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AZ CORP COMMISSION
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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission
DOCKETED
JUN 10 2013
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IN THE MATTER OF THE APPLICATION OF SANDARIO WATER COMPANY, INC. FOR APPROVAL OF A RATE INCREASE IN THE MATTER OF THE APPLICATION OF SANDARIO WATER COMPANY, INC. FOR AUTHORITY TO INCUR LONG-TERM DEBT.	DOCKET NO. W-01831A-12-0392 DOCKET NO. W-01831A-12-0467 **RESPONSE TO THE REVISED STAFF REPORT**

Pursuant to the Procedural Order dated May 1, 2013, the Sandario Water Company ("Company" or "Applicant") hereby files its Response to the Revised Staff Report.

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PRELIMINARY STATEMENT AND ISSUES

This case illustrates the classic idiom "death by a thousand cuts" – meaning many damaging things are happening, none of which are fatal themselves, but which add up to a slow and painful demise. Originally, Arizona Corporation Commission Staff ("Staff") recommended Sandario should receive a revenue requirement of $158,003. *See* Staff Report at Schedule BCA-1 (Jan. 4, 2013). This would produce an operating income of $27,107. *See* Attachment 1. Overall, the Company was pleased with this initial recommendation, but there were a few errors that needed to be corrected.

First, Staff had miscalculated depreciation expense as $7,740 rather than $10,864, which is a difference of $3,124 to the Company's detriment. *See* Company Response to Staff Report, p. 2 (Jan. 14, 2013). Staff corrected the error, but rather than taking the logical step of increasing the revenue requirement by $3,124, Staff instead **reduced** the Company's operating income by $3,124. *See* Attachment 1. Thus, as a reward for finding the error, the Company's operating income was dropped by $3,124 from $27,107 to $23,983.

Next, after the rate and finance cases were consolidated, Staff agreed to utilize a surcharge to pay the loan principal and interest, but they refused to account for the estimated $8,892 Debt Service Reserve ("DSR") the Company must pay WIFA. Staff neither (a) includes the DSR in the surcharge nor (b) increases revenues to pay for the DSR. So under Staff's revised proposal, after the Company pays WIFA, Sandario will have $15,091 left over from its operating income. *See Id.*

Finally, in February, the Arizona Corporation Commission ("Commission") directed Staff to allow entities like Sandario to recover income tax expense and gross up the revenue requirement accordingly in all pending and future rate cases. *See* Docket No. W-00000C-06-0149, Decision No. 73739 at Attachment 1, p. 2 (Feb. 21, 2013). However, Staff has never made this adjustment in this case. The Company calculates its recoverable tax liability to be $16,891 annually. Consequently, after taxes are

considered, Sandario will have very little of its operating income left and is on the verge of losing money.

Again, Staff's original recommendation setting the revenue requirement at $158,003 to generate $27,107 of operating income for a system serving 330 customers seemed a little low, but reasonable. Staff's recommendation became unreasonable, however, as Company income was cut away by the $3,124 depreciation expense error, the $8,892 DSR expense, and the $16,891 tax expense, leaving Sandario simply hoping to break even. Under Staff' recommendation this Company that lost money in the test year will continue its slow and painful demise due to underfunding.

Instead, the Court should adopt the Company's recommendation and increase the revenue requirement by $20,015 to account for the depreciation error and pass through tax expenses as directed by the Commission. In addition, the Court should account for the DSR by adding $4.25 to either the monthly minimum or the WIFA surcharge.

The Company is addressing the following six issues in this response to the latest Revised Staff Report:

1. Income Tax Recovery
2. CIAC Mismatch
3. Loan Amount Authorization
4. Recovery of Debt Service Reserve
5. Project Completion Date
6. Best Management Practices ("BMPs")

The Company believes its positions will make Sandario financially sound and are consistent with current Commission policies.

