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AZ CORP COMMISSION
DOCKET CONTROL

IN THE MATTER OF THE APPLICATION OF FAR WEST WATER & SEWER, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS WASTEWATER RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE	DOCKET NO. WS-03478A-12-0307

OPENING BRIEF OF FAR WEST WATER AND SEWER, INC.

Arizona Corporation Commission
DOCKETED
JUN 11 2013
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OPENING BRIEF OF FAR WEST WATER AND SEWER, INC.

I. INTRODUCTION

Far West provides water and wastewater utility services in Yuma County, Arizona. Far West was issued a Certificate of Convenience and Necessity on April 8, 1998, in Decision No. 60799, which authorized the transfer of the Certificate of Convenience and Necessity ("CC&N') held by H&S Developers, Inc. dba Far West Water Company and Far West Sewer Company to Far West.[1] Far West currently serves approximately 7,064 residential wastewater customers, 42 commercial wastewater customers and 5 recreational vehicle parks containing 761 spaces.[2]

The Far West wastewater system consists of a collection system with 16 lift stations.[3] There are six wastewater treatment plants. Treated effluent is either reused on golf courses or recharged into the regional aquifer. Far West's water division currently serves approximately 15,500 customers in Yuma County. Most, but not all, of Far West's wastewater customers are also Far West water customers.

Historically, Far West's service area, the Foothills, was served by septic tanks and much of the area still remains on septic tanks, making it a difficult service area in which to provide wastewater service.[4] These factors resulted in forming Far West's initial wastewater system consisting of small isolated collection and treatment systems serving individual subdivisions or developments.[5] Three of the treatment systems were not planned or developed by Far West. Rather, they were acquired by Far West in 2000 or 2001 as one of the very first steps in consolidating wastewater services across the Foothills area.[6]

Far West experienced substantial growth in the late 1990s and through the first half of the 2000s. Far West's small and isolated sewer facilities were simply unable to keep up with this

[1] Jones Direct Testimony (admitted as Exhibit A-1) at 3:8-12.
[2] Far West Final Schedule H-2. Jones Rejoinder Testimony (admitted as Exhibit A-4) at 11:14-24.
[3] This paragraph, Jones Direct at 3:15-21.
[4] See transcript at 920:1-4.
[5] This paragraph, Jones Direct at 4: 3-8 and See transcript 947:19-23.
[6] See transcript at 948:15-21.

rapid growth and more stringent environmental regulation. As a consequence, Far West received a number of notices of violation from ADEQ.

In order to resolve ADEQ compliance issues, Far West and ADEQ ultimately entered into a Consent Judgment, which mandated that Far West complete a wastewater system improvement program.[7] The Consent Judgment required Far West to:

- Expand its Del Oro, Section 14, and Seasons wastewater treatment plants.
- Close its Villa del Rey and Villa Royal wastewater treatment plants, and direct their flows to the upgraded Del Oro plant.
- Close the Palm Shadows wastewater treatment plant, and direct its flow to the upgraded Section 14 wastewater treatment plant.

The improvements consolidate Far West's wastewater collection and treatment system, bring the system into compliance with all applicable environmental regulations, and position it to handle anticipated growth over the next several years.

Far West's plan to consolidate and replace some of its smaller facilities is typical of the development in many other wastewater service areas around the state. Due to the economics of wastewater systems, it is not possible to initially build the ultimate solution, such as the Section 14 wastewater treatment plant, in the early years of development.[8]

As of the end of the 2011 test year, Far West has completed Phase I of the Section 14 expansion, closed the Palm Shadows wastewater treatment plant and directed its flow to Section 14, and completed the Phase I Del Oro plant expansion.[9] Far West's new wastewater treatment plants are state-of-the-art facilities that, through an ultra-filtration process, produce reclaimed water that is A+ quality as required by the ADEQ Consent Judgment.

Far West's current wastewater rates are based on a calendar-year 2004 test year and went into effect on February 20, 2007, pursuant to Decision No. 69335.[10] Decision No. 69335

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[7] This paragraph, Jones Direct at 4: 9-19.
[8] See transcript at 317:8:18, 946:2:6 and 947:12-19.
[9] This paragraph, Jones Direct at 4:31 – 5:3.
[10] This paragraph, Jones Direct at 5:6-8.

increased Far West's sewer rate from $20.00 to $21.75 per month, which is the only rate increase since Far West's predecessor began providing wastewater service in 1994. The rate base approved in Decision No. 69335 was just $1,549,650.

On July 7, 2007, Far West filed a financing application requesting authorization to acquire up to $25,215,000 in long-term debt to fund its wastewater system improvement program and to repay and consolidate certain existing long-term and short-term debt.[11] The application was approved on October 30, 2007, in Decision No. 69950. On December 13, 2007, Far West obtained $25,190,000 in revenue-bond financing from the Yuma County Industrial Development Authority pursuant to the authorization.

