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BEFORE THE ARIZONA CORPORATION CC

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

Docket No. W-01445A-12-0348

RUCO'S OPENING BRIEF

Arizona Corporation Commission

DOCKETED

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1 **INTRODUCTION**

2 The Residential Utility Consumer Office ("RUCO") submits this Brief in response to
3 Settlement ("Settlement") reached between the Arizona Water Company's ("Arizona Water" or
4 "AWC" or the Company") and the Arizona Corporation Commission Staff's ("Staff"). The
5 Settlement requests that the Arizona Corporation Commission ("Commission") authorize a rate
6 increase of \$2,240,329 for AWC's Northern Group¹.

7 RUCO recommends the Commission reject the Settlement as proposed. RUCO takes
8 issue with the following aspects of the Settlement - the implementation of a System
9 Improvement Surcharge ("SIB"), the proposed declining usage adjustment, and the
10 recommended 10 percent return on equity. Adjusting for these three issues as will be further
11 explained results in a proposed revenue increase of \$1,691,803.

12 .

13 **1. THE COMMISSION SHOULD REJECT THE SIB. THE SIB SHIFTS RISK**
14 **FROM THE COMPANY TO THE RATEPAYER WITHOUT ADEQUATE**
15 **FINANCIAL CONSIDERATION TO THE RATEPAYER**

16 RUCO opposes the SIB mechanism because ratepayers are not adequately
17 compensated for the additional risk associated with the SIB and because it is illegal². The SIB
18 mechanism reduces regulatory lag in favor of AWC because the Company will not have to wait
19 until new rates go into effect to recover a return on SIB eligible plant or the depreciation
20 expense associated with it. 0310 RUCO-12 at 10³. However, any actual cost savings, such as
21 lower operating and maintenance expenses, attributable to the new plant are not truly captured
22 by the mechanism and are not adequately flowed through to ratepayers. Id. The reason for

23 ¹ For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of
24 Proceedings. The transcript volume number will identify references to the transcript. A-1 at 1.

² Not surprisingly, many of the arguments here are taken from RUCO's Brief filed in the Phase II Docket (11-0310) but are worth repeating.

1 the mismatch is the SIB filings will consider eligible plant placed in service after the time period
2 considered in the rate case. 0310 Transcript at 258. Hence, the operating expenses
3 associated with the SIB plant as well as all of the other rate case elements normally
4 considered in a rate case will not be considered. Id. This mismatch works against the
5 ratepayer's interests and assures that ratepayers will not pay their actual cost of service and
6 will more than likely pay more over time.

7 Ratepayers will be paying for the recovery of and return on routine plant placed into
8 ratebase in between rate cases that the ratepayer would not otherwise pay until the next rate
9 case. To the extent the ratepayer receives a benefit through the efficiency credit on the return
10 associated with the SIB related plant that paltry benefit is only available until the next rate case
11 filing when the relevant plant is rolled into the ratebase and subject to the COE awarded in the
12 next rate case. 0310 Transcript at 457.

13 While no one will know the true extent of the efficiency credit until the Company actually
14 makes its SIB filing, the Company's Schedule A-3 provides a good idea. Schedule A-3 shows
15 a hypothetical calculation of the overall SIB revenue requirement for the Superstition Division
16 in the Eastern Division. 0310 A-3 at 1. With an overall SIB revenue requirement of \$292,300,
17 the overall efficiency credit would be \$14,615 (5 percent). 0310 A-3. This hypothetical
18 exemplifies the imbalance between the ratepayer's benefit and the shareholder's benefit.

19 Of course, in this case, when considering the shareholder benefits, the Commission
20 should not limit its consideration to just the SIB. The 10 percent Cost of Equity ("COE") is 90
21 basis points above what Staff recommended in its direct case (9.1 percent) and 125 basis
22 points above what RUCO recommended in its direct case (8.75 percent). S-3 at 34, RUCO-8
23

24 ³ As per the ALJ's suggestions, references to exhibits incorporated in this record from Docket W-01445A-11-0310 will be preceded with or identified with the Docket Number 0310.

1 at 5. The COE is just an additional shareholder benefit which further distorts the imbalance
2 between the SIB financial benefit to the ratepayer and the SIB financial benefits to the
3 shareholder.

4 Another argument advanced in support of the SIB that has a link to the financial benefit
5 is that the SIB will promote rate gradualism. 0130 Transcript at 283 and 317. While the SIB
6 may promote rate gradualism, it comes at a cost. Ratepayers will pay higher rates because,
7 among other things, the Company will earn a return on plant in between rate cases that it
8 traditionally would not earn until the next rate case. Gradualism will also come at the expense
9 of rate stability. 0130 Transcript at 306-307. Ratepayer's rates will change yearly as the result
10 of each SIB filing. Id., A-1 at 5.

11 Each filing will also result in a rate increase. For reasons which will be addressed
12 below, the SIB is not an adjustor. Ratepayers will see no actual cost savings that might be
13 realized and will no longer benefit from the rate stability that exists under the present
14 ratemaking procedure. Id. The Commission should reject the SIB.