1. Income Tax Recovery

On February 21, 2013, the Commission adopted the policy proving "a tax pass-through entity should be allowed to recover income tax expense as part of its cost of service and that its revenue requirement should be grossed up for the effect of income

taxes". *See* Docket No. W-00000C-06-0149, Decision No. 73739 at Attachment 1, p. 2 (Feb. 21, 2013). The Commission further directed "[t]his new policy **will be applied in pending and future rate cases**." *Id.* (emphasis added).

Sandario's application for rates was filed in August 2012 and was pending when the Commission adopted this policy. As Staff explains, "Sandario is a class D for-profit S-Corporation", which is a pass-through entity. *See* Revised Staff Report at p. 1. However, the Revised Staff Report does not gross up revenues for the effect of income taxes.

Pursuant to the Commission's instructions set forth in Decision No. 73739, the Company has calculated the authorized income tax allowance. *See* Attachment 2. The monthly recovery amount will be $1,407.61. The most straightforward way to incorporate this recovery into rates is to add $4.25 to the monthly minimum rates of all customers. The effect would be that the typical residential user's monthly minimum would still be less than $20.00 per month, which is clearly reasonable.

Accordingly, pursuant to Commission directive, the Company is requesting that the revenue requirement be increased by $16,891.37 to allow for recovery of income tax expense. Sandario further requests that the requisite $4.25 per month simply be added to the monthly minimum or include it in the WIFA Surcharge.

2. CIAC Mismatch

The mismatch between depreciation expense and CIAC amortization has a significant detrimental impact on the Company's rate base. Sandario is a company on the edge of either having a rate base or being relegated to a company with negative rate base, which is not desirable.

Companies with negative rate base have no financial incentive to invest in the water system because the owner does not receive a return on the investment. Further, when an owner makes a capital expenditure to replace a well, for example, that investment could be lost because the rate base is already negative. Therefore, companies

in this situation suffer from a lack of investment. Sandario does not want to be put in this position. But Staff's failure to match depreciation and amortization for AIAC converted to CIAC artificially drags down Sandario's rate base by $80,563, which is enough for Sandario's rate base to change from positive as the Company proposes to negative.

To be clear, the Company is **matching** the plant accumulated depreciation of CIAC, which started as AIAC, with CIAC amortization. As the Company explained in its response to the original Staff Report, Staff's $80,563 decrease in Sandario's rate base is a direct result of Staff incorrectly applying an artificially low amortization rate of 4.03% retroactively to 1994. But the correct depreciation rate was 5% during that period, thereby creating the mismatch and adversely impacting rate base far into the future.

As illustrated in Sandario's Response, Schedules SSR-2 to 4, the consequence of Staff's position is that even after the Company's plant is fully depreciated, the CIAC amortization drags down its rate base for another 10 years. *See* Attachment 3. The way to correct this mismatch is to adopt the test year end CIAC amortization balance as proposed by the Company. The amortization rate must take into account the years that the plant was considered AIAC and not amortized, yet it was being depreciated. This is the correct and reasonable way to ensure that small water companies like Sandario avoid having their rate base needlessly eroded, taking away the owners incentive to reinvest in the company.

3. Loan Authorization Amount

The Company has requested authorization for a loan not to exceed $633,450 to design and construct a 100,000 gallon storage tank and upgrade substandard electrical equipment at Well Site 3. In response, Staff proposes that the Company's borrowing authority should be limited to no more than $587,650. Without any explanation, Staff simply provides a table with its calculation that is $45,800 less than the Company's estimate.

Sandario believes the Commission should authorize the Company to borrow $633,450. First and foremost, the Company will seek proposals for the design and construction of the project. The Company will accept the best offer, and the cost of that offer. Certainly, the Company hopes all of the bids are far less than $633,450 because Sandario does not receive any benefit from taking out a loan that is larger than necessary.

The problem with Staff's estimate is that it may be too low. If all responsible bids exceed $587,650, then the Company would have to come back to the Commission and ask for additional financing authorization. This would be a waste of time and money.