On August 29, 2008, Far West filed an application requesting a permanent 214.8% increase in wastewater rates.[12] On December 19, 2008, Far West filed an emergency application requesting an interim rate increase of 101.02% until such time as permanent rates were set. On January 26, 2009, a Procedural Order was issued, which suspended the permanent rate case until the Commission could complete consideration of the interim rate request. On December 16, 2009, Far West's request for interim rate relief was denied pursuant to Decision No. 71447. Due to concerns about the staleness of the test year and other matters, on March 24, 2010, Far West filed a motion to withdraw the permanent rate case. On April 14, 2010, a Procedural Order was issued ordering that Far West's Motion to Withdraw Application be held in abeyance and the current rate case suspended pending the filing of a new permanent rate case.

Far West is and has been struggling financially and is unable to meet all of its financial obligations.[13] In 2009, the Commission found (Decision No. 71447, page 22) that Far West's wastewater division was insolvent. Conditions have not improved since then. Far West has only been able to maintain wastewater operations through subsidies from its water division, additional short-term borrowings, and additional capital contributions.

[11] This paragraph, Jones Direct at 5:9-14
[12] This paragraph, Jones Direct at 5:15 – 6:2.
[13] This paragraph, Jones Direct at 6:4-9.

Far West's poor financial condition is primarily the result of Far West's wastewater system improvement program.[14] As noted in 2007 (Decision No. 69950), Staff's analysis indicated that the approved debt for implementing Far West's wastewater system improvement program would result in a pro forma debt service coverage ratio ("DSC")' of 1.15 and a times interest earned ratio ("TIER") of 0.50. While these ratios indicated that Far West could meet its debt obligations over the short-term, they were not indicative of a healthy financial position or that the debt obligations were sustainable over the long-term.

Since 2007, Far West has completed the first phase of a massive construction program without any further rate relief. Both the DSC ratio and TIER are now negative for the wastewater division and continue to be at undesirably low levels for Far West as a whole.[15] Far West's plant-in-service balance has increased from $13,420,251 (2004 test year) to $37,751,132 in this filing. The associated <u>rate base has increased from $1,549,650 to $22,800,578</u>. This enormous investment in plant and equipment is primarily responsible for Far West's current crippling financial condition.

In the short-term, Far West is unable to meet its obligations to vendors and other creditors, including being unable to make its property tax payments to Yuma County, and it is struggling to obtain the needed funds to complete the wastewater system improvement program.[16] In the long-term, Far West will be unable to attract the necessary capital to maintain and expand the water and wastewater systems, will not be able to maintain adequate staffing levels, and ultimately will be unable to provide safe and reliable service to its customers. Without significant additional revenue, Far West's unpaid creditors could take legal action to recover amounts due.

The only viable solution to Far West's financial crisis is to increase rates to allow Far West to recover a reasonable rate of return on the amounts invested in new and improved

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[14] This paragraph, Jones Direct at 6:15-22.
[15] This paragraph, Jones Direct at 7:1-6.
[16] This paragraph, Jones Direct at 7:9-17.

wastewater facilities.[17] Far West realizes that the magnitude of the increase requested in this case is very large and may be a hardship for many of its customers. However, not addressing Far West's financial condition would be even more harmful to Far West's customers. Of note, Far West currently charges residential customers a flat monthly charge of only $21.75 for wastewater service. By comparison, the City of Yuma charges $43.20 per month for wastewater service to customers outside the City limits, or approximately twice as much as Far West is authorized to charge.

II. SUMMARY OF PARTIES' POSITIONS

The parties' final schedules show that they are extremely close concerning their recommended rate increases.[18] They all recognize that Far West requires a large rate increase. The following table summarizes their positions:

Table 1 – Summary of Parties' Positions

Party	Gross Revenue Increase	Percentage Increase
Far West	$3,482,612	156.09%
Staff	$3,284,021	147.1 9%
RUCO	$2,754,266	123.45%

Far West and Staff have settled all major issues, with the exception of four rate base issues, which will discussed below. The major issue separating Far West and RUCO is RUCO's arbitrary 30.1% rate base disallowance. This will also be discussed below.

III. RATE BASE

A. Response to Staff

1. Zenon Treatment Equipment at Seasons

Staff recommends removal of $1,060,096 in Plant in Service from Account 380, Treatment and Disposal Equipment and removal of $291,526 from Accumulated Depreciation.[19]

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[17] This paragraph, Jones Direct at 7:20-8:5.
[18] Far West, Staff, and RUCO filed final schedules on May 3, 2013. Spartan Homes did not file final schedules. The Gilkeys and Rists adopted RUCO's final Phase 1 schedules, contingent on the appointment of an interim manager and the completion of a forensic audit. They did not support RUCO's Phase 2 increase.

This adjustment is related to the Zenon treatment equipment now located at the Seasons WWTP. Staff recommends that the Zenon equipment be removed from rate base because it was not in service during its engineering review.

Staff's adjustments are inappropriate. The Zenon equipment was in service during the test year and is presently in service.

