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BEFORE THE ARIZONA CORPORATIO!

COMMISSIONERS

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Arizona Corporation Commission
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IN THE MATTER OF THE APPLICATION OF NEW RIVER UTILITY COMPANY FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS WATER RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.

DOCKET NO. W-01737A-12-0478

STAFF'S OPENING BRIEF

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby submits its Opening Brief in this matter as directed by the Administrative Law Judge ("ALJ") on September 13, 2013.[1]

I. INTRODUCTION.

New River Utility Company ("New River" or "Company") is a Class "B" public service corporation with its business office located in Peoria, Arizona.[2] New River is engaged in providing water utility service to portions of Maricopa County pursuant to certificates of convenience and necessity granted by the Commission in Decision No. 33131 issued May 24, 1961, and Decision No. 33354 issued August 15, 1961.[3] On November 29, 2012, New River filed its application for a permanent rate increase based on a test year ending December 31, 2011.[4] During the test year New River served approximately 2,900 water service connections.[5] New River's current rates and charges were authorized in Decision No. 65134 dated August 22, 2002, and went into effect September 1, 2002.[6]

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[1] Tr. Vol. II at 370:12-20.
[2] Application, Ex. A-1 at 1:17, 21-23; Jones Direct at 3:3-4.
[3] Application, Ex. A-1 at 1:17-20.
[4] *Id.*; Jones Direct at 5:15.
[5] Application, Ex. A-1 at 1:20-21; 3:21-22.
[6] *Id.* at 2:18-21

In its application, New River requested an increase in gross revenues of $1,087,457, or 86.28%, and has asserted that this increase, when the proposed rates and charges are fully implemented, will result in a rate of return on its Fair Value Rate Base ("FVRB") of 8.72%.[7] The Company is proposing a revenue increase of $761,820, or 60.44% over the Company's adjusted test year revenues of $1,260,429 for a total revenue requirement of $2,022,249.[8] This would result in an operating income of $586,849 or 8.72% rate of return on its FVRB of $6,729,925.[9] New River has proposed a 10.00% return on equity ("ROE").

Staff recommends a revenue increase of $463,422, or 36.77%, over Staff's adjusted test year revenues of $1,260,428 for a total revenue requirement of $1,723,850.[10] This results in an operating income of $500,894 or a 7.80% rate of return on a FVRB of $6,421,716.[11] Staff recommends an 8.9% ROE which is based on the average of its discounted cash flow ("DCF") method and capital asset pricing model ("CAPM") cost of equity methodology estimates for sample companies of 8.6% and 7.9%, respectively, as well as an upward economic assessment adjustment of 60 basis points (0.6%).[12]

Prior to commencing the hearing in this matter, the parties had resolved all but four (4) rate base adjustments and twelve (12) income statement adjustments. These items, which remain disputed after the hearing, also result in unresolved amounts of Original Cost Rate Base ("OCRB"), Reconstruction Cost Rate Base ("RCRB"), FVRB and Total Test Year Expenses. The parties also dispute the ROE, Fair Value Adjustment ("FVA"), Fair Value Rate of Return ("FVROR"), and rate design. The parties are in accord regarding New River's 100% equity capital structure.

II. UNRESOLVED ISSUES.

A. <u>Rate Base Adjustments</u>.

Four rate base adjustments remain in dispute between Staff and New River. First, the parties dispute the amount of inadequately supported plant that should be removed from rate base. Second,

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[7] *Id.* at 4:7-9.
[8] Jones Rejoinder, Ex. A-4 at 1:26-2:13.
[9] *Id.* at Schedule A-1.
[10] Ex. S-3, Brown Revised Surrebuttal Schedule CSB-1.
[11] *Id.*
[12] Cassidy Surrebuttal, Ex. S-5 at 2:12, 2:21, 3:2.

there is disagreement regarding the amount of accumulated depreciation attendant to the removal of the inadequately supported plant. Third, Staff and New River differ in the method of treating excessive depreciation attributable to the Pumping Plant account. Fourth, the parties dispute the calculation of working capital.

