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BRENDA BURNS
BOB BURNS
SUSAN BITTER SMITH

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ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

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

DOCKET NO. W-01445A-11-0310

**NOTICE OF FILING DIRECT
TESTIMONY
(REHEARING)**

Arizona Water Company hereby files the direct testimony of Joel M. Reiker regarding the rehearing/reopening, respectively, of Decision Nos. 73938 and 73736.

RESPECTFULLY SUBMITTED this 4th day of October, 2013.

Arizona Corporation Commission

DOCKETED

OCT 04 2013

DOCKETED BY

ARIZONA WATER COMPANY

By:
Joel M. Reiker
Vice President - Rates and Revenue
ARIZONA WATER COMPANY
3805 North Black Canyon Highway
Phoenix, AZ 85015
Telephone: (602) 240-6860

Steven A. Hirsch (No. 006360)
Stanley B. Lutz (No. 021195)
BRYAN CAVE, LLP
Two North Central Avenue, Suite 2200
Phoenix, AZ 85004
Telephone: (602) 364-7000
Attorneys for Arizona Water Company

1 **ORIGINAL and 13 COPIES** of the foregoing filed this 4th day of October, 2013, with:

2 Docket Control
Arizona Corporation Commission
3 1200 West Washington Street
Phoenix, Arizona 85007
4

5 **COPY** of the foregoing hand-delivered this 4th day of October, 2013, to:

6 Janice Alward, Chief Counsel
Legal Division
7 ARIZONA CORPORATION COMMISSION
1200 West Washington Street
8 Phoenix, Arizona 85007

9 Wesley Van Cleve
10 Legal Division
ARIZONA CORPORATION COMMISSION
11 1200 West Washington Street
Phoenix, Arizona 85007
12

13 Bridget Humphrey
Legal Division
14 ARIZONA CORPORATION COMMISSION
1200 West Washington Street
15 Phoenix, Arizona 85007

16 Steven M. Olea, Director
Utilities Division
17 ARIZONA CORPORATION COMMISSION
1200 West Washington Street
18 Phoenix, Arizona 85007

19 Lyn Farmer
20 Chief Administrative Law Judge
Hearing Division
21 ARIZONA CORPORATION COMMISSION
1200 West Washington Street
22 Phoenix, Arizona 85007

23 Daniel W. Pozefsky, Chief Counsel
24 RESIDENTIAL UTILITY CONSUMER OFFICE
1110 West Washington Street, Suite 220
25 Phoenix, Arizona 85007
26
27
28

1 **COPY** of the foregoing e-mailed and/or mailed this 4th day of October, 2013, to:

2 Scott S. Wakefield
3 RIDENOUR, HIENTON & LEWIS, PLLC
4 201 N. Central ave. Suite 3300
5 Phoenix, AZ 85004-1052
6 swakefield@rhlfirm.com
7 *Attorney for Residential Utility Consumer
8 Office*

9 Jay L. Shapiro
10 FENNEMORE CRAIG PC
11 2394 E. Camelback Road, Suite 600
12 Phoenix, AZ 85016-3429
13 jshapiro@fclaw.com
14 *Attorney for Liberty Utilities*

15 Christopher Krygier
16 LIBERTY UTILITIES
17 12725 W. Indian School Road, Suite D101
18 Avondale, AZ 85392
19 chris.krygier@libertyutilities.com

20 Michael Hallam
21 LEWIS ROCA ROTHBERGER, LLP
22 40 N. Central
23 Phoenix, AZ 85004
24 Mhallam@LRRlaw.com
25 *Attorney for EPCOR Water Arizona, Inc.*

26 Michael M. Grant
27 GALLAGHER & KENNEDY, PA
28 2575 E. Camelback Road
Phoenix, AZ 85016-9225
mmg@gknet.com
Attorney for Arizona Investment Council

Gary Yaquinto
ARIZONA INVESTMENT COUNCIL
2100 N. Central Avenue, Suite 210
Phoenix, AZ 85004
gyaquinto@arizonaic.org

Michael W. Patten
Timothy J. Sabo
ROSHKA DEWULF & PATTEN, PLC
One Arizona Center
400 E. Van Buren, Suite 800
Phoenix, AZ 85004-2262
mpatten@rdp-law.com
tsabo@rdp-law.com
Attorneys for Global Water

Ron Fleming
GLOBAL WATER UTILITIES
21410 N. 19th Avenue, Suite 201
Phoenix, AZ 85027
ron.fleming@gwresources.com

Garry D. Hays
LAW OFFICES OF GARRY D. HAYS PC
1702 E. Highland Avenue, Suite 204
Phoenix, AZ 85016
ghays@lawgdh.com
Attorney for City of Globe

Greg Patterson
916 W. Adams, Suite 3
Phoenix, AZ 85007
greg@azcpa.org

Ms. Kathie Wyatt (by mail only)
1940 N. Monterey Drive
Apache Junction, AZ 85120

28 By: _____

TABLE OF CONTENTS

Page

I.	Introduction and Background	3
II.	Section II.b of RUCO's Application	7
III.	Conclusion	20

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
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1 **ARIZONA WATER COMPANY**

2
3 **Testimony of**
4 **Joel M. Reiker**

5 **I. Introduction and Background**

6 **Q. PLEASE STATE YOUR NAME, EMPLOYER AND TITLE.**

7 A. My name is Joel M. Reiker. I am employed by Arizona Water Company (the
8 "Company") as Vice President – Rates and Revenue.