15 **a) THE SIB IS ILLEGAL IN ARIZONA**

16 The SIB is a DSIC, and the same legal arguments made in the Eastern Division case
17 apply here. See 0130 RUCO Opening Brief at 11-14 (Phase I), 0130 RUCO Reply Brief at 2-5,
18 (Phase I). RUCO also incorporates the legal arguments made by Staff in its Eastern Division
19 Opening Brief (0130 pps. 25-28, Phase I) and Reply Brief (0130 pps. 19-23, Phase I) to the
20 extent they are consistent with RUCO's legal arguments. In all fairness to Staff, Staff did not
21 foreclose the possibility that a DSIC mechanism could be constitutional. According to Staff,
22 "...where exceptional circumstances exist, and a mechanism for a future rate adjustment is
23 adopted in the context of a rate case as part of a utility's rate structure and if that mechanism
24 meets the constitutional requirements that rate base is determined and the overall impact on

1 the rate of return prescribed, that mechanism will not violate the Arizona Constitution.” Staff’s
2 Opening Brief (0130 Phase 1) at 26 citing *Scates v. Ariz. Corp. Comm’n*, 118 Ariz. 531, 533,
3 578 P.2d 612, 614 (App. 1978). While the signatories may contend that the SIB meets the
4 Constitutional hurdles by such provisions as Schedule D in the Settlement, in truth, as will be
5 more fully explained below, the SIB does not meet the Constitution’s Fair Value Requirement.

6 Since the hearing in this matter concluded the Commission has decided the Eastern
7 Division Case. The ROO in that matter was issued on May 28, 2013 and the Commission
8 decided the matter on June 12, 2013. The final written Decision has not been docketed as of
9 the writing of this Brief. However, it appears that the Commission has adopted the legal
10 arguments set forth in the ROO.⁴ RUCO has reviewed the Nodes ROO and does not agree
11 with the legal arguments and conclusions. Given the timeliness of the Nodes ROO the
12 following legal analysis is not meant to be exhaustive - RUCO will address the legal
13 conclusions raised and will explain legally why it does not agree with the legal portion of the
14 Nodes ROO.

15 The Nodes ROO concludes that the SIB mechanism requires a fair value finding.
16 Nodes ROO at 50. The Nodes ROO further concludes that the SIB is an adjustment
17 mechanism. ROO at 51. Finally, the Nodes ROO suggests that the SIB would still qualify as
18 an exception to the fair value requirement under the “third exception” suggested in the *Scates*
19 case. Nodes ROO at 44, 52-53. “In limited circumstances, the Commission may engage in
20 ratemaking without ascertaining a utility’s ratebase.” *Residential Util. Consumer Office v.*
21 *Arizona Corp. Comm’n (“Rio Verde”)*, 199 Ariz. 588, 591 ¶ 11, 20 P.3d 1169, 1172. If in fact
22 the SIB ascertains the Company’s fair value ratebase, there should be no reason to consider
23 the exceptions and surely no need to expand the exceptions to the constitutional fair value
24

1 requirement. The SIB does not ascertain the fair value rate base nor qualify as an exception
2 under Arizona law. By way of order, RUCO will start with the exceptions first and then address
3 the SIB's fair value rate base finding.

4 **b) THE SIB IS NOT AN ADJUSTOR MECHANISM**

5 At the risk of being repetitive it is important to establish what the SIB is and what it is not
6 when considering its constitutionality. The Arizona Constitution protects consumers by
7 generally requiring that the Commission only change a utility's rates in conjunction with making
8 a finding of the fair value of the utility's property.⁵ However, Arizona's courts recognize that, "in
9 limited circumstances," the Commission may engage in rate making without ascertaining a
10 utility's rate base.⁶ One of those circumstances exists where the Commission has established
11 an automatic adjustor mechanism. *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 535, 578
12 P.2d 612, 616; *Residential Util. Consumer Office v. Arizona Corp. Comm'n ("Rio Verde")*, 199
13 Ariz. 588, 591 ¶ 11, 20 P.3d 1169, 1172. An automatic adjustor mechanism permits rates to
14 adjust up or down "in relation to fluctuations in certain, narrowly defined, operating expenses."
15 *Scates* at 535, 578 P.2d 616. An automatic adjustor permits a utility's rate of return to remain
16 relatively constant despite fluctuations in the relevant expense. An automatic adjustor clause
17 can only be implemented as part of a full rate hearing. *Rio Verde* at 592 ¶ 19, 20 P.3d 1173,
18 *citing Scates* at 535, 578 P.2d 616.

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

23 ⁴ The Phase II ROO for reference in this Brief will be referred to as the Nodes ROO.

24 ⁵ Arizona Constitution. Art. XV, § 14; *Simms v. Round Valley Light & Power Company*, 80 Ariz. 145, 151, 294
P.2d 378, 382 (1956); see also *State v. Tucson Gas*, 15 Ariz. 294, 308; 138 P.781, 786 (1914); *Arizona
Corporation Commission v. State ex rel. Woods*, 171 Ariz. 286, 295, 830 P.2d 807, 816 (1992).

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

4 The Commission went on to discuss the undesirability of such adjustors because they can
5 cause piecemeal regulation that is inefficient and undesirable. *Id.* at 8. *See also Scates* at
6 534, 578 P.2d 615.

7 In the subject case, the SIB clearly is not an adjustor mechanism – its purpose is not to
8 account for fluctuating operating expenses. Its purpose is to allow for recovery of plant costs
9 which increase rate base and thereby increase operating income. Unlike an adjustor, the SIB
10 does not allow for rates to adjust “in relation to fluctuations in certain, narrowly defined,
11 operating expenses.” Moreover, the SIB only permits rates to adjust up, not down as the result
12 of allowing for the SIB related plant recovery. 0130 RUCO -12 at 11.

13 Staff also recognized the *Scates* definition when it concluded that the Company’s
14 proposed DSIC was not an adjustor⁷. Staff Reply Brief at 21-22 (0130). While the SIB is
15 different than the DSIC mechanism originally proposed by the Company in the Eastern
16 Division case, there was no change made to it that automatically changed it from a non-
17 adjustor mechanism to an adjustor mechanism. For the very same reasons, the SIB is not an
18 adjustor.