1. Inadequately Supported Plant.

Staff recommends removal of 100% of $222,346 of original cost plant in service, or $264,855 of fair value plant, because that plant is not supported by any documentation.[13] Staff submits that such adjustment is "typical" and not "excessive and punitive" as argued by the Company.[14] Generally, Staff only departs from its usual 100% disallowance recommendation when it represents a significantly large percentage of a utility's plant in service.[15] In this case, Staff has recommended a fair value plant in service balance of $13,089,746 of which Staff's $264,855 fair value adjustment represents but 2.02%.[16]

Staff further submits that its inadequately supported plant disallowance is consistent with the recommended audit evidence outlined in the National Association of Regulatory Utility Commissioners ("NARUC") Rate Case and Audit Manual which lists invoices as one of the records to be reviewed during audits.[17] It is also consistent with the record keeping requirements of Arizona Administrative Code ("A.A.C.") R14-2-610 D.1 which provides in pertinent part that "[e]ach utility shall keep general and auxiliary accounting records reflecting the cost of its properties…and all other accounting and statistical data necessary to give complete and authentic information as to its properties…."[18] Moreover, Staff submits that it is New River's responsibility to support its claimed costs[19] and, if unsupported plant costs are not removed from rate base, ratepayers are at risk of paying for non-existent or overstated costs.[20]

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13 Brown Surrebuttal, Ex. S-2 at 6; Tr. Vol. II at 278:17-22, 279:7-14.
14 Brown Surrebuttal at 6:8-10; Jones Rebuttal, Ex. A-3 at 4; Tr. Vol. II at 280:1-8.
15 Brown Surrebuttal, Ex. S-2 at 6:10-12; Tr. Vol. II at 280:3-8.
16 Brown Surrebuttal, Ex. S-2 at 6:16-17.
17 *Id.* at 7:3-5.
18 Brown Direct, Ex. S-1 at 11:20-23; Brown Surrebuttal at 7:5-9.
19 Brown Direct, Ex. S-1 at 9.
20 *Id.*; Brown Surrebuttal, Ex. S-2 at 7:24-25.

As noted above, the Company believes Staff's disallowance is "excessive and punitive" and contends that only 10% of the subject unrecorded plant balance, or $22,235 original cost and $30,737 reconstruction cost, should be disallowed.[21] However, New River has provided no reason or authority to warrant departure from the record keeping requirements of NARUC, the A.A.C. or Staff's typical treatment of inadequately supported plant.[22]

2. Accumulated Depreciation Attendant to Inadequately Supported Plant.

Staff recommends that $46,966 of accumulated depreciation related to the above-discussed inadequately supported plant should be removed from the accumulated depreciation account.[23] Such deduction is also evidenced in Staff witness Crystal Brown's Revised Surrebuttal Schedule CSB-11.[24] Since the Company does not agree with Staff's removal of 100% of unsupported plant, it correspondingly does not agree with the removal of the above-stated accumulated depreciation.[25]

In essence, the Company agrees with Staff on the nature of the item and characterizes it as a "companion adjustment" to the inadequately supported plant.[26] New River's witness, Ray Jones, did not propose any adjustment to accumulated depreciation because at the level of plant he proposed to disallow he considered it a "rather de minimus adjustment."[27] However, he further related that the Company would not object to this adjustment being made using Staff's methodology.[28]

3. Depreciation Methodology.

Staff is recommending that the Company employ the vintage year group method of depreciation ("vintage year method"). The Company currently employs the group method of depreciation ("group method") and is requesting Commission authorization to continue using that methodology. However, there are significant concerns and problems associated with use of the group method of depreciation.

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[21] Jones Rebuttal, Ex. S-2 at 4:28-5:5.
[22] Brown Surrebuttal, Ex. S-2 at 7:14.
[23] *Id.* at 8:4-5; Tr. Vol. II at 280:21-281:4.
[24] Ex. S-3 at CSB-11, page 2 of 2.
[25] Ex. A-6 at 2.
[26] Tr. Vol. I at 26:5-11.
[27] *Id.* at 26:12-17.
[28] *Id.* at 26:17-22, 27:2-10.