Further, the Staff Report gives no indication regarding how Staff arrived at its estimates and some of its estimates appear woefully low. For example, Staff estimates the engineering design costs will be $10,000. This is simply not feasible. The Company's preliminary estimates indicate that engineering firms will charge around $75,000 for the work. Next, Staff is budgeting $1,000 for permits, but ADEQ's fees for the storage tank and related piping will be at least $2,200. Meanwhile, Staff recommends that the control panel upgrade can be performed for $20,000. However, Southwestern Utility Management had a less complex but similar upgrade done for the Valle Verde Water Company and it cost $49,567. The Company suspects that Staff's estimates do not account for the fact that this project will be funded by WIFA, which requires the Company to pay Davis-Bacon Wages. Consequently, hourly rates for electricians and boilermakers will be very expenses, around $35.00 and $52.00 per hour, respectively. This is why the Court should recommend that the Commission authorize the Company to enter into a WIFA loan not to exceed $633,450.

4. Recovery of Debt Service Reserve

The company asserts that DSR should be either a component of the WIFA Surcharge or the revenue requirement should be increased by $8,892 to account for this obligation. WIFA requires the Company to pay the DSR and the Company will never be able to use this money. For the first five years of the loan, the Company will pay WIFA

$8,892 a year to hold just in case the Company cannot make a loan payment. After the Company pays the DSR for five years, this WIFA controlled money is rolled into another reserve account. The Company still cannot use this money unless something catastrophic happens to the tank it will finance. Sometime around the 19th year of the loan, the money held in reserve will equal the loan balance, and at that time, WIFA will sweep the reserve account and the loan will be paid in full. The Company will not receive this money. Instead, the loan term will be shortened and the WIFA surcharge will go away in the 19th year.

There are three options for addressing the DSR expense: (1) include it as part of the WIFA Surcharge; (2) increase the Company's revenue requirement by $8,892 to pay it; or (3) offer no revenue stream to offset this expense, thereby requiring the Company to pay for it using other funds from somewhere. The Company would support either option 1 or 2, but not option 3.

Nonetheless, Staff's position is the Company should pay the DSR out of its own pocket without any additional revenue. Again, Staff offers no rationale for its position that effectively reduces the Company's available funds by another $8,892. Consequently, under Staff's approach, the Company will have to pay the DSR by using its cash flow. This is a significant financial **disincentive** for the Company to borrow money to make necessary improvements, and should not be adopted.

5. Approval of Construction Deadline

Staff recommends as a compliance item that the Company file the storage tank Approval of Construction by no later than December 15, 2015. Presuming the Staff anticipated this matter would be heard by the Commission in the Summer of 2013, the Company believes that Staff is intending to give the Company about 30 months to complete the construction project.

The Company believes a 30 month construction deadline is reasonable; however, the "trigger" for the clock to start running should be the effective date of the Commission

decision. If a hard and fast deadline date is provided, then the Company's timeclock is essentially running while the Court is drafting its decision and the Commission is addressing this matter in due course, which can take many months.

In addition, WIFA's loan approval process routinely takes six months. After the loan is secured, the engineer has to draft plans, which takes several months as well. These plans have to be approved by ADEQ, which can take another 6 months. Thereafter, the project bid process requires another 3 months. So it is not surprising that WIFA projects often take more than a year before construction can begin. By the time the contractor mobilizes, the facilities are constructed, and ADEQ approves what was built, it is quite common for the project timeline to exceed 2 years. Therefore, the Company believes that the Approval of Construction filing deadline should be 30 months after the Commission renders a final decision is this matter.

6. BMPs

Staff recommends that the Company be required to adopt at least three BMPs for Commission review and consideration. See Revised Staff Report at Attachment A, p. 1. Staff offers no explanation for its recommendation. Put another way, Staff does not identify any problem that is being remedied; it only suggests additional regulation for no apparent reason.

Sandario believes BMPs are unnecessary here. The Company is already subject to the Arizona Department of Water Resources' BMP regulations. Further, the BMPs will be another needless expense to the Company and its customers. Sandario has no staff, so it will have to pay either its management company or consultants to draft, revise, finalize, copy, and file the BMPs. Management and consultants will have to engage in the approval process that requires, at a minimum, reviewing the BMP staff report as well as travel to and attend a Commission open meeting. After the BMPs are adopted, they will have to be finalized and filed with docket control and tracked as a compliance matter.