9 **Q. ARE YOU THE SAME JOEL M. REIKER THAT PREVIOUSLY TESTIFIED IN**
10 **PHASE 1 AND PHASE 2 OF THIS PROCEEDING?**

11 A. Yes.

12 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

13 A. The purpose of my testimony is to address issues raised in the Residential Utility
14 Consumer Office's ("RUCO") July 17, 2013, Application for Rehearing of
15 Decision No. 73938 ("Application") pursuant to Arizona Revised Statutes
16 ("A.R.S.") § 40-253. My testimony also addresses the Arizona Corporation
17 Commission's ("Commission") reopening of Decision No. 73736 pursuant to
18 A.R.S § 40-252.

19 **Q. WHAT DID RUCO REQUEST IN ITS APPLICATION?**

20 A. RUCO requested in its Application that the Commission reopen Decision No.
21 73938 for the purpose of conducting additional hearings on two issues: the
22 Commission's authorized return on equity ("ROE") for the Company's Eastern
23 Group, and the legality under Arizona law of the Company's System
24 Improvement Benefits ("SIB") mechanism. Specifically, RUCO argues that the
25 Commission's "failure" to decrease the ROE it already authorized for the
26 Company's Eastern Group when it approved the SIB mechanism in Decision No.
27 73938 was both "unlawful" and "unreasonable," and that the SIB mechanism

1 does not "qualify" as an adjuster mechanism and, according to RUCO, is
2 therefore illegal under Arizona Law.

3 **Q. DID THE COMMISSION GRANT RUCO'S REQUEST FOR REHEARING?**

4 A. The Commission ruled on RUCO's Application in a Utilities Division ("Staff")
5 Open Meeting on August 15, 2013, passing a motion to:

6 ...grant RUCO's Application for Rehearing of Decision No.
7 73938, and also [re]open Decision No. 73736, under A.R.S §
8 40-252, for consideration of modifying the Decision [73736]
9 concerning the determination made related to the return on
equity...

10 As indicated above, in addition to granting RUCO's request for rehearing
11 of Decision No. 73938, the Commission reopened Decision No. 73736 for the
12 purpose of addressing the ROE it authorized for the Company's Eastern Group.
13 By procedural order issued on September 16, 2013, the parties were ordered to
14 file direct testimony regarding the rehearing of Decision No. 73938 and the
15 reopening of Decision No. 73736.

16 **Q. WILL YOU BE ADDRESSING THE LEGAL ARGUMENTS RAISED BY RUCO**
17 **IN ITS APPLICATION?**

18 A. No. My testimony addresses only Section II.b of RUCO's application, concerning
19 the reasonableness of the Commission not reducing the ROE it authorized for
20 the Company's Eastern Group in Decision No. 73736 in exchange for approving
21 the SIB mechanism in Decision No. 73938. As a result, my testimony applies to
22 both the rehearing of Decision No. 73938 and the reopening of Decision No.
23 73736. As I explain in Section II of my testimony below, RUCO fails to cite any
24 evidence in the record that the Commission acted unreasonably by not reducing
25 its authorized ROE for the Company's Eastern Group when it approved the SIB
26 mechanism.

1 Q. PLEASE PROVIDE A SUMMARY OF THE PROCEEDINGS IN THIS DOCKET
2 LEADING UP TO THE COMMISSION GRANTING RUCO'S APPLICATION
3 FOR REHEARING OF DECISION NO. 73938 AND REOPENING DECISION
4 NO. 73736.

5 A. On August 5, 2011, the Company filed an application with the Commission
6 seeking adjustments to the rates and charges for utility service provided by its
7 Eastern Group of water systems and, among other things, the approval of a
8 DSIC mechanism. On February 20, 2013, the Commission issued Decision No.
9 73736, authorizing adjustments to the Company's Eastern Group rates. As part
10 of that decision, the Commission authorized a 10.55 percent ROE for the
11 Company's Eastern Group, stating that "due to the age of some of its systems
12 and the resulting increased need for infrastructure replacement and
13 improvement," the Eastern Group "necessitates a somewhat higher [cost of
14 equity]."¹ The Commission did not authorize a DSIC mechanism in Decision No.
15 73736, but indicated its support for a DSIC-type mechanism and ordered that this
16 docket remain open. The Commission also urged the parties to enter into
17 settlement discussions regarding the Company's proposed DSIC mechanism,
18 thereby creating "Phase 2" of this docket.²

19
20 On April 1, 2013, Staff filed a Settlement Agreement between itself, the
21 Company and various other intervenors setting forth the details of the SIB
22 mechanism, which is a DSIC-type mechanism. RUCO was not a signatory to the
23 Settlement Agreement. Hearings concerning the Settlement Agreement were
24

25
26
27 ¹ See Decision No. 73736, dated February 20, 2013. p. 61, lines 14 – 17.