The Zenon equipment was only temporarily out of service because it was being relocated from the Del Oro WWTP to the Seasons WWTP.[20] The equipment was in service for five years and three months between September 30, 2006 and December 22, 2011. APS completed installation of upgraded power facilities to the relocated equipment on March 7, 2013. Far West crews, as well as the electrician for the installation contractor, began the start-up and testing of the relocated equipment and the expanded Seasons WWTP the same day. The plant entered service on April 16, 2013.[21]

The relocated equipment has been fully tested, has been in service for two months, and will be in service when rates go into effect in this case. Staff offers no legal or policy reasons why the net cost of the Zenon equipment should be disallowed. The Zenon equipment satisfies both traditional tests for including investment in rate base. First, the plant was in-service during the test year. Second, the plant will be in service when rates go in effect.

2. <u>AFUDC</u>

Staff limits AFUDC to a period ending April 30, 2009, approximately six months after the Zenon obligation became due.[22] Staff used six months for the cut-off date because, once Far West paid the Zenon bills in March 2011, it took approximately six months to complete the work.

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[19] This paragraph, Becker Direct Testimony (Exhibit S-5) at pages 6-7.
[20] This paragraph, Jones Rebuttal Testimony at 12:14-22.
[21] See transcript at 50:16:18.
[22] This paragraph, Becker Direct Testimony at pages 8-14

Far West does not agree with Staff's AFUDC recommendation.[23] The AFUDC as of the cut-off date does not include a significant portion of AFUDC that should be allowed in rate base. This is because the AFUDC accrued during the six-month period after the Zenon obligation was incurred did not include the large unpaid Zenon bills or the significant additional costs to complete the project. By contrast, if AFUDC were to be calculated during the actual final six months of construction during 2011, the calculation would take into account all bills, including the then unpaid Zenon bills and significant additional costs incurred to complete the projects.

Staff's adjustment is too high. This is because the AFUDC accrued during the six-month delay period is substantially less than what would have been accrued if the project had been completed during the same six-month period. In other words, it is inconsistent for Staff to state that construction should have been completed in six months, but not to include all the AFUDC for the construction that should have been completed in those six months.

Far West will accept some adjustment to account for the delay in completing projects.[24] However, as just discussed, Staff's adjustment removed capital expenses that would have been included in AFUDC if the projects had been completed in six months. Far West reduces Staff's AFUDC disallowance to an amount equal to one-half of the interest charges and late fees actually incurred on the unpaid bills. This amount is a fair proxy for the understatement of AFUDC created by Staff's proposed adjustment. The Company's proposed Rate Base Adjustment RB-5 reduces PIS by $1,024,942 and is detailed on page 6 of Schedule B-2 – Rebuttal. The adjustment includes a decrease to accumulated depreciation of $23,005 in accordance with Staff's methodology.

Staff's overstated AFUDC adjustment should be rejected in favor of Far West's more reasonable adjustment.

[23] This paragraph, Jones Rebuttal Testimony at 5:5-16.
[24] This paragraph, Jones Rebuttal Testimony at 5:18-24.

3. **<u>Management Fees</u>**

Staff states that $201,562 of capitalized construction management fees incurred by Mr. Capestro were incurred during a period when the plants should have already been complete and that the Company had already paid Coriolis for construction management.[25] Staff, therefore, proposes to disallow these fees.

Far West does not agree with Staff's recommended disallowance.[26] Although Coriolis was paid for construction management, its contract was terminated in April 2009, with over $750,000 remaining unpaid on the contract. Mr. Capestro did not duplicate the services of Coriolis. Rather, he provided services that Coriolis would have provided if the contract had not been terminated, <u>and at a significantly lower cost</u>.

Mr. Capestro is also a full-time contractor to Far West.[27] He provides the services equivalent to a Vice President of Operations, which Far West does not employ. During the test year, his services were directed toward construction management and capitalized. If they had not been capitalized, they should have been included in test-year operating expense.

As a result of Staff's adjustment, Mr. Capestro's undisputed significant ongoing efforts on behalf of Far West would be reflected neither in rate base nor in operating expenses. This would be unfair and unreasonable.

As a compromise solely to minimize the magnitude of the rate increase, Far West would accept one-half of Staff's proposed disallowance of Mr. Capestro's management fees.[28] Far West's Rate Base Adjustment RB-8 removes $100,782 from PIS and is detailed on page 9 of Schedule B-2 – Rebuttal. The adjustment includes a $2,494 decrease to accumulated depreciation in accordance with Staff's methodology.

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[25] This paragraph, Becker Direct Testimony at pages 16-17.
[26] This paragraph, Jones Rebuttal Testimony at 7:6-15.
[27] *Id.*
[28] This paragraph, Jones Rebuttal Testimony at 7:17-21.

4. Working Capital

Far West and Staff differ on their recommended working capital amounts. This is solely because of the impact of the other disputed rate base items on the working capital computation. However, they do agree on how to calculate working capital.