The first fundamental problem with the group method is that it allows plant to be depreciated beyond its original cost.[29] Staff witness Crystal Brown provided an example to underscore this fundamental problem with the group method:

> Take for example, a $10,000 pump that is installed in the year 2013, is depreciated using the Company proposed 20 year life or 5 percent rate…but remains in service for 25 years. The pump would be fully depreciated in 20 years, or in the year 2033. The total depreciation recovered during the 20 years that the pump is in service (i.e. at the end of the 2033) would be $10,000 and depreciation would cease.
>
> However, under the group methodology, the pump is not considered fully depreciated until it is retired. Therefore, the pump would continue to be depreciated for an additional 5 years, accumulating an additional $2,500 in depreciation expense (i.e. $10,000 original cost x 5% depreciation rate x 5 years = $2,500) because it remains in service for five years longer than its estimated 20 year useful life.[30]

As seen from this example, Staff's vintage year method is more appropriate because it allows the Company to recover the *original cost* of an asset, no more and no less. On the other hand, the group method allows for the *over recovery* of the cost of an asset by allowing plant to be depreciated beyond its original cost (over depreciation).

In fact, Staff's concern regarding over depreciation under the group method materialized in this rate case. Specifically, plant account No. 331 (pumping equipment) resulted in over depreciation. The Company claims that the "pumping equipment account is over depreciated because the depreciation rate…did not match the actual expected lives of New River's pumping plant."[31] However, the Company's claim ignores the fundamental problem with the group method. The pumping equipment account was over depreciated in this case because the group method allows the Company to recover depreciation expense until the asset is taken out of service. Since the assets were in service longer than the rate of depreciation, the pumping equipment account became over depreciated. This reality exemplifies why the group method should be abandoned in favor of the vintage year method. Not surprisingly, the Company has agreed to implement Staff's vintage year method (instead of the group method) for this specific account only.[32]

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[29] Tr. Vol. II at 282:18-283:10.
[30] Brown Direct, Ex. S-1 at 13:10-20.
[31] Jones Rebuttal, Ex. A-3 at 7:10-12.
[32] Tr. Vol. I at 134:10-24.

Another problem with the group method is that it can cause negative net plant balances.[33] As seen in this case with plant account No. 331, utilization of the group method can cause a plant group to be depreciated beyond its original cost where the plant is in service longer than its original anticipated useful life.[34] This, in turn, could cause the net plant balance of the group to be negative which would reduce a regulated utility's rate base.[35] Unlike the group method, negative plant balances caused by over-depreciation of assets do not occur with the vintage year method.[36]

However, in this case, the net plant balance of account No. 331 was not negative because the Company placed a cap on accumulated depreciation.[37] This presents another problem associated with the group method. Capping accumulated depreciation violates the NARUC Uniform System of Accounts ("USoA") which requires depreciation expense to be calculated on all plant in service and that this expense be added to accumulated depreciation each year for as long as the plant is in service.[38] By placing a cap on accumulated depreciation, the Company has understated accumulated depreciation.[39] This, in turn, overstates rate base.[40] An over-stated rate base would be unfair to the utility's customers who must pay a rate of return on the over-stated rate base.[41] Placing caps on accumulated depreciation in order to avoid negative plant balances is not needed under the vintage year method since depreciation ceases once the original cost of the asset has been fully depreciated.[42]

The group method is also problematic because it creates a mismatch between the actual useful life of new plant investments and the time period over which these new investments are recovered through rate-recognized depreciation expense.[43] As the Company concedes, the group method of depreciation does not keep track of the year that an individual asset within the group is placed in