² See Decision No. 73736, dated February 20, 2013. p. 104, lines 22 – 25.

1 conducted on April 8 and 11, 2013, and on June 27, 2013, the Commission
2 issued Decision No. 73938 approving the Settlement Agreement with certain
3 modifications, thereby authorizing a SIB mechanism for the Company's Eastern
4 Group.

5
6 As part of that decision, the Commission thoroughly considered and
7 addressed the issue of whether the 10.55 percent ROE it authorized for the
8 Company's Eastern Group in Decision No. 73736 should be modified. RUCO
9 specifically argued during Phase 2 that if the Commission approved the
10 Settlement Agreement, it should reduce the ROE it had already authorized for
11 the Company's Eastern Group to account for what RUCO believed to be, but
12 presented no evidence of, "decreased risk." The Commission disagreed with
13 RUCO in Decision No. 73938, stating that "the existence or lack of a DSIC does
14 not change the risk of the utility, and therefore the existence or lack of a DSIC
15 should not change the utility's ROE."³

16
17 On July 17, 2013, RUCO filed an Application for Rehearing of Decision
18 No. 73938 pursuant to A.R.S. § 40-253. As mentioned above, the Commission
19 granted RUCO's Application, and reopened Decision No. 73736 pursuant to
20 A.R.S. § 40-252 in a Staff Open Meeting on August 15, 2013.

21 **Q. IN APPROVING THE SETTLEMENT AGREEMENT, DID THE COMMISSION**
22 **ADOPT AN EFFICIENCY CREDIT TO BENEFIT CUSTOMERS?**

23 **A.** Yes. The SIB mechanism includes an Efficiency Credit equal to five percent of
24 the required SIB mechanism revenues. This Efficiency Credit is a monetary
25

26
27 ³ See Decision No. 73938, dated June 27, 2013. p. 55, lines 6 – 13.

1 benefit to customers in that it is not tied to any known and measurable reductions
2 in costs.⁴ The effect of the Efficiency Credit is an 87-basis point reduction to the
3 ROE applicable to all SIB-eligible infrastructure replacements.⁵

4 **II. Section II.b of RUCO's Application**

5 **Q. DOES RUCO PROVIDE A BASIS FOR ITS CLAIM THAT THE COMMISSION**
6 **ACTED UNREASONBLY BY NOT REDUCING THE ROE IT AUTHORIZED**
7 **FOR THE COMPANY'S EASTERN GROUP WHEN IT APPROVED THE**
8 **SETTLEMENT AGREEMENT?**

9 A. No. RUCO fails to cite any evidence in the record and offers only conclusory
10 statements in its Application. For example, RUCO first argues on page 3 (lines
11 15-17) of its Application that the Commission authorized an "inflated" ROE for the
12 Company's Eastern Group in Decision No. 73736. RUCO goes on to argue on
13 page 4 (lines 22-23) of its Application (without citing any evidence), that the so-
14 called "inflated" ROE is intended to "serve the same purpose" as the SIB
15 mechanism. RUCO concludes on page 5 (lines 2-4) of its Application (again,
16 with no supporting evidence), that the Commission adopted "duplicative devices
17 to address the same problem" and in doing so acted unreasonably.

18 **Q. DID THE COMMISSION AUTHORIZE AN "INFLATED" ROE FOR THE**
19 **COMPANY'S EASTERN GROUP IN DECISION NO. 73736, AS RUCO**
20 **CLAIMS?**

21 A. No. Nowhere in Decision No. 73736 did the Commission state that the 10.55
22 percent ROE it authorized was "inflated," or otherwise above and beyond its
23 determination of the appropriate cost of equity for the Company's Eastern Group.

24
25
26 ⁴ See Phase 2 transcript, p. 276.

27 ⁵ See Decision No. 73938, Attachment A (SIB Settlement), Paragraph 3 & Exhibit F to Attachment A (SIB
28 Schedule D).

1 Contrary to RUCO's claim, the Commission clearly stated in Decision No. 73736
2 that it authorized an ROE for the Company's Eastern Group based on *actual*
3 *cost*:

4 In the end, the Commission must determine the appropriate
5 *[cost of equity]* for [the Company's] Eastern Group based
6 upon all of the evidence, after considering all of the
arguments presented...