All of this expense will occur without any justification if Staff's recommendation is adopted.

Meanwhile, Staff seems to indicate that this expense will be passed along to the customers in the next rate case, stating "[t]he Company may request cost recovery of the actual costs associated with the BMPs implemented in its next general rate application." This carefully worded provision raises many questions regarding whether or not there will be any meaningful cost recovery. Moreover, most of the BMP expenses will be borne by the Company the next test year, and current Commission rules and policies indicate that the expenses would not be recoverable. So even though the Company "may request cost recovery" it seems unlikely that in practice cost recovery will materialize. And even if it does, then it will be the customers who are paying for this program that is not addressing an actual problem.

Finally, while the Company will adhere to the Commission's decision without protest, it is worth noting that the state administrative procedure statutes prohibit the Commission from including BMP conditions unless there is a statute or rule specifically authorizing such a condition. *See* A.R.S. § 41-1001, et seq. ("Regulatory Bill of Rights"); A.R.S. § 41-1001.01(A)(7) and A.R.S. § 41-1030(B) (agency conditions must be specifically authorized by statute of rule); A.R.S. § 41-1001(11) (defining licensing); A.R.S. § 41-1001(10) (defining license to include an agency approval). Accordingly, the Commission should follow state law and adopt rules regarding BMPs, based upon statutory authority, before requiring companies to implement BMPs. This is especially true here because the BPM rules fall under the jurisdiction of the Arizona Department of Water Resources.

CONCLUSION

In the beginning, the Company and Staff agreed on the revenue requirement of $158,003. The Court should add $16,891.37 to this revenue requirement to allow for recovery of income tax expense. Further, the Court should either increase the revenue

requirement by $8,892 to pay the DSR or include it as part of the WIFA Surcharge. The Court should adopt the Company's recommendation and match the plant accumulated depreciation of CIAC, which started as AIAC, with CIAC amortization.

The Court should also recommend that the Commission authorize the Company to enter into a WIFA loan not to exceed $633,450 and that the Company be given 30 months after the effective date of the Commission decision. Finally, the Company should not be required to adopt and implement additional BMPs.

RESPECTFULLY SUBMITTED this 10th day of June.

MOYES SELLERS & HENDRICKS LTD.

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Original and 13 copies filed
this 10th day of June 2013, with:

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ATTACHMENT 1

Sandario Rate Case
Analysis of Staff's Postion Evolution

	Original Staff Report	Revised Staff Report - no loan	Revised Staff Report - with loan	Company Adj Test Year + Increases
Operating Income [1]	$ 27,107	$ 23,983	$ 23,983	$ 39,523
Surcharge	-	-	44,461	60,199
Op Inc Incl Surcharge	$ 27,107	$ 23,983	$ 68,444	$ 99,722
Interest Expense	-	-	(25,831)	(31,243)
Net Income	$ 27,107	$ 23,983	$ 42,613	$ 68,479
Principal	-	-	(18,630)	(18,923)
DSR	-	-	(8,892)	(10,003)
Post WIFA payment	$ 27,107	$ 23,983	$ 15,091	$ 39,553
Depreciation Expense	7,740	10,864	10,864	-
Cash Flow	$ 34,847	$ 34,847	$ 25,955	$ 39,553
Operating Margin	17.16%	15.18%	33.81%	45.70%

[1] $39,523 = ($5,477) adjusted test year operating loss plus $45,000 increase to base rates as proposed by the Company

ATTACHMENT 2

Sandario Water Company
Income Tax Calculation per Decision 73739

1 The Lewis Family Trust, which is itself a taxable entity, owns 100% of the pass-through entity, Sandario.

2 The Lewis Family Trust files a trust income tax return.

3 Since there is only one owner of Sandario, the pass-through entity, 100% of the taxable income is allocated to the Lewis Family Trust.