19 Even if one could set aside the argument that Arizona’s courts have only recognized
20 adjustors for very limited operating expenses and not for operating income, the SIB
21 mechanism still would not qualify as an adjustor because the justification for the mechanism is

22
23 ⁶ *Residential Utility Consumer Office v. Arizona Corporation Commission*, 199 Ariz. 588, 591 ¶11, 20 P.3d 1169,
1172 (App. 2001).

24 ⁷ There seems to be a difference of opinion in Staff on whether the Company’s DSIC was an adjustor. 0130
Transcript at 297, Decision No. 73736 at 101, S-3 at 35 (Phase I). However, it appears that the legal section
does not believe it was an adjustor.

1 not the volatility in the price of the plant. As explained, the concern here is the amount of the
2 investment, and no case law parities the need for an adjustor mechanism with the magnitude
3 of investment in plant. The SIB is not an adjustor mechanism nor should the exception be
4 expanded in any manner to treat it as such.

5 **c) THE COMPANY HAS NOT REQUESTED INTERIM RATES**

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

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

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21
22

⁸ *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533-35, 578 P.2d 612, 614-16 (App. 1978).

23 ⁹ 199 Ariz. at 591, ¶12, citing *Scates*.

¹⁰ 71-17 Opinion Arizona Attorney General at 50. (1971).

24 ¹¹ The Company acknowledges that it has operated the Bisbee system for over 60 years and that much of the infrastructure is from the early 1900's. (0130 Tr. At 400-401)

1 **d) THE SIB WOULD NOT QUALIFY UNDER THE 'THIRD EXCEPTION'**

2 The Nodes ROO also lists what it refers to as a "third exception" contemplated by the
3 Arizona Courts to the fair value requirement. Citing *Scates*, the ROO references the following:

4 We do not need to decide in this case whether as a matter of law
5 there must be a *de novo* compliance with all provisions of the order in
6 connection with every increase in rates. The Commission here not only
7 failed to require any such submissions, but also failed to make any
8 examination whatsoever of the company's financial condition, and to
9 make any determination of whether the increase would affect the
10 utility's rate of return. There may well be exceptional situations in which
11 the Commission may authorize partial rate increases without requiring
12 entirely new submissions. We do not decide in this case, for example,
13 whether the Commission could have referred to previous submissions
14 with some updating or whether it could have accepted summary
15 financial information.

16 (118 Ariz. 531, at 537, 578 P.2d 612, at 618) Nodes ROO at 44.

17 RUCO believes that an unabridged gap exists between a conclusion that a third
18 exception exists and that the Arizona courts have determined that a third exception exists.
19 RUCO is unaware of any case in Arizona that specifically identifies and sets forth the criteria
20 for a third exception. Moreover, the Commission, if anything should be looking to narrow, not
21 expand the exception to Arizona's Constitutional requirement that fair value be found. The
22 provisions of Arizona's Constitution should be liberally construed to carry out the purposes for
23 which they were adopted. *Laos v. Arnold*, 141 Ariz. 46, 685 P.2d 111 (1984). Conversely,
24 exceptions to a constitutional requirement should be narrowly construed. See *Spokane &*
I.E.R. Co. v. U.S., 241 U.S. 344, 350, 36 S.Ct. 668, 671 (1916) (an "elementary rule" that
exceptions from a general policy embodied in the law should be strictly construed).
Essentially, the Commission should not use the "emergency" exception or the adjustor
mechanism exception liberally or create a "third exception" to set aside the rule of finding fair
value when setting rates.

1 If a third exception does exist, the SIB in this case should not qualify. The SIB
2 contemplates the inclusion of routine plant in between rate cases. There is hardly anything
3 extraordinary about a utility that needs to replace aging infrastructure. In fact it is normal and
4 usually the reason why a utility files a rate case. The SIB, at the very least will be support for
5 any utility to seek extraordinary ratemaking to include routine plant for recovery in between
6 rate cases. Staff's Director, Steve Olea provided insight on this important consideration in the
7 Eastern Division case. Staff concluded in that the Company had not demonstrated
8 extraordinary circumstances in the underlying case to justify the Company's proposal. 0130 S-
9 3 at 35 (Phase I). When asked in Phase 2 what had changed, Mr. Olea responded the
10 Commission's request that the parties were all directed to talk about the DSIC. 0130
11 Transcript at 301. In the hearing in this case, Mr. Olea again testified the same regarding the
12 extraordinary circumstances. Transcript at 274. In Staff's view, a Commission directive to look
13 at the DSIC constitutes an extraordinary circumstance. Staff's definition of "extraordinary" is
14 even more murky and inconsistent when one considers that the Commission in the last
15 company-wide rate case ordered the Company to do a DSIC study and report in its next rate
16 case. Decision No. 73736 at 14-15. While it does not appear that Arizona's case law defines
17 extraordinary or exceptional, it is doubtful that it would include the Commission's directive in
18 this case. For example, *Scates* did define what was needed for interim rates – an emergency
19 which is far more tangible than a mere directive. *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531,
20 535, 578 P.2d 612, 616 (App. 1978).

21 Moreover, the Judge in the Phase 1 of the Eastern Division case warned that a DSIC
22 can be viewed as a reward given a utility's own failure to maintain and improve its systems
23 responsibly. 0130 Phase One ROO at 105. In the Eastern case, the Judge was worried about
24 the Company's payment of shareholder dividends that could have been used to cover the

1 necessary infrastructure costs for some of its divisions. Id. Undoubtedly, that was one of the
2 reasons which led the Judge to conclude it was not appropriate for the Commission to
3 authorize a DSIC in that Decision. Id. In the present case we are still talking about the same
4 Company having paid out, as its own witness admits, increasing dividends. Transcript at 100.
5 RUCO believes that the same reasons exist in this case to deny the Company a DSIC.