B. Response to RUCO

1. Arbitrary Capacity Disallowance

RUCO witness Royce Duffett argues that 30.1% of Far West's treatment capacity is excess capacity.[29] Based on this flawed calculation, RUCO disallows 30.1% of all plant in service, much of it completely unrelated to treatment, such as sewer collection mains, computers, and furniture.[30]

RUCO's analysis is seriously flawed, for at least four reasons:

1. The analysis is made on a system-wide basis instead of by individual wastewater treatment facility.
2. The design capacity utilized is not correct.
3. The analysis is based on test year actual flows plus an arbitrary 10% allowance for future growth. It should instead be based on a five-year growth projection typically used by the Commission to make used and useful determinations.
4. RUCO disallows capacity already excluded from rate base.

Far West will take up each flaw in order.

a. RUCO's analysis is made on a system-wide basis instead of by individual wastewater treatment facility.

Each wastewater treatment plant serves a separate and distinct service area.[31] The plants are not physically interconnected and flows cannot be diverted from one plant to another. Therefore, evaluating the capacity of the system as a whole is meaningless. It provides no useful information about which specific plants, if any, may have excess capacity. More importantly,

[29] Duffett Direct Testimony (Exhibit R-9).
[30] RUCO Final Schedule TJC-4(a).
[31] This paragraph, Jones Rebuttal Testimony at 14:15-21.

from a rate-making perspective, it provides no meaningful information as to what specific plant costs should be excluded from rate base if there were excess capacity at a plant.

b. **RUCO's design capacity calculation is incorrect.**

The design capacity of 2,332,500 gallons per day used by Mr. Duffett is mismatched with the test year plant in service and is larger than the total planned capacity of Far West's wastewater system, even if all ongoing improvement projects were complete.[32] The design capacity of wastewater treatment plant in service during the test year was 2,057,500 gallons per day. This is the number Mr. Duffett should have used in his system-wide capacity analysis. Since it is about 11% lower than the number used by Mr. Duffett, his analysis is significantly in error. In fact, the test year design capacity is actually less than the required capacity per ADEQ requirements calculated by Mr. Duffett.

c. **RUCO's analysis is improperly based on test year actual flows plus an arbitrary 10% for future growth.**

Mr. Duffett applies a 10% growth factor to a customer base of 7,067 residential customers.[33] This provides capacity for just 707 additional customers. However, as noted by Mr. Jian Liu, Utilities Engineer for Commission Staff, in his Engineering report the expected growth in the Far West system is between 100 and 400 customers per year. Consistent with Mr. Liu, the Company estimates between 1,100 and 1,200 new customers over the five-year period of 2012 – 2016. Using these numbers, Mr. Duffett's approach underestimates five-year growth by about 60%.

d. **RUCO disallows capacity already excluded from rate base.**

Final Schedule TJC-4(a) clearly indicate that RUCO applies its 30.1 percent proposed adjustment to the Company's proposed plant balance after the Company's $2,165,201 adjustment for not used and useful plant has already been removed.[34] If RUCO's across-the-board approach were to be used, it should have been applied to the unadjusted plant balance,

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[32] This paragraph, Jones Rebuttal Testimony at 15:1-11.
[33] This paragraph, Jones Rebuttal Testimony at 15:14 – 16:5.
[34] This paragraph, Jones Rejoinder Testimony at 9:19 – 10:4.

without first removing the Company's $2,165,201 adjustment. The following table shows these two scenarios.

Table 2 – RUCO's Inappropriate Disallowance of Already Excluded Plant

		RUCO as Proposed	RUCO Corrected	Difference
Section 14 Plant In Service		$ 12,583,565	$ 12,583,565	$ -
Company Adjustment RB-1.7		(2,165,201)	-	2,165,201
Adjusted Plant		10,418,364	12,583,565	2,165,201
RUCO Adjustment 1(a)	-30.1%	(3,135,928)	(3,787,653)	(651,725)
Used and Useful Plant		$ 7,282,436	$ 8,795,912	$ 1,513,475

As indicated, the adjustment proposed by RUCO causes the used and useful plant to be $1,513,475 less than it would be if RUCO used the correct plant balance to calculate its adjustment. The resulting additional $1,513,475 in plant disallowance removes the plant disallowed by the Company a second time. This is a clearly incorrect methodology, even assuming that RUCO's capacity disallowance had any merit, which it does not.

2. Working Capital

Far West and RUCO differ on their recommended working capital amounts solely because of the impact of the other disputed rate base items on the working capital computation. However, they do agree on how to calculate working capital.

IV. INCOME STATEMENT

The parties now agree on all income statement issues. The remaining income statement differences concern interest, depreciation, property tax and income tax expenses. These all flow from the parties' differing rate base and cost-of-capital positions. However, the parties do agree on the methodology to calculate these expenses.