Taxable Net Income			$ 68,479.00
	Bracket	Rate	Tax
$	2,450	15.00%	$ 367.50
	5,700	25.00%	812.50
	8,750	28.00%	854.00
	11,950	33.00%	1,056.00
	56,529	39.60%	22,385.48
		Total Federal Tax	$ 25,475.48
		Federal Trust Rate	37.20%
		Arizona Trust rate	3.550%
		Total Effective Trust Income Tax Rate	40.752%

4 Since the pass-through entity, Sandario, only has one owner, the Lewis Family Trust, this does not apply.

5

Total Effective Trust Income Tax Rate	40.752%
Taxable Net Income	$ 68,479.00
Trust Income Tax Allowance	$ 27,906.49

6

Taxable Net Income			$ 68,479.00
	Bracket	Rate	Tax
$	50,000	15.00%	$ 7,500.00
	18,479	25.00%	4,619.75
		Total Federal Tax	$ 12,119.75
		Federal Corporate Rate	17.70%
		Arizona Corporate Rate	6.968%
		Total Corporate Tax Rate	24.67%
		Taxable Net Income	$ 68,479.00
		C-Corporation Income Tax Allowance	$ 16,891.37

7

Trust Income Tax Allowance	$ 27,906.49
C-Corporation Income Tax Allowance	$ 16,891.37

Company proposed income tax recovery amount in rates:	$ 16,891.37
Number of Months in Year	12
Recovery amount per month for income tax	$ 1,407.61
Number of customers	331
Monthly Amount for Income Tax Allowance	$ 4.25

1. Identify all taxable persons or entities and all non-taxable entities[5] (if any) which are owners of the tax pass-through entity. If the tax pass-through entity has an owner which is itself a tax pass-through entity, identify all taxable persons or entities and all non-taxable entities (if any) of such tax pass-through owner. Income tax expense shall be permitted based only upon the effective income tax rates of owners which have actual or potential state and federal income tax liability. The owner or owners of a tax pass-through entity shall not be required to submit personal income tax returns to the Commission, but shall submit documentation showing all owners of the tax pass-through entity, the respective ownership percentages of each owner, and the tax status of each owner (i.e., whether the owner is a taxable entity or a non-taxable entity).

2. Identify the tax filing status (ie. Married filing jointly, married filing single, single, etc.) of the individuals and entities from step 1 above.

3. Compute the actual effective income tax rate for each owner of the tax pass-through entity based upon such owner's proportionate share of taxable income at the proposed revenue level using applicable statutory federal and state income tax rates.

4. Calculate a weighted average effective income tax rate for the combined ownership of the tax pass-through entity.

5. Use the weighted average effective income tax rate for calculating the income tax allowance.

6. Also, calculate the income tax allowance (federal and state) for the tax pass-through entity as though it were a stand-alone Subchapter C corporation.

7. The authorized income tax allowance for the tax pass-through entity shall be the lower of: (i) the income tax allowance using the weighted average effective tax rate for the combined ownership calculated using steps 1 through 5 above; and (ii) the income tax allowance assuming the tax pass-through entity is a stand-alone Subchapter C corporation calculated using step 6 above.

[5] Non-taxable entities are not-for-profit corporations, municipal corporations or other entities which do not have actual or potential state or federal income tax liability.

ATTACHMENT 3

Sandario Water Company, Inc.
Docket No. W-01831A-12-0392
Test Year End June 30, 2012

Schedule SSR-2

Example of Depreciation/Amortization Matching for Contributions

CIAC Amortization Rate	5.00%
Plant Depreciation Rate	5.00%

Year	a Plant Asset	b Accumulated Depreciation	c CIAC Balance	d CIAC Amortization	(a+b) - (c+d) Impact on Rate Base
1	$ 100	$ (5)	$ 100	$ (5)	$ -
2	100	(10)	100	(10)	-
3	100	(15)	100	(15)	-
4	100	(20)	100	(20)	-
5	100	(25)	100	(25)	-
6	100	(30)	100	(30)	-
7	100	(35)	100	(35)	-
8	100	(40)	100	(40)	-
9	100	(45)	100	(45)	-
10	100	(50)	100	(50)	-
11	100	(55)	100	(55)	-
12	100	(60)	100	(60)	-
13	100	(65)	100	(65)	-
14	100	(70)	100	(70)	-
15	100	(75)	100	(75)	-
16	100	(80)	100	(80)	-
17	100	(85)	100	(85)	-
18	100	(90)	100	(90)	-
19	100	(95)	100	(95)	-
20	100	(100)	100	(100)	-