6
7 **e) THE SIB WILL INCREASE THE COMPANY'S FAIR VALUE RATE
8 BASE WITHOUT ANY DETERMINATION OF FAIR VALUE**

8 Having established that the SIB does not meet any of the criteria required by Arizona's
9 Courts to side-step the Constitution's fair value requirement, the question then becomes
10 whether or not the SIB complies with the Constitution's fair value requirement. First, it is
11 important to recognize what the SIB is – it is a mechanism, not an adjustor mechanism, which
12 will allow for the recovery of, and a return on routine plant in between rate cases, needed to
13 address the Company's plant and improvement needs¹².

14 The SIB mechanism itself will be established as part of the pending rate case. Within
15 12 months of the date of the Commission's final decision, AWC will be able to file a request to
16 implement the SIB surcharge. 0130 A-1 at 5, Section 4.2. The Company will be able to file for
17 the SIB surcharge no more than five times between rate case decisions. 0130 A-1 at 5,
18 Section 4.4. The Commission will ultimately consider and then may approve each surcharge
19 filing. The Commission, however, will not be making a new FVRB finding as part of each
20 surcharge filing in such a way as to make fair value meaningful. 0130 RUCO-12 at 13. As
21 Staff noted concerning the DSIC, the SIB will do far more than simply pass on increasing costs
22 to the Company - it will allow "...surcharges based on the cost of the new plant, effectively
23

24 ¹² Again, its purpose is the same as the higher ROE that the Commission awarded in the underlying Eastern
Division case. See Decision No. 73736 at 61.

1 increasing the fair value rate base without any determination by the Commission of what that
2 fair value is.” (See Staff Opening Brief at page 26 (0130)). The SIB suffers from the same
3 constitutional deficiency effectively making it illegal in Arizona.

4
5 **f) THE SETTLEMENT AND THE NODES ROO DO NOT CURE THE
6 CONSTITUTIONAL INFIRMITIES OF THE SIB**

7 Undoubtedly, the signatories will claim that the necessary constitutional safeguards are
8 in place and the SIB passes constitutional scrutiny. RUCO challenges such a conclusion – the
9 facts are the facts and the fact is that each SIB filing will not result in a meaningful FVRB
10 finding nor will there be any finding by the Commission of what fair value is:

11 “It is clear . . . that under our constitution as
12 interpreted by this court, the commission is required to find the fair
13 value of (the utility's) property and use such finding as a rate base for
14 the purpose of calculating what are just and reasonable rates. . . . While
15 our constitution does not establish a formula for arriving at fair value, it
16 does require such value to be found and used as the base in fixing
17 rates. The reasonableness and justness of the rates must be related to
18 this finding of fair value.” Simms v. Round Valley Light & Power Co., 80
19 Ariz. 145, 151, 294 P.2d 378, 382 (1956).

20 Section 7.17 of the SIB Settlement (“SIB Settlement”) requires the filing of Schedule D
21 which will show an analysis of the impact of the SIB plant on the fair value rate base, revenue,
22 and the fair value rate of return as set forth in Decision No. 73736. 0130 A-1 at 9. This
23 provision was obviously put in to satisfy *Scates*, but it does not go far enough:
24

25 We do not need to decide in this case whether as a matter of law
26 there must be a de novo compliance with all provisions of the order in
27 connection with every increase in rates. The Commission here not only
28 failed to require any such submissions, but also failed to make any
29 examination whatsoever of the company's financial condition, and to
30 make any determination of whether the increase would affect the
31 utility's rate of return. There may well be exceptional situations in which
32 the Commission may authorize partial rate increases without requiring
33 entirely new submissions. We do not decide in this case, for example,
34

1 whether the Commission could have referred to previous submissions
2 with some updating or whether it could have accepted summary
3 financial information. *We do hold that the Commission was without*
4 *authority to increase the rate without any consideration of the overall*
5 *impact of that rate increase upon the return of Mountain States, and*
6 *without, as specifically required by our law, a determination of Mountain*
7 *States' rate base. Simms v. Round Valley Light & Power Co., 80 Ariz.*
8 *145, 294 P.2d 378 (1956); Ariz.Const. art. 15, section 3; A.R.S. section*
9 *40-250. The Commission not only failed to make any findings to support*
10 *its conclusion that the increases were just and reasonable, but it*
11 *received no evidence upon which such findings could be based. Scates*
12 *at 537, 578 P.2d 618. (Emphasis added).*

13 While the SIB Schedule (D) may show the impact of the SIB plant on the rate base, the
14 revenue and the fair value rate of return, the Commission will not, as required by law, make a
15 meaningful finding of fair value and use that finding as a rate base for the purpose of
16 establishing rates. 0130 R-12 at 13-15. In order to meet *Scates*, and hence fair value, the SIB
17 filing would have to be on the scale of a rate case or at least a mini-type rate case where all of
18 the rate case elements are considered. Schedule D shows the rate base (O.C.L.D.) but it only
19 shows the capital costs and the depreciation expense associated with the plant additions.
20 0130 A-1, Schedule D, Transcript at 469. Hence, the SIB filings will only consider one piece –
21 the SIB plant. 0130 Transcript at 258 and 469. It will not consider the operating expenses
22 associated with that plant, the working capital, etc. *Id.* at 258, 292. The operating expenses
23 that will be included in the rates that the Commission will approve after each SIB filing will be
24 the operating expenses approved in Decision No. 73736 - operating expenses from a
completely different period than the SIB plant under consideration. *Id.* In sum, there is no tie
back to fair value and the SIB raises the specter of single issue ratemaking which was a
concern of the *Scates* Court, the Commission's judges but apparently is no longer a concern of

1 Staff¹³. *Scates* at 534, 578 P.2d. 615, RUCO 5 at 5. **The SIB mechanism is single issue**
2 **ratemaking, it is not fair value ratemaking - Schedule D renders fair value meaningless.**

3 The Nodes ROO adds an earnings test. Nodes ROO at 51. While an earnings test will
4 provide the Commission with a measure of the Company's earnings at a designated point in
5 time, it will not cure the constitutional fair value infirmity. The earnings test is an after-the-fact
6 indicator of whether the Company's actual rate of return exceeded its authorized rate of return
7 looking back over a designated time period. See Nodes ROO at 51. An earnings test is not
8 relevant to an actual finding of fair value. There are other provisions of the SIB Settlement
9 which will assure Commission oversight and approval of the SIB filings but nothing that
10 requires a meaningful finding of fair value as required by Arizona's Constitution. The SIB is
11 illegal and should be rejected.