V. COST OF CAPITAL

A. Return on Equity

Far West's highly leveraged capital structure and associated higher than average financial risk requires a higher cost of equity than less leveraged companies.[35] In addition, Far West's test

[35] This paragraph, Jones Direct Testimony at 16:2-20.

year operating cash flow was negative, and Far West's cash flow is projected to remain negative until the rates requested in this case are put into effect. Far West's deteriorating financial condition, negative cash flow, and a highly leveraged capital structure justify a significant financial risk adjustment to any comparative cost of capital analysis. Based on a review of the Commission's 2012 decisions, an 11.00% return on equity is the minimum return on equity that is appropriate for Far West's capital structure and financial risk profile. However, in order to somewhat mitigate the impact of its rate increase request and to eliminate contested issues, Far West selected a return on equity of 10.00%, which does not include the discussed risk premium.

Staff also recommends that the Commission adopt a 10.00% return on equity.[36] Staff's estimated return on equity is based on the average of its discounted cash flow ("DCF") method and capital asset pricing model ("CAPM') cost of equity methodology estimates for the sample companies of 8.8 percent for the DCF and 8.5 percent for the CAPM. Staff's recommended ROE includes an upward economic assessment adjustment of 60 basis points and an upward financial risk adjustment of 70 basis points.

RUCO recommends a 9.25% return on equity.

B. <u>Cost of Debt and Capital Structure</u>

Far West, Staff, and RUCO agree on an overall cost of debt of 6.71%, and on a capital structure of 20.82% equity and 79.78% debt.[37]

C. <u>Weighted Cost of Capital</u>

Far West and Staff agree that the Company's weighted cost of capital is 7.5%. RUCO recommends a weighted cost of capital of 7.24%.

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[36] This paragraph, Cassidy Direct Testimony (Exhibit S-3).

[37] See final schedules filed on May 3, 2013. Far West and RUCO separately break out the costs and percentages of long-term and short-term debt, but if these are averaged, the composite costs and percentages of debt are equal to those in Staff's final schedules.

D. Discussion

The following table summarizes reported Commission decisions since 2011 concerning return on equity and weighted cost of capital:

Table 3 – Recent Returns on Equity and Weighted Average Costs of Capital

Company	Decision No.	Date	Return on Equity	Percent Equity	Weighted Average Cost of Capital
Southwest Gas Corp.	72723	1/6/2012	9.50	52.30	8.95
Bermuda Water Co.	72892	2/17/2012	8.82	100.00	8.82
Chino Meadows II Water Co.	72896	2/12/2012	10.00	100.00	10.00
Indiada Water Co.	73091	4/4/2012	10.00	100.00	10.00
Arizona Water Co. (Western Group)	73144	5/1/2012	10.00	50.97	8.44
Arizona-American Water Co.	73145	5/1/2012	10.60	41.27	7.10
UNS Electric	73142	5/1/2012	9.50	50.82	8.27
Arizona Public Service Co.	73183	5/14/2012	10.00	53.94	8.33
Pima Utility Co.	73573	11/21/2012	9.49	64.64	7.63
Arizona Water Co. (Eastern Group)	73736	2/20/2013	10.55	50.97	8.72
Average			**9.85%**	**66.49%**	**8.63%**

Several key points are illustrated by the table.

First, all parties agree that to compensate for increased financial risk, a company's return on equity must increase as the equity percentage decreases.[38] Mr. Jones supported a financial risk adjustment of 100 basis points, Mr. Cassidy recommended 70 basis points, and Mr. Rigsby recommended 49 basis points.[39] The table shows that the average return on equity authorized by the Commission since 2011 was 9.85% and the average equity percentage was 66.49%, over three times more than Far West's equity percentage of just 20.82%. Essentially, although a far greater risk adjustment would be justified, the 10% return on equity recommended by Far West and Staff would only carry a 15 basis point adjustment over the 9.85% average return on equity provided by the Commission for companies with much higher equity percentages.

The second point is even more important. Customers do not pay rates based on the authorized return on equity; customers pay rates based on the weighted average cost of capital.

[38] Jones Direct Testimony at 16:2-20; Cassidy Direct Testimony at 37:9 – 38:11; and Rigsby Direct Testimony at 56:1-13.
[39] *Id.*

The table shows that the average of weighted average costs of capital authorized by the Commission is 8.63%. Far West and Staff are recommending a weighted average cost of capital of just 7.5% - 113 basis points below the average cost of capital. Far West's customers will pay rates based on this extraordinarily low weighted average cost of capital, not on the 10% return on equity (already in line with Commission precedent). Far West's customers benefit, at least for ratemaking purposes, from its low equity percentage.

Finally, there is a more subtle point. Debt payments are deducted dollar-for-dollar from taxable income.[40] In contrast, there is no deduction for "payments" to equity investors. So the allowance for equity return built into rates must be grossed up to allow for increased income-tax payments.[41] A more highly leveraged capital structure requires a lower revenue requirement (less income) to pay for tax expenses.