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[33] Ex. S-1 at 21:14-28.
[34] *Id.*
[35] *Id.*
[36] *Id.* at 22:3-4.
[37] Ex. S-1 at 22:6-13; Tr. Vol. II at 286:4-14.
[38] Ex. S-1 at 22:15-20; Tr. Vol. II at 286:7-14.
[39] Ex. S-1 at 22:15-23:2.
[40] *Id.*
[41] *Id.*
[42] *Id.* at 23:4-6.
[43] *Id.* at 19:24-20:8.

service.[44] Rather, the group method lumps assets together, regardless of the year it was put in service, and calculates depreciation expense on those assets as long as they are in service.[45] This mismatch is inconsistent with the widely accepted ratemaking principle of recovering only the cost of the asset through rates.[46]

The group method is also inconsistent with the matching principle of the NARUC USoA. The NARUC USoA generally accepts the use of only one type of depreciation methodology, namely, the straight line methodology.[47] According to the NARUC USoA,

> 37. "Straight-line method" as applied to depreciation accounting means the plan under which *the service value of property* is charged to operating expenses (and to clearing accounts if used), and credited to the accumulated depreciation account through equal annual charges during its useful life....[48]

The straight line methodology allows only the service value (i.e. the original cost of the asset) to be depreciated.[49] Under Staff's vintage year method, the original cost of the asset is appropriately recovered under the straight line methodology. However, under the group method, the Company may recover more than the original cost of the asset because that method allows more than the service value to be depreciated.[50] As a result, the group method is inconsistent with NARUC USoA.

For the foregoing reasons, Staff urges the Commission to require the Company to adopt the vintage year method for all plant accounts.

4. Cash Working Capital.

Staff recommends removing $96,775 from working capital due to the Company failing to conduct a lead-lag study which, in turn, failed to reflect any customer-provided capital as part of its working capital requirement.[51] Staff witness Crystal Brown pointed out that the most accurate method of calculating working capital is with a lead-lag study.[52] Ms. Brown also related that it is

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[44] Tr. Vol. I at 137:16-22.
[45] Ex. S-1 at 20:12-15.
[46] *Id.* at 20:4-8.
[47] NARUC USoA, Ex. S-8.
[48] *Id.* (emphasis added).
[49] Ex. S-1 at 20:25-26.
[50] *Id.* at 20:25-21:2.
[51] *Id.* at 29:7-8; 23; Tr. Vol. II at 288:13-17.
[52] *Id.* at 288:9-10.

inequitable for a utility the size of New River to calculate its working capital allowance by ignoring its cash working capital position because it guarantees a positive working capital result for the Company.[53] Ms. Brown further opined that a lead-lag study might have shown working capital as a negative component of rate base.[54]

In this case, New River calculated its cash working capital using the "formula method" which is equal to one-eighth of operating expenses less depreciation, rate case expense, taxes, purchased water, and purchased pumping power expense, plus one twenty-fourth of purchased water and purchased pumping power expense.[55] Staff submits that it is inappropriate for a utility company of New River's size to use the formula method to calculate cash working capital.[56] According to Ms. Brown, the formula method is appropriate for only Class D and E companies due to their small size, the cost and time involved in performing the lead-lag study, and the relative minor impact it has on rate base.[57] Moreover, in Staff's experience, the wealth of recent Class A, B, and C rate case filings support cash working capital with a lead-lag study.[58] Conversely, the large majority of filings without a lead-lag study have either not requested cash working capital or have accepted Staff's recommendation to remove it from rate base.[59]

The inherent problem with using the formula method for Class A, B and C utilities is that a utility's cash working capital requirement can be positive or negative and, thus, yield a positive or negative result to rate base.[60] As Ms. Brown indicated, a positive number indicates cash was provided by investors to pay operating expenses before receipt of revenues from customers; a negative number indicates customer sales revenue was received by a company prior to the company paying operating expenses.[61] However, as above-stated, the formula method always provides a positive result and, therefore, effectively ignores the cash working capital provided by rate payers.[62]