7 After considering all of the evidence presented in this case,
8 including each party's *[cost of equity]* estimates and each
9 party's criticisms of other parties' analyses and input data,
10 *we conclude that the just and reasonable [cost of equity] for*
11 *the Eastern Group is 10.55 percent.*⁶ (emphasis supplied)

12 The Commission even went so far as to emphasize that the ROE it
13 authorized for the Company's Eastern Group *must* be reflective of actual cost
14 (i.e. result in neither under- nor over-earnings) in order to satisfy its obligation to
15 act in the public interest:

16 The Commission *must* also take into account the best
17 interests of the Eastern Group's ratepayers, who are best
18 served *neither by a [cost of equity] that is set too low and will*
19 *result in jeopardy to [the Company's] financial health and*
20 *ability to attract capital nor by a [cost of equity] that is set too*
21 *high and will result in [the Company's] overearning for*
22 *services to the Eastern Group.*⁷ (emphasis supplied)

23 RUCO ignores the Commission's thorough treatment of this issue in
24 Decision No. 73736, as well as evidence in both phases of this proceeding, in
25 claiming that the Commission authorized an "inflated" ROE to "serve the same
26

27 ⁶ See Decision No. 73736. p. 61, lines 3 – 11.

28 ⁷ See Decision No. 73736. p. 61, lines 5 – 8.

1 purpose" as a DSIC-type mechanism. RUCO simply *opines* in its Application that
2 the Commission's authorized ROE is too high.

3 **Q. DOES RUCO CITE ANY EVIDENCE IN THE RECORD TO SUPPORT ITS**
4 **OPINION THAT THE COMMISSION AUTHORIZED AN "INFLATED" ROE?**

5 A. No. RUCO fails to cite any evidence in the record to support its opinion that the
6 Commission's 10.55 percent authorized ROE is "inflated." To the extent there is
7 any evidence in the record about a higher or lower ROE, the Commission already
8 considered it in "determin[ing] the appropriate [cost of equity]" for the Company's
9 Eastern Group. As Decision No. 73736 states on page 61 (lines 9-11), the
10 Commission considered "all of the evidence presented" and concluded not only
11 that the Company's cost of equity is 10.55 percent, but that a 10.55 percent cost
12 of equity is "just and reasonable."

13 **Q. IS IT TRUE THAT THE COMMISSION CONCLUDED THE COST OF EQUITY**
14 **IN THE COMPANY'S EASTERN GROUP IS "SOMEWHAT HIGHER" DUE TO**
15 **ITS INFRASTRUCTURE REPLACEMENT NEEDS?**

16 A. Yes. The Commission concluded that such factors as the age of the systems
17 and the magnitude of the need for infrastructure replacement and improvement in
18 the Eastern Group have an impact on the Company's cost of equity. By
19 definition, the cost of equity is that rate of return investors require on their equity
20 investment *given its associated risk*. Accordingly, the Commission concluded
21 that the Company's cost of equity for the Eastern Group in this proceeding is
22 "somewhat higher." Again, nowhere did the Commission state in Decision No.
23 73736 that it simply "inflated" its authorized ROE to "serve the same purpose" as
24 a DSIC-type mechanism. To the contrary, the Commission's findings were
25 consistent with the testimony and evidence submitted by the Company's
26 witnesses, as detailed below.

1 Q. HOW DOES RUCO ATTEMPT TO SUPPORT ITS CLAIM THAT THE
2 COMMISSION'S AUTHORIZED ROE OF 10.55 PERCENT FOR THE
3 COMPANY'S EASTERN GROUP IS INTENDED TO SERVE THE SAME
4 PURPOSE AS A DSIC-TYPE MECHANISM?

5 A. RUCO attempts to support its argument by citing deleted language from the
6 Recommended Opinion and Order ("ROO") that preceded Decision No. 73938.
7 After considering all of the evidence in the record as stated above, the
8 Commission removed such language when it adopted Decision No. 73938. In
9 amending the ROO, the Commission reaffirmed its conclusions regarding the risk
10 of an equity investment in the Company, and the cost of equity it found to be
11 commensurate with such risk:

12
13 We disagree with RUCO. As Mr. Olea testified, the
14 existence or lack of a DSIC does not change the risk of the
15 utility, and therefore the existence or lack of a DSIC should
16 not change the utility's ROE... Logically, to the extent (if
17 any) that a DSIC impacts risk, the reduced risk would be
18 reflected in the sample companies used to set the ROE, and
19 we are not persuaded that any adjustment to ROE is
20 warranted.⁸

21 RUCO also tries to base its claim on the assumption that the
22 compromised 10.00 percent ROEs the Company agreed to as part of *settlement*
23 *agreements* in its Western Group (Docket No. 10-0517) and Northern Group
24 (Docket No. 12-0348) rate cases are relevant to this case.

25
26
27 Q. ARE THE COMPROMISED 10.00 PERCENT ROEs THE COMPANY AGREED
28 TO AS PART OF SETTLEMENT AGREEMENTS IN ITS WESTERN GROUP
AND NORTHERN GROUP RATE CASES RELEVANT TO THIS CASE?

⁸ See Decision No. 73938. p. 55, lines 11 – 20.