12
13 **g) THE SIB SETTLEMENT ITSELF IS TOO BROAD UNDER THE**
14 **CIRCUMSTANCES OF THE EASTERN DIVISION CASE AND MANY OF**
15 **ITS PROVISIONS ARE FLAWED**

16 The SIB Settlement goes far beyond its original purpose. Moreover, many of its
17 provisions and the Agreement as a whole raise more questions than answers. Admittedly, no
18 Agreement is perfect. RUCO understands that, but the SIB Settlement should be tight and not
19 subject to different interpretations.

20 RUCO takes issue with the following:

- 21 1) Section 3.3. The 5.00 percent efficiency credit is inadequate to
22 compensate ratepayers for the shift in risk – it is paltry compared to the
23 benefits the shareholders receive.

24 ¹³ Staff was concerned about the element of single issue ratemaking as concerns the DSIC in the underlying
case. 0130 S-4 at 2-3.

1 2) Section 4.6 and 4.7. These provisions explain when the Company is
2 required to file its next rate case and reset of the SIB surcharge. They do
3 not, nor does the Settlement, explain what happens to the SIB after the
4 next rate case. The circumstance after 2016 will be different than now
5 and leaving such an important point open to interpretation is perilous.

6 3) Section 6 – Eligibility of SIB Plant. The Commission was originally
7 concerned with the Company’s water loss and looking at DSIC’s designed
8 to implement leak detection devices and make conservation-based
9 repairs. The objective was to replace/repair/improve the infrastructure
10 specifically to address the water loss. Decision No. 73736 at 15. The SIB
11 expands the purpose to include almost every type of plant. For example,
12 the SIB includes upgrades to fire mains which could clearly include
13 upgrades whose sole purpose is for fire flow improvement. The
14 Commission has made clear that such improvements do not warrant
15 extraordinary ratemaking treatment. See for example Decision No. 70351
16 at 36. Staff claims it will be diligent in its review of the plant but Staff’s
17 personnel change as does the Company’s personnel and who can say
18 how such excess will be controlled in the future. This is only one example
19 of how unintended plant could easily fit into the broad “categories”
20 described in paragraph 6.4. The better question to ask is what plant is not
21 eligible under the terms of the Agreement? Mr. Olea responded at
22 hearing that plant not described in 6.4 would be ineligible. 0130 Transcript
23 at 331. Staff’s answer is of little to no value since 6.4 only describes
24 categories (and a lot of them) and not specific types of plant.

1 RUCO's concern here, like most of the following concerns could
2 easily be addressed with more detailed provisions. Instead, many of the
3 provisions of the agreement are subject to different interpretations. On the
4 issue of eligibility, it is worth noting that Section 6.3.1 lists as one of the
5 eligibility criteria, water loss of a system that exceeds 10 percent. This
6 specific provision, standing alone, could create perverse incentives. A
7 Company with a water loss less than 10 percent could easily be motivated
8 to ignore or neglect the issue or even take measures to worsen the
9 situation to achieve eligibility. SIB approval would reward such impure
10 conduct. This concern is not hollow – to be eligible all a utility needs to do
11 is meet the standard – it then becomes the burden of Staff/RUCO and
12 ultimately the Commission to ascertain whether the Companies motives
13 are pure or not. It would not be difficult to hide such conduct –
14 ascertaining one's intent is one of the most difficult things in the law to
15 prove. Towards this end, a provision in this section which provides that
16 eligibility is subject to the consideration of all of the facts and
17 circumstances of any given case would tighten the agreement and
18 perhaps provide a disincentive to questionable conduct.

19 A catch all provision would also cover the concerns Judge Harping
20 raised in her ROO and Judge Nodes raised in the Eastern Group hearing
21 concerning the Company's recent payout of dividends in view of its need
22 for infrastructure improvement. 0130 ROO at 105. The Company
23 complains of underearning and its inability to cover its expenses. When
24 asked by Judge Nodes whether it would be appropriate for the Company

1 to account for all of its depreciation expense before being eligible for a
2 SIB, the Company believed such a requirement would be unnecessary.
3 The Company appears to believe that the issue is not accountability, but
4 strictly cost recovery. 0130 Transcript at 116. The Company claims to
5 have lost approximately \$41 million since 1996. 0130 Transcript at 118.
6 Nonetheless, as the Judge noted, the Company still managed to pay \$5
7 million in dividends a year which over the same time period exceeded the
8 \$41 million it lost. Id. at 119. While Judge Harping would not go so far as
9 accusing the Company of malfeasance, she did note that the Company
10 was in a position to ameliorate its situation. The point should not be lost -
11 such circumstances should be considered when contemplating the SIB.

12 It is not entirely clear under Section 6 of the SIB Settlement that
13 the history of company, its past financial circumstances, etc. are
14 considerations for eligibility. Section 6.3.3 provides for the engineering,
15 operational and financial justification for SIB eligibility, but the language,
16 again is subject to interpretation.