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[53] Ex. S-1 at 29:10-12; Tr. Vol. II at 288:22-25.
[54] Ex. S-1 at 29:12-13.
[55] Ex. S-2 at 18:2-5.
[56] *Id.* at 18:9; Tr. Vol. II at 288:22-25.
[57] Ex. S-2 at 18:9-11.
[58] *Id.* at 17:4-5.
[59] *Id.* at 17:5-7.
[60] *Id.* at 18:15-17.
[61] *Id.* at 18, Footnote 3.
[62] *Id.*

Had New River conducted a lead-lag study, it might have shown working capital as a negative component of rate base.[63] Instead, New River's use of the formula method yielded the expected positive effect on rate base without any realistic basis therefor. According to Ms. Brown, acceptance of the Company's position relative to working capital has the potential to adversely affect ratepayers if the lead/lag study showed the working capital was negative.[64] In such case, customers would be providing capital in advance of the service without getting any recognition for it and, in essence, paying for a positive cash working capital that does not exist.[65]

To support Staff's position in this regard, reference can be made to the recent Southland Utilities Company case (Decision No. 72429 dated June 24, 2011). There, the Commission adopted Staff's recommendation to remove working capital from a Class C water company's rate base because it had not performed a lead-lag study.[66] The Commission determined that "[b]y looking at actual data, the lead-lag study determines whether there is a revenue lag, whereas the formula method assumes there is." The Commission further determined that A.A.C. Rule 14-2103(a)(3)(h) states that an OCRB calculation "should include a proper allowance for working capital" and that Southland failed to demonstrate a proper allowance for working capital because it relied on the formula method to calculate this amount and supplied no evidence that there was a revenue lag.[67]

Based on the foregoing, Staff requests that the Commission accept Staff's recommended removal of $96,775 of cash working capital from rate base.

B. <u>Income Statement Adjustments</u>.

1. Salaries and Wages.

Staff recommends denial of the Company's proposed hiring of an additional employee at a cost of $48,600[68] to address record keeping issues Staff identified in Ms. Brown's Direct Testimony.[69] The Company has indicated its willingness to accept the record keeping

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[63] *Id.* at 18:17-19.
[64] Trans. Vol. II at 289:4-5.
[65] *Id.* at 289:6-9.
[66] Ex. S-2 at 17:15-17.
[67] *Id.* at 17:21-31.
[68] Jones Rebuttal, Ex. A-3 at 20:13-28.
[69] Ex. S-2 at 19:10-20.

recommendations of Staff as they pertain to the want of adequate records for plant investments.[70] In this regard, Staff believes it would be more cost efficient for the Company to attempt to resolve the issues through training of its existing employees because the hiring of a new employee whose actual cost is not presently known and measurable would not resolve the record keeping issues.[71] Moreover, this expense was not incurred in the test year and does not rise to the standard of known and measurable because the Company has not advertised or interviewed anyone for the position.[72]

Irrespective of Staff's recommendations, New River maintains its preference to incur significant cost to hire an additional employee when Staff believes it more time and cost efficient to train the Company's present employees.

2. Repairs and Maintenance Expense.

a. <u>Inadequate Credit Card Support</u>.

As part of its repairs and maintenance expense, the Company charged $27,584 on the personal credit card of its owners, Mr. and Mrs. Fletcher.[73] Despite Staff's requests therefor, the Company failed to provide underlying invoices to support these credit card purchases.[74] Under normal circumstances, Staff would have disallowed the entire amount claimed.[75] However, after speaking with the owners, Staff determined to give the Company the benefit of the doubt[76] and reviewed copies of their personal credit card bills[77] and allowed more than Staff might otherwise recommend.[78]

Approximately 75% of each credit card bill was completely blacked out.[79] Given this, Staff assumed the redacted charges were the personal expenses of the owners and the unredacted charges were the proposed repairs and maintenance charges for New River.[80] However, upon review, Staff disallowed all but $9,328[81] of the unredacted charges due to their being (1) deemed unneeded for the