1 A. No. Both of those settlements and compromises were the product of extensive
2 give-and-take negotiations over a wide range of issues related to different
3 systems, in different parts of the state, involving different parties at different times
4 with different circumstances affecting utility service. It is inappropriate to select
5 specific pieces of carefully-negotiated past settlement agreements and then to
6 employ those factors in isolation – without knowing what was given up in
7 exchange for a particular compromise – in an attempt to justify a result in a
8 different case involving a different system. Further, a party should be
9 comfortable in offering a compromise of a position in the interest of settlement
10 without fear that those concessions will later be cited as precedent and authority
11 against them in unrelated proceedings. Finally, the facts of those settled cases
12 and the evidence presented in this litigated proceeding are consistent with the
13 Commission's findings regarding the ROE it authorized for the Company's
14 Eastern Group, which "necessitates a somewhat higher [cost of equity]" "due to
15 the age of some of its systems and the resulting increased need for infrastructure
16 replacement and improvement..."⁹

17
18 As RUCO is aware, the Company requested a 12.10 percent ROE and an
19 11.30 percent ROE in its Western Group and Northern Group rate cases,
20 respectively. As RUCO is also aware, the Company requested, and submitted
21 substantial evidence and testimony in the record supporting, a 12.50 percent
22 ROE in Phase 1 of this proceeding. The difference between the Company's
23 requested 12.10 percent ROE in the Western Group rate case and its requested
24

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27 ⁹ See Decision No. 73736. p. 61, lines 14 – 17.

1 12.50 percent ROE in this proceeding was explained by Company witness Dr.
2 Thomas M. Zepp in Phase 1:

3 Q. DOES ARIZONA WATER'S EASTERN GROUP
4 REQUIRE A RISK PREMIUM HIGHER THAN 50
5 BASIS POINTS?

6 A. Yes. In my opinion, the Eastern Group requires a risk
7 premium of 90 basis points instead of the 50 basis
8 points I recommended for the Western Group.

9 Q. WHY IS THE REQUIRED RISK PREMIUM HIGHER?

10 A. Mr. Harris reports the preliminary cost estimate to
11 replace failing water facilities in the Eastern Group
12 systems is almost \$67 million. These types of facility
13 replacements add to the Company's cost of providing
14 service but do not generate more revenues. For
15 perspective, this \$67 million cost is more than double
16 the \$31 million in common equity allocated to this
17 Group and thus is a very significant cost for a Company
18 with limited financial resources. Arizona Water has
19 proposed a DSIC for the Eastern Group. **While such a
20 ratemaking tool will improve cash flow it will not
21 fund the cost of replacing the aging facilities.** The
22 tremendous cost of plant replacement increases the
23 risk of the Company being able to make a fair rate of
24 return.

25 Q. HAVE YOU STUDIED THE IMPACT OF FINANCING
26 REQUIREMENTS ON THE RISK AND COSTS OF
27 CAPITAL FACED BY UTILITIES?

28 A. Yes, I have. Several years ago, I conducted a study of
expected differences in bond costs and common equity
costs that faced utilities with different financing
requirements. I found that utilities with above average
financing requirements required an ROE that was
approximately 80 basis points higher than was required
by a utility with average or below average requirements.
This study is one of the factors I took into account in

1 determining the appropriate risk premium for the
2 Eastern Group.¹⁰ (emphasis supplied)

3 The Commission's conclusion that such factors as the age of the systems
4 and the need for infrastructure replacement and improvement in the Eastern
5 Group have an impact on the Company's cost of equity is consistent with Dr.
6 Zepp's testimony and the other evidence provided in Phase 1 of this proceeding.

7 **Q. DOES THE SIB MECHANISM ITSELF FUND THE \$67 MILLION THE**
8 **COMPANY NEEDS TO INVEST IN REPLACING WHAT THE COMMISSION**
9 **ACKNOWLEDGES IS THE COMPANY'S INCREASED NEED FOR**
10 **INFRASTRUCTURE REPLACEMENT AND IMPROVEMENT?**

11 A. No. As Dr. Zepp testified, a DSIC-type mechanism is a ratemaking tool that can
12 improve cash flow but will not fund the tremendous cost of replacing aging
13 facilities. To pay for these facilities the Company must be able to raise the nearly
14 \$67 million of capital (just for the Eastern Group) through a combination of
15 additional shareholder equity investment (e.g. retained earnings) and additional
16 long-term debt capital. Raising those prodigious amounts of capital depends in
17 large part on the Commission adopting ROEs that are both realistic and
18 reasonable – not by cutting the ROE the Commission already determined is just
19 and reasonable in this case.

20 **Q. DOES AN ROE BASED ON THE COST OF EQUITY SERVE THE SAME**
21 **PURPOSE AS A DSIC-TYPE MECHANISM?**

22 A. No. An ROE that is based on the cost of equity *cannot* serve the same purpose
23 as a DSIC-type mechanism. As stated above, the cost of equity is that rate of
24 return equity investors require on their investment given its level of risk. In other
25

26
27 ¹⁰ See Phase 1 Exhibit A-32 (Direct Testimony of Thomas M. Zepp, pp. 42 – 43).