Sandario Water Company, Inc.
Docket No. W-01831A-12-0392
Test Year End June 30, 2012

Schedule SSR-3

Example of Depreciation/Amortization Matching for AIAC Converted to CIAC After 10 Years of Repayments - 5% CIAC Amortization Rate

CIAC Amortization Rate	5.00%
Plant Depreciation Rate	5.00%

Year	a Plant Asset	b Accum Depr	c AIAC Repmts	d AIAC Balance	e CIAC Balance	f CIAC Amort	(a+b) - d - (e+f) Impact on Rate Base
1	$ 100	$ (5)		$ 100	$ -	$ -	$ (5)
2	100	(10)	(1)	99	-	-	(9)
3	100	(15)	(1)	98	-	-	(13)
4	100	(20)	(1)	97	-	-	(17)
5	100	(25)	(2)	95	-	-	(20)
6	100	(30)	(2)	93	-	-	(23)
7	100	(35)	(2)	91	-	-	(26)
8	100	(40)	(2)	89	-	-	(29)
9	100	(45)	(2)	87	-	-	(32)
10	100	(50)	(2)	85	-	-	(35)
11	100	(55)			85	(4)	(36)
12	100	(60)			85	(9)	(37)
13	100	(65)			85	(13)	(37)
14	100	(70)			85	(17)	(38)
15	100	(75)			85	(21)	(39)
16	100	(80)			85	(26)	(40)
17	100	(85)			85	(30)	(40)
18	100	(90)			85	(34)	(41)
19	100	(95)			85	(38)	(42)
20	**100**	**(100)**			**85**	**(43)**	**(43)**
21	100	(100)			85	(47)	(38)
22	100	(100)			85	(51)	(34)
23	100	(100)			85	(55)	(30)
24	100	(100)			85	(60)	(26)
25	100	(100)			85	(64)	(21)
26	100	(100)			85	(68)	(17)
27	100	(100)			85	(72)	(13)
28	100	(100)			85	(77)	(9)
29	100	(100)			85	(81)	(4)
30	100	(100)			85	(85)	-

Sandario Water Company, Inc.
Docket No. W-01831A-12-0392
Test Year End June 30, 2012

Schedule SSR-4

Example of Depreciation/Amortization Matching for AIAC Converted to CIAC After 10 Years of Repayments - 10% CIAC Amortization Rate

CIAC Amortization Rate	10.00%
Plant Depreciation Rate	5.00%

Year	a Plant Asset	b Accum Depr	c AIAC Repmts	d AIAC Balance	e CIAC Balance	f CIAC Amort	(a+b) - d - (e+f) Impact on Rate Base
1	$ 100	$ (5)		$ 100	$ -	$ -	$ (5)
2	100	(10)	(1)	99	-	-	(9)
3	100	(15)	(1)	98	-	-	(13)
4	100	(20)	(1)	97	-	-	(17)
5	100	(25)	(2)	95	-	-	(20)
6	100	(30)	(2)	93	-	-	(23)
7	100	(35)	(2)	91	-	-	(26)
8	100	(40)	(2)	89	-	-	(29)
9	100	(45)	(2)	87	-	-	(32)
10	100	(50)	(2)	85	-	-	(35)
11	100	(55)			85	(9)	(32)
12	100	(60)			85	(17)	(28)
13	100	(65)			85	(26)	(25)
14	100	(70)			85	(34)	(21)
15	100	(75)			85	(43)	(18)
16	100	(80)			85	(51)	(14)
17	100	(85)			85	(60)	(11)
18	100	(90)			85	(68)	(7)
19	100	(95)			85	(77)	(4)
20	100	(100)			85	(85)	-