At the 39.5% combined federal and state tax rate the Commission uses to calculate income tax expense, it is simple to calculate the after-tax cost of debt. One dollar of debt payments results in $0.395 in tax savings. Thus, one can calculate the after-tax cost of debt for a company by multiplying its debt cost by (1 – 0.395) to account for the tax savings.

Table 4 uses the same companies included in Table 3 and also includes Far West with the capital structure, equity cost, and debt cost jointly recommended by Far West and Staff. Table 4 adds the after-tax costs of debt for the companies and concludes with the calculated after-tax weighted cost of capital:

[40] Transcript at 381:15-22.
[41] Transcript at 381:25 – 382:5.

Table 4 – Calculation of After-Tax Weighted Costs of Debt and Weighted Costs of Capital

Company	Return on Equity	% Equity	% Debt	Debt Cost	After-tax Debt Cost	WACC	After-Tax WACC
Southwest Gas Corp.	9.50	52.30	47.70	8.34	5.05	8.95	7.38
Bermuda Water Co.	8.82	100.00	0.00	0.00	0.00	8.82	8.82
Chino Meadows II Water Co.	10.00	100.00	0.00	0.00	0.00	10.00	10.00
Indiada Water Co.	10.00	100.00	0.00	0.00	0.00	10.00	10.00
Arizona Water Co. (West. Group)	10.00	50.97	49.03	6.82	4.13	8.44	7.12
Arizona-American Water Co.	10.60	41.27	58.73	5.66	3.42	7.10	6.39
UNS Gas	9.50	50.82	49.18	6.74	4.08	8.27	6.83
Arizona Public Service Co.	10.00	53.94	46.06	6.38	3.86	8.33	7.17
Pima Utility Co.	9.49	64.64	35.36	4.25	2.57	7.63	7.04
Arizona Water Co. (East. Group)	10.55	50.97	49.03	6.82	4.13	8.72	7.40
Average	**9.85**	**66.49**				**8.63**	**7.82**
Far West (Staff and Far West)	**10.00**	**20.80**	**79.20**	**6.70**	**4.05**	**7.39**	**5.29**

With the debt tax savings calculated, the tax benefits of debt for the ratepayer are striking. For each company with debt in its capital structure, the after-tax weighted average cost of capital is significantly lower than the weighted average cost of capital that disregards tax savings. Far West, with its highly leveraged capital structure, has by far the lowest after tax weighted cost of capital – just 5.29%. This is 110 basis points lower than Arizona-American, the next lowest in the table, and 253 basis points lower than the average!

If Far West's return on equity were set just to the level required to set the after tax weighted tax cost of capital to 6.39%—the level allowed for Arizona-American—Far West's equity return would be far higher. Table 5 demonstrates that Far West's allowed return on equity would have to be set at 15.3% for its after tax weighted cost of capital to just equal Arizona-American's 6.39%.

Table 5 – Adjusted Far West Return on Equity

Company	Return on Equity	Percent Equity	Percent Debt	Debt Cost	After-tax Debt Cost	WACC	After-Tax WACC
Arizona-American Water Co.	10.60	41.27	58.73	5.66	3.42	7.10	6.39
Far West)	**15.30**	**20.80**	**79.20**	**6.70**	**4.05**	**8.49**	**6.39**

Now, Far West is not advocating a capital structure as highly leveraged as its present one. Far West would much prefer to increase its equity percentage and believes that increased rates should help attract equity investors. The point of this exercise is that customers actually benefit if rates are set based on the existing capital structure and a 10% allowed return on equity. Rates would be far higher if Far West had a more balanced capital structure.

VI. RATE DESIGN ISSUES

A. Response to Staff

Far West and Staff are in complete agreement concerning the rate design to be used in this case.[42]

B. Response to RUCO

Far West and RUCO appear to be in agreement concerning most rate design issues with the exception of commercial meter multipliers and the applicable effluent rate. The difference in meter multipliers is small and Far West recommends that the Commission adopt the multipliers used by Far West and Staff.

In regard to effluent rates, Far West has provided undisputed evidence regarding the costs and benefits related to effluent disposal and sales.[43] Far West's cost benefit analysis shows that the best lowest cost option for effluent disposal is a must-take contract with a third party, which allows Far West to avoid constructing any costly facilities for effluent disposal. This is the case with Mesa Del Sol, and no party has recommended discontinuing providing Mesa Del Sol with effluent at no cost under the terms of the existing contract. The Commission should allow Far

[42] Transcript at 1045-47.
[43] This paragraph, Transcript at 370-378 and Exhibit A-7.

West to continue providing Mesa Del Sol with effluent at no cost pursuant to the existing contract.

With respect to the effluent sold by Far West to affiliated golf courses, Far West's cost benefit analysis indicates that the optimal effluent rate is slightly higher than the cost to pump groundwater. Far West and Staff have agreed that $0.25 per 1,000 gallons, a rate that is slightly higher than the cost of pumping groundwater, is an appropriate effluent rate. The Commission should adopt the rate supported by Far West's cost benefit analysis and agreed to by Far West and Staff.