1 words, it is the cost to the utility of the dollars provided by its investors. Because
2 its rates are subject to regulation, a public utility does not have the luxury of
3 adjusting those rates to reflect the costs associated with new plant at the time it
4 places that plant in service. As a result, the utility's equity investors are required
5 to bear those costs, and thereby subsidize the cost of service, until the regulator
6 adjusts the utility's rates to account for those costs. The purpose of a DSIC-type
7 mechanism such as the SIB is to address this problem by allowing the utility to
8 recover a *portion* of these costs between general rate cases. In other words, a
9 DSIC-type mechanism *is a means of addressing regulatory lag*. Any argument
10 that the investors' required return and a DSIC-type mechanism "serve the same
11 purpose" ignores the very different definitions of the two.

12 **Q. DID THE COMMISSION'S APPROVAL OF THE SETTLEMENT AGREEMENT**
13 **"SHIFT RISK TO THE CONSUMER," THEREBY LOWERING THE**
14 **COMPANY'S COST OF EQUITY, AS RUCO CLAIMED IN PHASE 2 OF THIS**
15 **PROCEEDING?¹¹**

16 A. No. As stated above, the Commission agreed with Staff in Decision No. 73938
17 that "the existence or lack of a DSIC does not change the risk of the utility."
18 Moreover, the Commission found RUCO's claim ironic, stating that it did not
19 "recall RUCO ever arguing that the absence of a DSIC results in *higher* risk," or
20 otherwise shifts risk from customers to the utility.¹² (emphasis supplied)

21 **Q. ON WHAT BASIS DID RUCO CLAIM THE SIB MECHANISM SHIFTS RISK**
22 **FROM THE COMPANY TO ITS CUSTOMERS?**

23
24
25
26
27 ¹¹ See Phase 2 RUCO Exhibit 11. (Direct Settlement Testimony of Patrick J. Quinn, p. 4 & Direct
Settlement Testimony of William A. Rigsby, pp. 10 – 12).

28 ¹² See Decision No. 73938. p. 55, lines 14 – 16.

1 A. In Phase 2 of this proceeding¹³, RUCO claimed that by reducing the amount of
2 regulatory lag associated with the Company's investment in certain qualifying
3 infrastructure replacement projects, "risk is shifted" from the Company to its
4 customers.

5 **Q. CAN A REGULATOR "SHIFT RISK" TO UTILITY CUSTOMERS BY**
6 **REDUCING REGULATORY LAG, AS RUCO CLAIMED IN PHASE 2?**

7 A. No. Risk is defined in mainstream finance as the uncertainty associated with the
8 end-of-period value of an *investment* in an asset or portfolio of assets.¹⁴ In other
9 words, one must be an *investor* in an asset in order to have a stake in, and bear
10 any risk associated with, the value of that asset.

11

12 From a practical perspective, the Commission routinely recognizes, as it
13 did in the excerpt from Decision No. 73736 cited in footnote 7 above, that it is in
14 the "best interests" of customers for a utility's rates to be based on *no less* than
15 cost. If the purpose of a DSIC-type mechanism is to gradually keep a utility's
16 rates in line with its costs and reduce the frequency of general rate cases, then
17 surely such a mechanism cannot impose additional risks on customers.

18 **Q. DID STAFF'S, RUCO'S AND THE COMPANY'S RECOMMENDED ROEs IN**
19 **PHASE 1 OF THIS PROCEEDING ALREADY INCORPORATE ANY EFFECT**
20 **THE APPROVAL OF A DSIC-TYPE MECHANISM MAY HAVE ON**
21 **INVESTORS' PERCEPTIONS OF RISK?**

22 A. Yes. As the Commission correctly noted in the excerpt from Decision No. 73938
23 cited in footnote 8 above, "to the extent (if any) that a DSIC impacts risk, the
24 reduced risk would be reflected in the sample companies used to set the ROE."

25

26

27 ¹³ See Phase 2 RUCO Exhibit 11. (Direct Settlement Testimony of William A. Rigsby, pp. 10 – 11).

¹⁴ See Alexander, Sharpe & Bailey. Fundamentals of Investments. 1993. p. 846.

1 A cursory review of the Securities & Exchange Commission filings of the seven
2 publicly traded water companies¹⁵ relied upon to estimate the Company's cost of
3 equity in Phase 1 of this proceeding reveals that *each of them* benefits from
4 DSIC-type infrastructure replacement surcharges, or the ability to implement
5 surcharges to recover the costs associated with capital projects outside of a
6 general rate case through an advice letter filing. *All* of this publicly-available
7 information, to the extent investors factor it into their perceptions of risk, is
8 already reflected in the market data relied upon in developing the range of equity
9 cost estimates presented in Phase 1 of this proceeding. That range was 9.4
10 percent to 12.5 percent.

11 **Q. TO YOUR KNOWLEDGE, HAS THE COMMISSION EVER INCREASED THE**
12 **AUTHORIZED ROE FOR A UTILITY TO ACCOUNT FOR ACTIONS TAKEN**
13 **THAT WOULD INCREASE THE NEGATIVE EFFECTS OF REGULATORY**
14 **LAG?**

15 **A.** No. I am not aware of any case where the Commission has increased its
16 authorized ROE to account for actions taken, such as *eliminating* an adjuster
17 mechanism, which would *increase* the negative effects of regulatory lag.
18 Likewise, in this proceeding the Commission appropriately decided not to reduce
19 the ROE it authorized for the Company's Eastern Group to account for actions
20 which serve to mitigate the negative cash flow effects of regulatory lag.