17 4) Section 6.5. This provision provides for the procedure after the Company
18 makes its request to modify or add SIB projects. Staff and RUCO will then
19 have 30 days to object. 0130 A-1 at 8. If either objects, it is left unstated
20 what will happen and subject to interpretation as was made obvious in the
21 hearing. 0130 Transcript at 250-252, 286-287.

22 5) Section 7.17. This provision provides for an impact statement. It appears
23 to be a provision put in place in an effort to meet the *Scates* requirements.
24

1 But as discussed above, it falls short of meeting Scates and the fair value
2 requirement.

3 6) RUCO is concerned that the SIB projects could generate revenues by
4 serving new customers. It is not made clear in the provisions of the
5 Agreement that the SIB plant is to be non-revenue producing. To some
6 degree RUCO's concern is diminished by the verbiage in Table 1 which
7 indicates for each project that it is not being constructed to serve new
8 customers. 0130 A-1, Exhibit A. Again, it is not spelled out in the
9 Settlement's provisions and it is easy to see how this point could get lost
10 or just amount to lip service as time goes by.

11 **h) THE SIB IS NOT IN THE PUBLIC INTEREST**

12 There are numerous reasons why RUCO does not believe the SIB is in the public
13 interest. The SIB is illegal in Arizona, and hence not in the public interest. The SIB does not
14 adequately compensate ratepayers for the shift in risk that will result – a five percent efficiency
15 credit is a paltry quid pro quo - all one needs to do is look at 0130 Exhibit A-3 to put it into
16 perspective. The Commission has made it clear in adopting Commissioner Pierce's
17 Amendment #3 to the Nodes ROO that it does not believe that there is a relationship between
18 the SIB and the ROE. RUCO respectfully disagrees and believes that not considering a
19 downward adjustment to the Company's ROE to reflect the lower risk, given the inadequacy of
20 the efficiency adjustment is not in the public interest. Judge Harping in the Eastern case and
21 Judge Rodda in the Rio Rico¹⁴ case seem to have a different opinion than the Commissioners'

22
23 ¹⁴ Judge Rodda noted that bifurcation as proposed by the Company in that case "hinders the ability of parties
24 to argue their positions as to whether and how the DSIC affects the cost of capital and/or operating
expenses, and could adversely affect the Commission's ability to set just and reasonable rates." Clearly,
Judge Rodda was at least willing to consider that a relationship between the DSIC and ROE exists. See
Procedural Order dated March 20, 2013, Docket No. WS-02676A-12-0196, at pp. 5-6.

1 on the relationship between a DSIC and the ROE – such conflict on such an important issue is
2 not good. Perhaps even more compelling is the fact that the Commission addressed the
3 infrastructure needs in the Eastern case by awarding a higher ROE. The Commission then
4 went ahead and approved the SIB in the Eastern case without reducing the ROE in that case.
5 In the Eastern case, the Commission, contrary to what Judge Nodes recommended, approved
6 two mechanisms to address the same issue. Likewise, in the present case, it will appear to be
7 doing the same thing, given the 10 percent COE proposed in the Settlement and the
8 recommended lower costs of equity that Staff and RUCO proposed in their direct cases.
9 Under the Settlement, the Company gets an SIB and a higher ROE, the ratepayer gets a paltry
10 5 percent efficiency credit. RUCO asks how that is in the public interest.

11 Approval of the SIB here will continue a bad precedent - why would a Company not ask
12 for both a higher ROE and a SIB to address its water loss related infrastructure needs in the
13 future? How will the Commission distinguish any future case and not allow for the approval of
14 two mechanisms to address the same thing? Seriously, can a reasonable argument be made
15 that it is fair to the ratepayer for the Commission to approve two mechanisms to address the
16 same thing?

17 The fact that the Commission is the "extraordinary" catalyst that now makes it
18 necessary to use extraordinary ratemaking is not in the public interest. In fact, its potential
19 future ramifications are nothing short of just plain scary. The SIB Settlement itself is loaded
20 with provisions that are subject to different interpretations and omissions on important points
21 as explained above. The Commission need only go back to the TEP Settlement in 1999 and
22 how the different interpretations of that settlement became the central focus of TEP's last rate
23 case. See Docket No. E-01933A-07-0472. The Commission should be wary of repeating that
24 situation – such confusion is surely not in the public interest.

1 There are other reasons why the SIB is not in the public interest - but the point is made.

2 RUCO believes that the SIB is not in the public interest.

3 **2. THE COMMISSION SHOULD REJECT THE DECLINING USAGE**
4 **ADJUSTMENT**

5 Like the SIB, the result of the declining usage adjustment is to shift risk to the ratepayer.

6 The point of the declining usage adjustment is to make the Company whole for declines in
7 projected water consumption. The adjustment will allow for the recovery of forecasted
8 shortfalls of revenue through a rate design calculated with usage-adjusted billing determinants.

9 RUCO-5 at 17. In the event the Company's forecasts are off and the anticipated declines in
10 consumption do not occur, the Company will over collect its authorized level of revenue, and
11 could see an unwarranted increase in operating income. Id. at 18. In fact, RUCO has
12 calculated in this case, that should declining usage trends flatten out, the Northern Group,
13 would realize an additional \$419,644 annually in operating revenue over the \$2,240,313 million
14 in operating revenue produced by the adjusted test year billing determinants adopted in the
15 Settlement Agreement. Id. at 21. Interestingly, Staff, whose role is to balance the interests of
16 the ratepayers and shareholders, no longer appears to be the least bit concerned that the
17 Company's forecasts could be off at a significant cost to the ratepayer. Transcript at 299-300.
18 Given the history of this adjustment and the circumstances of this case, the Commission
19 should reject this adjustment.