VII. <u>RATE INCREASE CONDITIONS</u>

Far West and Staff have agreed to a number of conditions that Far West must satisfy.[44] Several of these conditions must be satisfied before new rates go into effect. Several other conditions must be satisfied after new rates go into effect. The remaining conditions resolve issues between Far West and Staff.

Far West's agreement to these conditions was reluctant at best. Far West has demonstrated, and Staff and RUCO agree, that the company requires major rate relief. Anything that delays that rate relief will make it that much more difficult for Far West to begin moving toward financial health.

A. <u>Conditions That Must Be Satisfied before Rates Go into Effect</u>

1. <u>ADEQ Compliance</u>

Far West and Staff stipulated that rates not go into effect until Far West is in full compliance with the Arizona Department of Environmental Quality ("ADEQ") Consent Judgment:

> *Any increase in rates and charges approved in this proceeding shall not become effective until Far West files documentation from ADEQ that Far West's wastewater treatment plants are in compliance with ADEQ's Consent Judgment as it may be amended.*[45]

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[44] See Exhibit A-9.
[45] Exhibit A-8, ¶ 1.

2. Spartan Homes Compliance

Far West and Staff stipulated that rates not go into effect until Far West is in full compliance with Decision No. 72594, which resolve Spartan Homes' Complaint against Far West in Docket No. WS-03478A-08-0256:

> *Any increase in rates and charges approved in this proceeding shall not become effective until Far West makes the payments and files the CC&N extension required by Decision No. 72594.*[46]

3. Rate Phase-In

To further mitigate the impact of the rate increase, Far West reluctantly stipulated to a Staff rate phase-in proposal:

> *Any new rates approved in this proceeding will be phased in with 50 percent of the increase becoming effective for bills rendered on or after the first day of the month after the Company achieves compliance with both Conditions Nos. 1 and 2, above, with the remaining 50 percent becoming effective six months later. There will be no recovery of lost revenue or interest associated with the phase-in period.*[47]

The rate phase-in is especially difficult for Far West to accept.[48] Far West does not consider a phase in of rates to be feasible considering its deteriorating financial condition. Far West has been struggling financially for many years, and it continues to struggle financially. It has invested over $20 million in plant since its last rate case without any recovery in rates and endured significant loss of equity due to regulatory lag associated with the plant investment.

In 2009, the Commission found (Decision No. 71447, page 22) that Far West's wastewater division was insolvent, yet refused to provide any emergency rate relief. Rate relief in 2009 would have substantially obviated the need for rate relief today. However, <u>that</u> Commission chose to kick the can down the road, which forces <u>this</u> Commission to deal with this long-avoided rate problem of Far West.

Now, in 2013, rate relief is finally in sight. Delaying one-half of the justified rate relief for six months essentially further penalizes Far West on top of the draconian Decision No.

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[46] Exhibit A-8, ¶ 2
[47] Exhibit A-8, ¶ 3.
[48] This paragraph, Jones Rebuttal Testimony at 12:16-20.

71447. Far West is rightfully concerned that the rate phase-in may set up Far West to fail. But Far West recognizes that the magnitude of this rate increase will be large and a burden on most of its customers. In recognizing this reality, Far West has swallowed hard and accepted Staff's rate design condition.

B. Conditions That Must Be Satisfied after New Rates Are Effective

1. Property Taxes

Far West and Staff stipulated to the following condition:

Far West shall submit a payment plan for the full payment of all delinquent property taxes and penalties for years 2008, 2009, 2010, 2011, and 2012 that is acceptable to Yuma County for Staff review and Commission approval in this docket.[49]

2. Main Extension Agreements

Far West and Staff stipulated to the following condition:

Far West will make monthly payments to developers for unpaid amounts due under Main Extension Agreements with the condition that all amounts due be fully paid not later than June 30, 2015.[50]

3. Collections from Related Parties

Far West and Staff stipulated to the following condition:

Far West will collect all amounts owed by related parties no later than 12 months from the date when Phase I of new rates are effective in this proceeding, or December 3 1, 2014, whichever is sooner.[51]

C. Conditions That Resolve Other Issues

1. Effluent Rates

Far West and Staff stipulated to the following condition:

Effluent rates should be set at a rate equal to the greater of $0.25 per thousand gallons and local market rate.[52]

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[49] Exhibit A-8, ¶ 4.
[50] Exhibit A-8, ¶ 5.
[51] Exhibit A-8, ¶ 6.
[52] Exhibit A-8, ¶ 7.