21 **Q. A PURPOSE OF THE SIB MECHANISM IS TO PROVIDE PARTIAL COST**
22 **RECOVERY DURING PERIODS OF REGULATORY LAG. CAN**
23 **REGULATORY LAG PROVIDE AN OPPORTUNITY FOR UTILITIES TO**
24 **BENEFIT FROM HIGHER EARNINGS AS WELL?**

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26
27 ¹⁵ American States Water, American Water, Aqua America, California Water Service Group, Connecticut
Water, Middlesex Water and SJW Corp.

1 A. In theory, perhaps. But the evidence in this case shows that theory does not
2 apply to the Company. A utility's actual revenues can fluctuate around actual
3 costs in any given year. However, over the long-term, those fluctuations should
4 cancel each other out such that, *on average*, revenues should equal costs. This
5 is consistent with the concept of a "just and reasonable rate" - that a utility
6 should, on average, over the long-term, recover its cost of service.
7 Unfortunately, RUCO has presented no evidence to support the argument that
8 regulatory lag "cuts both ways," and that argument simply doesn't apply under
9 current circumstances. Such circumstances include the compelling evidence the
10 Company presented of the need to replace massive amounts of aging and failing
11 infrastructure at costs that are, in some cases, 100 times that of existing
12 infrastructure,¹⁶ increasingly stringent drinking water standards,¹⁷ pervasive
13 declines in per-customer usage and revenues,¹⁸ the requirement to subsidize
14 expensive renewable energy programs, and generally increasing operating costs
15 such as property taxes and health insurance, among other burdens.¹⁹ As
16 illustrated in the following graph, the evidence in this proceeding²⁰ shows that,
17 contrary to the requirement of a "just and reasonable rate," the Company has *not*
18 recovered (much less, over-recovered) its cost of service in the last 16 years:
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24 ¹⁶ See Phase 1 Exhibit A-28 (Direct Testimony of Fredrick K. Schneider, Exhibit FKS-13) & Phase 1
25 Exhibit A-9 (Direct Testimony of Joseph D. Harris, Section VI).

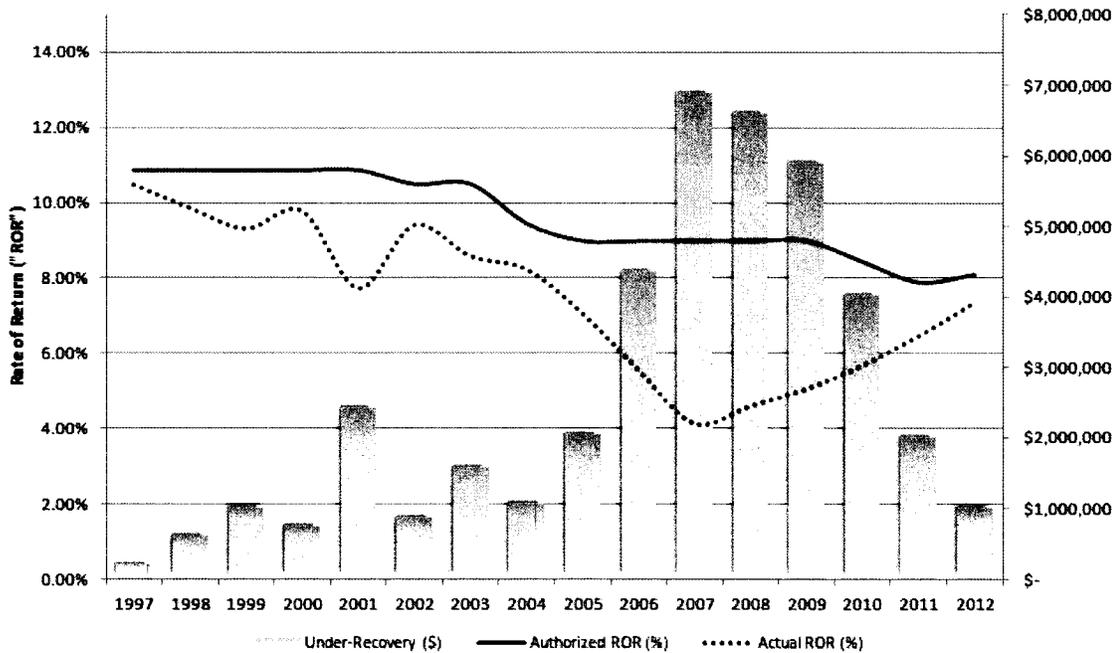
26 ¹⁷ See Phase 1 Exhibit A-9 (Direct Testimony of Joseph D. Harris, Section IV) & Phase 1 Exhibit A-1
(Direct Testimony of William M. Garfield, Section IX).

27 ¹⁸ See Phase 1 Exhibit A-2 (Direct Testimony of Joel M. Reiker, Section VI).