20 This case is not the first time the Company has proposed this type of adjustment. In the
21 Company's district wide rate case, the Company proposed the "Northern Group Conservation
22 Adjustment." Decision No. 71845 at 68. While that adjustment worked different than the
23 declining usage adjustment in this case, its purpose was to "... recognize the downward impact
24 on revenues that the Company claims will be experienced by the imposition of tiered rates for

1 the systems in that Group.” Id. Staff asserted that the Company’s proposal was speculative
2 and should have been denied. Id. at 69. The Commission ultimately denied the Company’s
3 proposal. Id.

4 Thereafter, in the Company’s Western Group Case (Docket No. W-01445A-10-0517),
5 the parties arrived at a Settlement that did not include a declining usage adjustment. Most
6 recently, in Eastern Group case the issue was squarely addressed. Similar to the subject
7 case, the Company proposed an adjustment for declining use. Decision No. 73736 at 66.
8 RUCO opposed the adjustment for the same reasons it opposes the present adjustment. Id. at
9 68. Staff also opposed the adjustment (at least as it applied to the residential customers) as it
10 found Mr. Reiker’s “... estimates of change in use per customer to be unstable, to vary with the
11 time frame for analysis, and thus not to be known and measurable. Id. at 68-69 (Ex. S-7 at 5
12 (0130)).”¹⁵ The Commission, in rejecting the proposed declining use adjustment concluded:

13 Because AWC chose to make its adjustments to billing
14 determinants rather than through revenues and expenses, we cannot
15 be confident that the appropriate associated reductions to future
16 operating costs, as reflected in the graph in Mr. Reiker’s direct
17 testimony, have also been made. AWC’s adjustment methodology also
18 makes it difficult to identify the projected annual impact of the
19 normalization adjustments (as opposed to the impact of the proposed
20 changes in rate design), although it appears that the normalization
21 adjustment would impact annual revenue in an amount between
22 \$155,438.91 and \$446,738.55 at AWC’s proposed rates.

23 It is possible that, with more complete and transparent
24 information as to the normalization adjustment methodology and its
impacts, the Commission might find such an adjustment to be
appropriate in the future. The Commission understands that a
consistent pattern of declining usage, and the diminished revenues that
follow, could jeopardize AWC’s ability to recover its cost of service,
which is contrary to the best interests of AWC, AWC’s customers, and
the Commission. However, the Commission will not approve such an
adjustment without first being confident that the changes in usage are
known and measurable, that any corresponding changes in costs have

¹⁵ Staff did accept a declining usage adjustment for the commercial customers in the Superstition Division.
Id. at 69.

1 been factored into the normalization calculation so as to avoid
2 mismatches and over-recovery, and that the Commission is aware of
3 the actual impacts of the adjustment on proposed rates.

4 Decision No. 73736 at 70-71. Decision No 73736 was docketed February 20, 2013 – several
5 months ago. The Commission did not mince words – the Commission made clear what would
6 be required to approve such an adjustment.

7 The Director of Staff, Steve Olea, when asked whether he had considered the
8 Commission's directives in the current case inferred that he had not. Transcript at 283. Mr.
9 Olea could not explain how the Commission could be confident that the appropriate associated
10 reductions to future operating costs were made under the proposal nor could he explain the
11 projected annual impact of the normalization adjustments. Id at 283-284. There is no
12 evidence which addresses the Commission's recent directive on this issue – in fact, the
13 evidence indicates that the changes in usage will not be known and measurable, there will be
14 no corresponding changes in costs factored into the normalization calculation so as to avoid
15 mismatches and over-recovery, and that the Commission cannot be assured of actual impacts
16 of the adjustment on proposed rates. Transcript at 283-285. The old baseball adage – “three
17 strikes and you are out” should be applied, and the Commission should reject the declining
18 usage proposal.

19 Staff's change of position on this is further puzzling in light of its position in its direct
20 case. There, Staff's witness, Jeffrey Michlik, recommended that the Commission reject the
21 Company's declining usage proposal. Mr. Michlik noted that the “normalization” adjustments
22 “... can result in higher rates because revenue requirement targets will be spread over fewer
23 billing determinants.” S-1 at 4. At the same time, Mr. Michlik recommended rejection of all of
24 the Company's

1 "...normalization adjustments based on the Company's estimates of
2 trends in use per customer. The adjustments are based on
3 slope coefficients determined by statistical regression analysis.
4 The coefficients vary significantly when the analysis is conducted
5 over varying time frames (e.g., ten vs. five years). Consequently
6 the adjustment cannot be known and measurable."

7 S-1 at 4. Mr. Olea confirmed that the Settlement proposal had not addressed Mr. Michlik's
8 concerns and that it could result in higher rates because of revenue requirement targets will be
9 spread over fewer billing determinants. Transcript at 278. In truth, there is no way a declining
10 usage adjustment will not result in higher rates if usage levels decline - so neither Mr. Olea's
11 testimony nor Mr. Michlik's testimony comes as a surprise. Mr. Michlik's testimony is at least
12 consistent with Mr. Olea's in that no attempt had been made to comply with the Commission's
13 *Eastern Group Decision* requirements for an acceptable adjustment.

14 Given these facts, the obvious question is why Staff would compromise this one away.
15 With the SIB, an argument can be made that there is some benefit, albeit small, to the
16 ratepayer. But a declining usage adjustment is counter to the ratepayer's interests in all
17 regards - it is a one sided adjustment - purely for the shareholder. There is always comfort in
18 a lower cost of equity to address the obvious imbalance favoring the shareholder, but in the
19 Settlement Staff is recommending a COE that is 90 basis point higher than its direct case -
20 another coup for the shareholder.

21 The only "logical" explanation is that Staff favors the shareholder over the ratepayer in
22 this case. When asked if there are situations where Staff would favor one group over the
23 other, Mr. Olea admitted there are circumstances. Transcript at 287. Mr. Olea explained that
24 an example would be the situation where it looks like Staff's position will not get adopted by the
 Commission. Id. Regardless of the reasons why, given the terms of the Settlement, it
 appears that Staff favors the shareholders over the ratepayers in this case.

1 Both Staff and the Company justify the adjustment based on their guess of future usage
2 – which is nothing more than a guess. If Staff and the Company are wrong, the Company gets
3 a windfall, ratepayers lose and there is no consideration to the ratepayer for the additional risk.
4 The Settlement proposes this adjustment despite no evidence that the declining usage the
5 Company has experienced in the past is the result of the Commission's inclining block tiered
6 rate design. RUCO-6 at 2. Declining sales could be related to the poor economy. Id. The
7 notion that usage will continue to decline is also inconsistent with the drying pattern recently
8 experienced. A-4 at 9. Even the Company admits that the drying patterns relation to usage is
9 "...troubling considering the historical correlation between water consumption and climate,
10 which normally would mean an *increase* in per capita water sales during this period." Id.

11 The Company at hearing presented an exhibit showing a summary of per capita sales
12 for the Navajo and Verde Valley districts. A-16. Admittedly, the graphs showing the usage
13 are declining slightly, but if anything, the linear line for both districts appear to be leveling. Id.
14 The evidence in this case is at best questionable to support the declining use estimate, and
15 ratepayers should not be subject to the risk if Staff and Company is wrong.

16 **3. THE PROPOSED COST OF EQUITY IN THIS CASE IS TO HIGH UNDER THE**
17 **CIRCUMSTANCES OF THIS CASE**

18 For the most part, RUCO has touched upon the cost of capital and the various
19 arguments associated with it throughout this brief. As a sanity check, however, it is worth
20 taking a look at the Settlement agreed to in the recent Western Group case. There, Staff, in
21 justifying its support for that Settlement noted that the Settlement was fair because it adopted a
22 10 percent cost of equity which Staff had recommended in its direct case and did not
23 implement a DSIC. Decision No. 73144 at 38-39. The Settlement also did not contain a
24 declining usage adjustment. By comparison, the present Settlement includes a DSIC

1 mechanism, a declining usage adjustment and a 90 basis point COE bump from Staff's direct
2 case. The Settlement in this case is not fair and balanced and should be rejected.

3 **4. THE SETTLEMENT IS NOT IN THE PUBLIC INTEREST**

4 The approval of the Settlement is not in the public interest if it includes the SIB, the
5 declining usage adjustment and the overstated COE. The SIB is illegal in Arizona, and hence
6 not in the public interest. The SIB does not adequately compensate ratepayers for the shift in
7 risk that will result – a five percent efficiency credit is a paltry quid pro quo - all one needs to do
8 is look at Exhibit A-3 (0130) to put it into perspective. In the Eastern Group case, the
9 Commission has approved two mechanisms to address the infrastructure issue – the SIB and
10 the higher ROE. If the Commission approves the SIB here, like in the Eastern case, the
11 Company will get a SIB and a higher ROE than what Staff and/or RUCO originally
12 recommended. RUCO asks how that is in the public interest.

13 The approval of the Settlement in this case would also continue bad precedent¹⁶ - why
14 would a Company not ask for both a higher ROE and a SIB to address its water loss related
15 infrastructure needs in the future? How will the Commission distinguish any future case and
16 not allow for the approval of two mechanisms to address the same thing? Seriously, can a
17 reasonable argument be made that it is fair to the ratepayer for the Commission to approve
18 two mechanisms to address the same thing? Approval of the SIB in this case under these
19 circumstances will no doubt continue the Commission down a slippery slope.

20 The fact that the Commission is the "extraordinary" catalyst that now makes it
21 necessary to use extraordinary ratemaking is not in the public interest. In fact, its potential
22 future ramifications are nothing short of just plain scary. The Settlement itself is loaded with
23 provisions that are subject to different interpretations and omissions on important points as
24

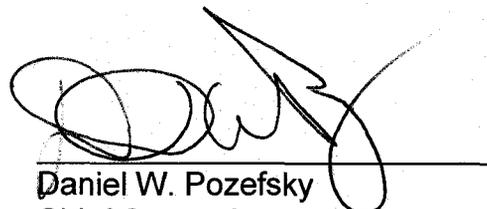
1 explained above. The Commission need only go back to the TEP Settlement in 1999 and how
2 the different interpretations of that settlement became the central focus of TEP's last rate case.
3 See Docket No. E-01933A-07-0472. The Commission should be wary of repeating that
4 situation – such confusion is surely not in the public interest.

5 The declining usage adjustment is not in the public interest. It is based simply on a
6 guess and if that guess is wrong ratepayers will pay and the Company will likely earn a
7 windfall. Moreover, and perhaps even more important, the Commission established criteria in
8 the months old Eastern case that must be met before it would approve such an adjustment.
9 Decision No. 73736 at 70-71. That criteria has not been met - aside from the obvious negative
10 connotations associated with approving an adjustment that does not meet the criteria the
11 Commission set less than six months ago, such approval could affect the integrity of the
12 Commission's decisions going forward – why would anyone have any faith in a Commission
13 decision if the Commission does not require compliance with its own judgment? The
14 Commission should not approve the declining usage adjustment as it would be contrary to the
15 public interest.

16 **5. CONCLUSION**

17 For all of the above reasons the Commission should reject the Settlement.

18
19 RESPECTFULLY SUBMITTED this 18th day of June, 2013.

20
21
22 
23 Daniel W. Pozefsky
24 Chief Counsel

24 ¹⁶ Assuming of course, that the SIB is approved in the Eastern case.

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