2. RV Tariff Language

Far West and Staff stipulated to the language set forth in Exhibit A-9.[53]

3. Affiliate Transaction Policy

Far West and Staff stipulated to the following condition:

Far West will formulate and adopt a formal written policy concerning affiliate transactions. The policy will address the specific steps that Far West will take to demonstrate that the transactions between Far West and its affiliates and related parties are arms-length, transparent and well documented. Further, the policies will include a competitive bidding process and require that Far West maintain evidence of competitive biddings for all major construction projects. Far West will submit such a policy for Staffs review and approval.[54]

VIII. OTHER ISSUES

A. Intervenor Issues

1. Interim Manager

Based largely on perceived grievances going all the way back to the last century, the Gilkeys and the Rists ("Intervenors") recommend appointment of an interim manager.[55] Intervenors ignore that in 2009, the Commission considered most if not all of the issues Intervenors brought up in the recent hearings that could support appointment of an interim manager. In Decision No. 71447, when these issues were fresh in the Commissioners' minds, the Commission refused to appoint an interim manager.

Far West is unaware of any new issues that would today justify appointment of an interim manager. Far West has completed—at great cost—the investment required by the first phase of the ADEQ Consent Judgment. Far West, given its struggling financial picture, is well run and fulfilling all its public service obligations. That is not to say that there are issues remaining to be dealt with, but that is true for every wastewater utility in Arizona. Funds from the rate increase will allow Far West to turn to any remaining issues. And neither Staff nor RUCO believe that an interim manager is needed at this time.

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[53] Exhibit A-8, ¶ 8.
[54] Exhibit A-8, ¶ 9.
[55] See e.g. Exhibit Gilkey-Rist 1.

Finally, no party has suggested how an interim manager could help Far West. Far West's problems are financial. An interim manager would be unable to raise any more funds; in fact, such an appointment would likely further disturb the willingness of investors to provide additional funds. Finally, an interim manager would not work for free – this would be one more cost to be borne by the customers.

In its Reply Brief, Far West will further respond to this issue once it is able to see any heretofore unidentified concrete reasons that Intervenors believe would warrant appointment of an interim manager and how appointment of an interim manager could allegedly improve Far West's operations.

2. <u>Forensic Audit</u>

Similar to their request for appointment of an interim manager, Intervenors have identified no reasons that justify a forensic audit. Intervenors have not reviewed Far West's financial records. Staff and RUCO have thoroughly reviewed these financial records through the test year and have found nothing to justify a forensic audit. Nor has any party suggested that it has been denied access to any relevant financial records. Far West supported and justified the expenditures and the items in this case. Far West provided its general ledger, provided requested cash disbursements ledgers and provided the reconciliations requested in this case, going far beyond that typically requested.[56] And the few minor issues that come up in any rate case have all been completely resolved.

Since the interim rate case, Far West paid for and was subject to a thorough, independent financial audit by Levitzacks for calendar year 2009.[57] A financial audit is a lengthy, labor intensive process that results in the auditing firm certifying the company's financial statements.[58] In addition, Far West paid for independent reviewed financial statements for calendar years 2010 and 2011.[59]

[56] Transcript at 350-351.
[57] Transcript at 785-87.
[58] Transcript at 776-77.
[59] Transcript at 350:19-20.

In its Reply Brief, Far West will further respond to this issue once it is able to see any heretofore unidentified concrete reasons that Intervenors believe would justify conducting a forensic audit and exactly what this forensic audit would hope to accomplish.

B. RESPONSE TO SPARTAN HOMES

Far West believes that with its agreement to Condition 2, discussed above, it has resolved all legitimate issues with Spartan Homes. In its Reply Brief, Far West will further respond if necessary to Spartan Homes.

IX. CONCLUSION

In 2009, the Commission found (Decision No. 71447, page 22) that Far West's wastewater division was insolvent, yet refused to provide any emergency rate relief. Rate relief in 2009 would have substantially obviated the need for rate relied today. However, that Commission chose to kick the can down the road, which forces this Commission to deal with this long-avoided rate problem of Far West.

The undisputed facts are that Far West has justified a rate increase at least to the 147% level recommended by Staff.[60] Based on the evidence and Far West's arguments in this brief, the 156% rate increase request is fully justified.

Decision No. 71447 was extraordinarily punitive. It cut past fat and into muscle and bone. As a consequence, Far West has struggled for four years to pay bills and complete required construction projects, although it has still provided adequate, safe customer service.

Regulatory lag is another huge penalty. Far West has shown and the parties agree that a very large rate increase was needed in 2011, the test year in this case. But, by the time new rates go into effect, Far West will have gone almost two years without the rate relief that was justified in 2011.

Far West is now constitutionally entitled to the rate increase it has justified. Nevertheless, Far West has agreed to one more penalty. To mitigate the effects of the rate

[60] Once RUCO's arbitrary capacity disallowance is corrected, RUCO's recommended rate increase would be between Staff's and Far West's recommendations.

increase, Far West has voluntarily agreed to defer for six months one half of the rate increase to which it is entitled, without interest or any mechanism to recover the effects of the deferral.

No more deferrals or other penalties can be justified. Far West must have the opportunity to begin the long journey back to financial health. Therefore, Far West asks the Commission to promptly approve its requested 156% rate increase.

Respectfully submitted on June 11, 2013, by:

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Original and 13 copies **filed**
on June 11, 2013, with:

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