28 ¹⁹ See Phase 1 Exhibit A-3 (2011 Rate Hearing Exhibit For Test Year Ending 12/31/10, Schedule C).

²⁰ See Phase 1 Exhibit A-10 (Rebuttal Testimony of Joseph D. Harris, pp. 5 – 6) & Phase 1 transcript, pp.
332 – 334.

Arizona Water Company
Actual Return, Authorized Return and Under-Recovery



The SIB mechanism is intended to alleviate, but not eliminate, the chronic under-earnings depicted in the above graph by reducing the subsidy that equity investors provide on qualifying infrastructure replacements before the Commission adjusts customer rates in the next general rate case. Requiring those equity investors to further subsidize the cost of service by lowering the authorized ROE to a level *below cost* not only negates such benefits, but serves to penalize investments to replace and improve Arizona's water infrastructure.

As Company witness Pauline M. Ahern testified in Phase 1 of this proceeding, it was, in part, the chronic under-earnings of the water utility industry that lead the National Association of Regulatory Utility Commissioners ("NARUC") to adopt a resolution in 2005 specifically citing DSIC-type mechanisms, along with sufficient ROEs, as a best regulatory practice:

1 And a couple of years ago, I guess it was in 2005, Fred
2 Butler, who was then president of the [Board of Public
3 Utilities] in New Jersey, and the water committee, the entire
4 water committee undertook a study to determine what – **to
5 address in part the inability of water companies to earn
6 their authorized ROEs** and what kinds of things could be
7 put – what kinds of ratemaking mechanisms could be put
8 into place to enable them to do so. Basically, I guess what
9 could the Commissions do to help the utilities meet the
10 standards of Hope and Bluefield of ensuring financial
11 integrity and attracting capital. **And the result was the
12 resolution, which is part of my testimony, with DSIC
13 being one such mechanism, as well as sufficient ROEs,
14 including adjustments to reflect risk factors.**²¹ (emphasis
15 supplied)

16
17 Q. IS IT CONSISTENT WITH THE REQUIREMENT OF JUST AND REASONABLE
18 RATES TO LOWER THE AUTHORIZED ROE APPLICABLE TO THE
19 EASTERN GROUP'S ENTIRE EXISTING RATE BASE OF OVER \$63 MILLION
20 IN EXCHANGE FOR THE OPPORTUNITY TO REDUCE THE REGULATORY
21 LAG ASSOCIATED WITH LIMITED, QUALIFYING FUTURE
22 INFRASTRUCTURE REPLACEMENTS?

23 A. No. This would conflict with the concept of just and reasonable rates, especially
24 considering, as I explained above, the fact that the SIB mechanism already
25 includes a negotiated five percent Efficiency Credit that is not tied to any known
26 and measurable cost savings. The Efficiency Credit translates to an 87-basis
27 point reduction to the ROE applicable to all SIB-eligible infrastructure
28 replacements. As the Commission's Utilities Division Director, Mr. Steve Olea,

²¹ See Phase 1 transcript, p. 1032 & Phase 1 Exhibit A-34 (Rebuttal Testimony of Pauline M. Ahern, pp. 12 – 13).

1 testified in Phase 2 of this proceeding, as long as the SIB mechanism
2 incorporates the Efficiency Credit, "you don't have to look at [the ROE]."²²
3

4 Imposing a further reduction to the ROE applicable to all existing and SIB-
5 eligible plant, on top of the 87-basis point reduction resulting from the Efficiency
6 Credit, amounts to a "double-dip," and would end up penalizing the Company for
7 replacing and improving aging and failing infrastructure.

8 **III. Conclusion**

9 **Q. BASED ON ALL OF THE EVIDENCE AND TESTIMONY IN THIS**
10 **PROCEEDING, SHOULD THE COMMISSION GIVE ANY WEIGHT TO**
11 **SECTION II.b OF RUCO'S APPLICATION CONCERNING ITS AUTHORIZED**
12 **ROE FOR THE COMPANY'S EASTERN GROUP?**

13 **A.** No. As the evidence in this proceeding shows, the Commission did not authorize
14 an "inflated" ROE for the Company's Eastern Group to "serve the same purpose"
15 as a DSIC-type mechanism, as RUCO argues. Further, a Commission-
16 authorized ROE based on the cost of equity cannot mitigate the negative effects
17 of regulatory lag, or otherwise "serve the same purpose" as a DSIC-type
18 mechanism, as RUCO claims. There is also no basis in the record, financial
19 theory or otherwise, to support RUCO's notion that the investors' risks arising
20 from their need to raise massive amounts of capital to replace aging and failing
21 infrastructure can be "shifted" to customers through a DSIC-type mechanism.
22 Further, to the extent the approval of a DSIC-type mechanism has any effect on
23 investors' perceptions of risk, those perceptions are already reflected in the ROE
24 the Commission authorized in Decision No. 73736. Finally, reducing the
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27 ²² See Phase 2 transcript, p. 272.

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authorized ROE to a level that is below cost would conflict with the concept of just and reasonable rates.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes.