEN THE**
15 **INTERESTS OF THE UTILITY AND THE RATEPAYERS.**

16 There is significant evidence in the record to the effect that a SIB will produce benefits to
17 ratepayers in addition to quality of service improvements. The repair and replacement of aged
18 infrastructure is less costly if done sooner because the cost of repairs increases as the system ages.¹⁷
19 Moreover, testimony illustrates that the water utility industry is a rising cost industry that does not
20 typically experience reductions in capital costs, thereby making it beneficial to ratepayers for
21 improvements to be performed sooner.¹⁸

22 Additionally, implementation of the proposed SIB will encourage rate gradualism because
23 ratepayers will avoid the shock of having to fund rate base additions that have been lumped into
24 general rate case proceedings spread years apart. In Staff witness Steve Olea's view,

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26 ¹⁵ Phase 2 – DSIC SA at Section 3; Tr. at 264-65.

27 ¹⁶ Staff's Phase 1 Op. Br. at 26.

28 ¹⁷ Phase 1 tr. at 524.

¹⁸ Phase 2 - DSIC tr. at 64-65.

1 [I]t allows AWC to make large plant investments to maintain and/or improve service
2 to existing customers in a way that will lessen rate shock by allowing smaller, more
3 incremental (although more frequent) rate increases to cover the costs of these
4 necessary plant investments.¹⁹

5 Company witness Joel Rieker likewise characterized the SIB as essentially a phase-in mechanism that
6 produces the benefits of gradualism.²⁰

7 Similarly, the SIB provides an efficiency adjustment to customers that will reduce the that
8 rates they pay. As Mr. Olea noted, the five percent efficiency adjustment reduces the actual amount
9 of the increase that the ratepayers will pay if the SIB is approved.²¹ Mr. Reiker quantified the benefit
10 in terms of its equivalent impact on the Company's cost of equity and estimated that the five percent
11 efficiency reduction amounts to an effective 100 basis point reduction to Commission approved
12 10.55.²²

13 **V. RUCO'S OBJECTIONS TO THE SIB MECHANISM DO NOT WARRANT REJECTION OF THE SETTLEMENT AGREEMENT.**

14 RUCO director Patrick Quinn testified at hearing that RUCO had three main objections to the
15 SIB, in addition to the constitutionality issue: 1) the bifurcation of the case prevented RUCO from
16 addressing the issues, primarily that of an adjustment to ROE; 2) the five percent efficiency credit
17 was too small; and 3) the type of eligible plant was too broad.²³ In addition, RUCO enumerates a
18 number of other provisions which should be included, deleted or modified, namely: "tightening up
19 specific provisions;"²⁴ expanding the type of things that should be considered in determining
20 eligibility;²⁵ the preclusive effect of the SIB on future rate cases;²⁶ the failure to limit eligible plant to
21 "non-revenue producing" plant;²⁷ the short time for objections to the annual surcharge filing;²⁸ the

22 ¹⁹ Olea SA Test., Ex. S-1 at 10.

23 ²⁰ Phase 2 – DSIC tr. at 64.

24 ²¹ Olea SA Test., Ex. S-1 at 10.

25 ²² *Id.* at 66. Note: this number changes slightly when the replacement Schedule D is used.

26 ²³ Phase 2 – DSIC tr. at 382-83.

27 ²⁴ *Id.* at 386.

28 ²⁵ *Id.* at 387.

²⁶ *Id.* at 388-89.

²⁷ *Id.* at 433-34.

²⁸ *Id.* at 439-41.

1 inclusion of water loss as a criteria;²⁹ the lack of clarity as to what happens to the surcharge in the
2 next rate case;³⁰ and how plant that replaces and improves for growth will be treated.³¹

3 **A. Bifurcation Of Hearings**

4 RUCO argues that as a DSIC-type mechanism materially reduces a utility's risk and as a
5 utility's ROE is determined, in part, by the level of risk, where a DSIC is in place, the ROE should be
6 reduced. RUCO perceives the Commission's adoption of an ROE of 10.55 in Decision No. 73736 as
7 precluding RUCO from presenting any evidence or argument on that issue in this part of the case.³²
8 Staff disagrees.

9 First, it should be noted that RUCO did have the opportunity to address a reduction to ROE
10 and to present evidence to support its theory in Phase 1 where a DISC-type mechanism was fully
11 litigated. Although RUCO opposed any such mechanism, it did not raise the issue of a reduction to
12 ROE in Phase 1 or present any evidence to justify the same in either Phase 1 or Phase 2.³³

13 RUCO has presented no evidence to support its belief that it is so precluded, nor, in Staff's
14 opinion, does the record contain any support therefor. In setting the ROE, the Commission carefully
15 reviewed the party's positions, noting that "the age of some of its systems and the resulting increased
16 need for infrastructure replacement and improvement necessitates a somewhat higher ROE."³⁴ No
17 DISC-type mechanism was adopted but the matter was sent back to hearing to enable the parties to
18 develop some appropriate mechanism to address that aging infrastructure.

19 It is Staff's position that, as part of a DSIC-type mechanism, the parties and the ALJ could
20 consider an *adjustment* to the ROE set by the Commission. In contrast, RUCO appears to perceive
21 any adjustment to ROE to be a reconsideration of the overall ROE. Unfortunately, RUCO made no
22 attempt to clarify the Commission's position in that regard. No appeal was filed. No A.R.S. § 40-

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25 ²⁹ *Id.* at 441.

26 ³⁰ *Id.* at 435-36.

27 ³¹ *Id.* at 437.

28 ³² *Id.* at 425-28.

³³ *Id.* at 487.

³⁴ Decision No. 73736 at 61.

1 252 request was filed. No offer of proof was made. No attempt to present that evidence was made.³⁵

2 However understandable RUCO's misperception might be its failure to seek clarification is not.

3 **B. Adjustment To ROE**

4 RUCO asserted abstractly that a DSIC-like mechanism reduces the Company's risk and
5 therefore should result in a downward adjustment to ROE, but presented no evidence to support is
6 theory other than Mr. Rigsby's generalized opinion.³⁶ No analysis was presented.³⁷ No studies were
7 provided.³⁸ Mr. Rigsby states only that "Our rationale for the lower return on equity being warranted
8 is really based on the fact that credit agencies like Standard & Poor's and Moody's tend to look
9 favorably on companies with adjustor mechanisms."³⁹ Further, RUCO was unable to cite any other
10 State which had adopted a DSIC mechanism that also adjusted the ROE.⁴⁰

11 In addition, Mr. Rigsby, who presented a cost of capital analysis in Phase 1 of this case,
12 acknowledged that some of the companies he used as proxies for AWC in calculating the ROE do
13 have DISC-type mechanisms in place.⁴¹ He testified that, in analyzing these companies, he
14 considered market data and accounting information provided by Value Line. He also acknowledged
15 that anything relating to the DSIC that is known by the investment company would be reflected in the
16 company stock and in the market data.⁴² Therefore, any adjustment in risk resulting from the
17 existence of a SIB has already been factored into RUCO's recommended ROE. In addition, Mr.
18 Rigsby's use of sample companies that have DSICs without adjusting or compensating for any
19 resulting reduction in ROE would support a conclusion that a DSIC does not, in fact, warrant a
20 reduction in the ROE.

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³⁵ Phase 2 – DSIC tr. at 425-27.

23 ³⁶ *Id.* at 487-89.

24 ³⁷ *Id.* at 488-89.

25 ³⁸ *Id.* at 489.

26 ³⁹ *Id.*

27 ⁴⁰ *Id.* Although Mr. Rigsby cited to a Maryland case wherein he *believed* Maryland had adjusted the
28 ROE, he conceded that the case involved a decoupling mechanisms, not a DSIC, and that the
company in question was a natural gas company.

⁴¹ *Id.* at 490.

⁴² *Id.* at 490-91.

1 Staff and RUCO agree that any DSIC-type mechanism adopted herein should have some
2 measurable monetary benefit to ratepayers, in addition to the conceptual benefits of rate gradualism
3 and more reliable service.⁴³ In this case, all of the Signatory parties agreed that the appropriate
4 mechanism to flow benefit to the customers was the efficiency credit, while RUCO chose a reduction
5 to ROE. Both the efficiency credit and a reduction to ROE accomplish the same goal; a reduction in
6 the surcharge amount. Staff does not take a position herein as to whether a reduction to ROE should
7 be considered or adopted in future cases. In the words of RUCO's counsel "There is more than one
8 way to peel a grape."⁴⁴ Perhaps Paul Walker, of Global Water, explained this best:

9 So multiple parties are debating a financial benefit. People have different
10 perspectives on why they think a benefit needs to exist. They come to a conclusion
11 on what the number should be. That doesn't necessarily mean that all the parties
12 agreed on why that number got put in there. One person might say, well, it went in
13 there because we got the operational money we were looking for. Another party
14 might say we got the number we wanted because we wanted to change the ROE for
15 the SIB surcharge. So I think to a certain extent, in a negotiation every party might
16 feel that the number represents a certain thing to them.⁴⁵

17 RUCO argues that the 5 percent reduction to the surcharge does not provide enough benefit to
18 ratepayers.⁴⁶ However, RUCO was unable to quantify any amount which would suffice.⁴⁷ Mr.
19 Walker testified that the efficiency credit in this case is the equivalent of a 87 to 100 basis point
20 reduction to the ROE, depending on the method of calculation.⁴⁸

21 C. Eligible Plant

22 RUCO criticizes the fact that the category of plant eligible to flow through the SIB have
23 expanded since Phase 1. In particular, RUCO now asserts that eligible plant should not include plant
24 attributable to water loss in excess of ten percent. Interestingly, at the outset of this case, both Staff
25 and RUCO proposed excess water loss as the only basis on which plant would be eligible.⁴⁹ RUCO's

26 ⁴³ *Id.* at 264-65.

27 ⁴⁴ Phase 1 RUCO Exceptions to ROO at 4.

28 ⁴⁵ Phase 2 – DSIC tr. at 183-84.

⁴⁶ *Id.* at 382.

⁴⁷ *Id.* at 427, 428-29.

⁴⁸ Walker Dir. Test., Ex. Global-2 at 3; Phase 2 – DSIC tr. at 233.

⁴⁹ Phase 2 tr. at 498; Rigsby Phase 1 Surrebuttal Test., Ex. RUCO-13 at 3.

1 fear now is that utilities will manipulate systems to produce excess water loss so that they may
2 qualify for a SIB. RUCO concedes that there is no evidence to support this.⁵⁰ Further, the inclusion
3 of other criteria for eligibility and the exclusion of replacement required due to the fault of the
4 Company address this concern.

5 Staff acknowledges that the criteria are broader than initially proposed, though the categories
6 of plant remain the same.⁵¹ Along with this expansion, additional protections have been incorporated.
7 The plant replacement projects must be approved in the rate case, where they will receive full
8 regulatory scrutiny. Any modifications must be approved by the Commission for eligibility to flow
9 through the SIB. Finally, Staff will monitor the projects through semi-annual reports by AWC.

10 **D. Miscellaneous Objections**

11 RUCO makes a number of other objections to the Settlement Agreement, none of which are
12 sufficient to render it contrary to the public interest.

13 RUCO expresses concern that the SIB in this case will become the new standard and that the
14 Commission will be precluded from considering other types of mechanisms or other factors.⁵²
15 Nothing in this case renders the SIB in general nor any of its terms binding in any future rate case
16 involving any other utility. While the Commission may consider what has been ordered in other
17 cases in terms of consistency, Commission decisions do not establish legal precedent.

18 Staff acknowledges that, once a mechanism such as this is adopted in one case, other utilities
19 are apt to follow suit. In fact, Staff hopes that the SIB in this case will serve as a template for use in
20 future rate cases by other water and wastewater public service corporations that meet the
21 requirements set forth in the SIB.⁵³ Thus, in developing this SIB, Staff sought the input of other
22 interested water and wastewater public service corporations with the goal of developing a format
23 which could have wide, if not universal, application for those regulate entities. This fact does not
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26 ⁵⁰ Phase 2 – DSIC tr. at 477-78.

27 ⁵¹ *Id.* at 370.

28 ⁵² Rigsby Phase 2 Dir. Test., Ex. RUCO-12 at 15.

⁵³ Phase 2 – DSIC tr. at 248.

1 preclude RUCO, a utility, or any other interested party from proposing, or the Commission from
2 adopting, a DSIC-type mechanism which differs from the SIB in this case.

3 In fact, the SIB evolved over the two year course of this case, and it can be expected that it is
4 likely to be refined further as experience is gained. To that point, Section 10.1 of the Settlement
5 Agreement recognizes the Commission's ability to modify or terminate the SIB at any time. This
6 further emphasizes the expectation that the SIB may well evolve even further in the future.

7 Somewhat ironically, since RUCO asserts that the Settlement Agreement limits the
8 Commission's ability to consider the circumstances in each case,⁵⁴ RUCO also expresses concern that
9 the agreement needs to be "tightened up."⁵⁵ Yet in detailing what should be tightened up, RUCO
10 recommends the insertion of terms which merely restate what is already prescribed in law or practice.
11 For instance, RUCO recommends including the term "non-revenue producing" in describing SIB
12 eligible plant.⁵⁶ The Settlement Agreement instead uses the term "not for growth," which is virtually
13 identical in meaning to "non-revenue producing."⁵⁷ In fact, as developed during testimony at hearing,
14 the phrase "not for growth" is more accurate in that even when it replaces infrastructure, the new
15 plant will produce revenue. More accurate phrases would include "non-revenue increasing" or
16 "creating no new revenue streams."⁵⁸

17 RUCO also claims that the Settlement Agreement is too vague in that it does not specify what
18 happens to the surcharge in the next rate case, what happens if there is an objection to the surcharge,
19 and how eligible plant would be treated if SIB plant consisted of a mixture of improvement and
20 replacement. Staff suggests that the Settlement Agreement is sufficiently clear on these points. The
21 very concept of the SIB is that replacement plant may be added to rate base between rate cases with
22 the costs recovered via a surcharge. In the next rate case, under basic rate-making principles, the
23 replacement plant would be included in rate base, the surcharge would cease, and the plant would go
24

25 ⁵⁴ Phase 2 – DSIC Test., Ex. RUCO-11 at 3.

26 ⁵⁵ Phase 2 – DSIC tr. at 432.

27 ⁵⁶ *Id.* at 433.

28 ⁵⁷ Phase 2 – DSIC SA at Section 2.1.

⁵⁸ Phase 2 – DSIC tr. at 134-35.

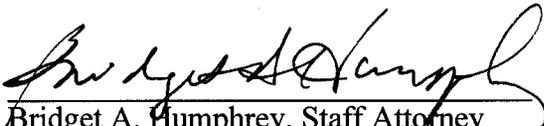
1 into general rates. It would be left to the Company to request a new SIB if circumstances so
2 warrant.⁵⁹

3 Section 6.5 provides that, if there is no objection to the annual surcharge request, that request
4 would be placed on an open meeting agenda. Implicitly, if there is an objection, this would not occur.
5 However, the agreement does not address this because it is within the Commission's discretion to
6 determine whether any additional action will occur.

7 **VI. CONCLUSION.**

8 In a collaborative process, the signatories to the Settlement Agreement have developed a
9 mechanism that Staff believes complies with the Arizona Constitution and that eliminates all
10 concerns regarding the Company's initial DSIC proposal. The SIB mechanism provides the
11 Commission with a tool to assure that AWC's infrastructure remains viable. The SIB also includes
12 numerous protections including Commission approval of the SIB eligible plant and surcharge. As
13 such, it provides benefits to ratepayers and the utility alike and is in the public interest.

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

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28 ⁵⁹ Phase 2 – DSIC tr. at 330.

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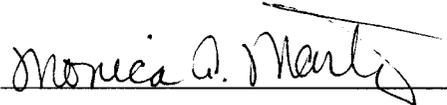
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