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[70] *Id.* at 7:18-20.
[71] *Id.* at 19:13-17; Tr. Vol. II at 291:20-22.
[72] Trans. Vol. II at 291:12-19.
[73] Ex. S-1 at 34:5-6.
[74] *Id.* at 34:9-13; Tr. Vol. II at 292:3-5.
[75] *Id.* at 292:5-6.
[76] *Id.* at 292:6-9 and 19-293:1.
[77] Ex. S-1 at 34:16.
[78] Tr. Vol. II at 292:8-9.
[79] Ex. S-1 at 34:20.
[80] *Id.* at 34:22-35:3.
[81] *Id.* at 36:3.

provision of services, e.g., those for Lauberge De Sedona Hotel, Supple Beverages (for joint relief), Mulqueen Sewing Center, Berean Christian Stores, FTD Jubilee Flowers, etc.[82] and/or (2) transactions where the locations of which were partially or completely redacted.[83]

Staff further determined that, for rate making purposes, some of the $9,328 of credit card purchases unsupported by actual invoices represented related party transactions, i.e., costs attributable to the Fletchers and/or its affiliate, Cody Farms.[84] Thus, though the Company failed to provide any actual documentation to support such claimed repair and maintenance expenses, Staff determined it equitable to allocate a third of the $9,328 to the Company, Mr. Fletcher and Cody Farms, respectively.[85]

b. Tank Painting Costs.

Staff recommends disallowance of the Company's $31,333 pro forma adjustment for tank painting expense.[86] The bases for Staff's recommendation are basically threefold. First, the actual amount for this expense is not known and measurable and, therefore, is not permitted under a NARUC historical cost principle.[87] Second, Staff asserts that, had Mr. Fletcher repaid a portion of a loan (discussed infra) made by the Company to him, the Company would have had sufficient funds to pay for the tank painting.[88] Third, Staff submits that its recommended operating income of $492,210, recommended depreciation expense of $71,127 and resulting cash flow of $563,338 would be sufficient to fund the Company's project $31,333 in annual tank painting costs.[89]

Moreover, Staff disputes the Company's allegation that removal of the pro forma tank painting adjustment "is nothing more than an attempt to force an affiliate of New River to fund the tank painting rather than New River's customers."[90] Staff contends that it is the owner's responsibility to provide the initial cash needed to fund tank painting, after which amortization of

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[82] *Id.* at 35:6-12; Ex. S-2 at 20:12-17; Tr. Vol. II at 292:13-18.
[83] Ex. S-1 at 35:15-16.
[84] *Id.* at 36:3-12.
[85] *Id.*; Tr. Vol. II at 293:5
[86] Ex. S-1 at 37:9; Ex. S-2 at 22:2-3.
[87] Trans. Vol. II at 293:9-11.
[88] Ex. S-1 at 37:3-5.
[89] Ex. S-2 at 21:23-25; Trans. Vol. II at 293:11-13.
[90] Ex. S-2 at 21:11-14; Ex. A-1 at 19.

such costs may be recovered from customers consistent with general ratemaking principles.[91] This is especially true where the subject tank painting is prospective, is based on a proposal submitted by a potential contractor, and the expense has not yet been incurred.[92]

3. Rent Buildings.

a. <u>Workshop Rent</u>.

In its Rejoinder testimony, the Company maintains that Workshop Rent of $12,000 per year is reasonable and prudent.[96] The Company disputes Staff's recommended $9,000 reduction to Workshop Rent.[97] However, based on its inspection, Staff determined that the Company used only a 10' x 10' area of a 1,000 square foot section of the 12,000 square foot building to house its materials and supplies needed to be stored indoors.[98] Notwithstanding the fact that the Company only actually utilized about 100 square feet of the workshop for storage of its supplies and materials, Staff multiplied 1,000 square feet by $3.00 to arrive at the $3,000 monthly workshop rent figure.[99] Staff bases this adjustment on the NARUC principle that costs be allocated appropriately among a utility and its affiliates given that such transactions are considered related-party and not arm's-length.[100] In this matter, Staff did not believe the Company's proposed allocation to its affiliate was reasonable based upon its inspection of the premises and the items stored in the facility.[101]

Staff also takes issue with Mr. Jones' account of which entity uses a greater portion of the workshop.[102] Given the presence of several classic autos and tractors, it is evident that Mr. Fletcher and/or Cody Farms use the workshop to a greater degree than contended by Mr. Jones.[103]

b. <u>Business Office/87th Avenue Booster Rent Reduction.</u>

The Company rents an office building and the 87th Avenue booster plant property from Cody Farms[104] which, as previously stated, is owned by the Company's owner, Mr. and Mrs. Fletcher.[105]

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[91] Ex. S-2 at 21:18-20.
[92] Ex. A-20
[96] Ex. A-4 at 11:16-18.
[97] A-6 at 4.
[98] Ex. S-2 at 24:3-7, Trans. Vol. II at 331:21 to 332:13.
[99] Ex. S-2 at 24:8.
[100] Trans. Vol. II at 295:21-24; 335:20-336:12.
[101] Trans. Vol. II at 295:24-296:25; Ex. S-9 at 11.
[102] Trans. Vol. II at 297:1-298:13; Ex. A-19.
[103] *Id.*

Under such circumstances, Staff considers the rents paid by New River to Cody Farms, an unregulated affiliate, a related-party transaction.[106] A related-party transaction refers to a matter where "a company and any other party with which the company may deal where one party has the ability to influence the other to the extent *that one party of the transaction may not pursue its own separate best interest.*"[107] [Emphasis in original.]

The Company accepted Staff's recommended adjustment to reclassify the $48,600 the Company had classified as Management Fees, Business Office & 87th Ave. Booster Plant Property to Rent Costs for Business Office.[108] However, after researching comparable rental real estate costs, Staff recommends that reasonable monthly rent for the business office should actually be $1,965, or $23,580 per year, and thereby recommends reducing office rent expense by $25,020.[109]

In addition, Staff completely eliminated any value for the booster station property again due to the fact that the lease is a related-party transaction.[110] Staff submits that the owner of the booster plant, Mr. Fletcher, could have assigned ownership thereof to the Company which would have eliminated rent expense and limited Mr. Fletcher to only the recovery of rate of return on that plant.[111] New River's renting of the booster plant from Cody Farms is not in the best interest of its rate payers as such property is not protected from possible creditor claims of Cody Farms and/or Mr. and Mrs. Fletcher.[112] Such possible legal and financial problems could threaten or possibly disrupt water service to the Company's customers.[113] As a result, Staff recommends that booster plant ownership be transferred to the Company.[114]

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104 Ex. S-1 at 42:11-13.
105 *Id.* at 41:13.
106 *Id.* at 41:15-16.
107 *Id.* at 41:20-13.
108 *Id.* at Schedule CSB-32; Ex. A-6 at 4.
109 Ex. S-1 at 43:9-15; Schedule CSB-32.
110 Trans. Vol. II at 338:23-25, 339:4-24.
111 Trans. Vol. II at 339:4-24.
112 Ex. S-1 at 42:27-28; Trans. Vol. II at 339:14-24.
113 Ex. S-1 at 42:28-30.
114 *Id.* at 43:3.

4. Rent Expense, Vehicles.

a. **Remove Cost of One Truck.**

Staff recommends removing $4,800 for the cost of one truck the Company rents from its affiliate, Cody Farms.[115] According to Staff witness Brown, since the Company leases its five trucks from Cody Farms, the transactions are considered "related-party" and must be disclosed in the notes to the Company's financial statements in accordance with generally accepted accounting principles ("GAAP").[116] New River's proposed allocation of all of the trucks to the Company is an unreasonable allocation and not in accordance with NARUC standards.[117]

In addition, the job duties of the Company's employees do not necessitate the high amount of travel reported by the Company or the number of vehicles used.[118] Consequently, Staff considered the rental of three vehicles excessive and disallowed the $4,800 rental cost of one truck.[119]

b. **"Days Used" Adjustment.**

Due to New River failing to maintain an employee travel log to show when each employee used which vehicle and for what purpose, Staff also recommends removing $8,364 from Rent Expense, Vehicles.[120] Staff submits that the Company's allocation methodology for the estimated hours a vehicle is used by New River employees does not comport with NARUC's Guideline for Cost Allocations and Affiliate Transactions.[121] Absent an appropriate allocation methodology among affiliated companies, costs can be improperly identified and allocated and costs of an unregulated affiliate can be shifted to the captive customers of the regulated utility.[122] Such cost shifting results in the regulated utility's customers subsidizing the business operations of the unregulated affiliate and, thereby, harming such customers by creating artificially higher rates.[123] As a result of the foregoing, Staff recommends that the Rent Expense, Vehicle account be further reduced by $8,364.[124]

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[115] Ex. S-2 at 27:13; Ex. S-3 Schedule CSB-33.
[116] Trans. Vol. II at 299:3-11; 301:2-6.
[117] *Id.* at 299:23-300:2.
[118] Ex. S-2 at 25:19-20; Trans. Vol. II at 301:14 to 302:21.
[119] Ex. S-2 at 25:22-24.
[120] *Id.* at 26:6 and 27:13; S-3 at CSB-33; Trans. Vol. II at 300:3-10; 302:13-21.
[121] Ex. S-2 at 26:10.
[122] *Id.* at 27:2-3
[123] *Id.* at 27:3-5.
[124] Ex. S-3 at 27:13; S-3 at CSB-33.

5. Transportation Expense Reduction.

Staff recommends removal of $2,797 in transportation (oil and gas) expenses for one truck.[125] This adjustment coincides with the removal of the rent expense for one vehicle addressed in section (e)(i) Rent Expense, Vehicle above.

6. Bad Debt Expense.

In its application, New River claimed a normalized bad debt expense of $7,688 based on the amount recorded in its 2011 test year.[126] Staff normalized the Company's bad debt expense using a three year average, or $2,563, and recommends reducing this expense by $5,125.[127] In its Rebuttal testimony, New River claimed that Staff inappropriately normalized bad debt expense and did not recognize bad debt expense in its gross revenue conversion factor calculation.[128] In its Surrebuttal testimony, Staff acknowledged that bad debt should be recognized in the gross revenue conversion factor calculation and changed such calculation.[129] Notwithstanding such recalculation, Staff maintains that its adjustment to the Company's bad debt expense was appropriate.[130] Staff asserts that the revenue requirement should be determined using only normal levels of expenses, adopting a NARUC recognized ratemaking principle that helps ensure just and reasonable rates.[131]

Under Commission rules, Class A, B & C utilities are required to file three years of comparative income statements (Schedule E-2) which present revenues and expenses for the test year and two prior years.[132] A review of the three Schedule E-2s can assist Staff in identifying abnormal levels of expenses.[133] If a test year expense amount is incurred at approximately the same level as the two other years, then Staff would consider that expense normal for the test year and no normalization

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[125] Ex. S-3 at SCB-34.
[126] Application Schedule E-2 at 1.
[127] Ex. S-1 at 46:2-7; Tr. Vol. II at 304:10-23.
[128] Ex. S-2 at 27:24-26.
[129] *Id.* at 28:3.
[130] *Id.* at 28:7.
[131] *Id.* at 28:7-9.
[132] *Id.* at 28:13-14.
[133] *Id.* at 28:18.

adjustment is necessary.[134] If an expense level varies from year to year it may not be normal and Staff investigates the discrepancies to determine if a normalization adjustment is needed.[135]

In this matter, New River's bad debt expense varied widely in the test year and two prior years, i.e., $0, $0 and $7,688 for 2009, 2010 and 2011, respectively.[136] In response to Staff's data request CSB 1.33, the Company noted that "prior to the test year bad debt expense was not recorded."[137] Moreover, the Company failed to provide any supporting documentation to indicate that the bad debt amount claimed would likely be incurred at approximately the same level on an ongoing basis.[138] As a result, Staff normalized the claimed $7,688 bad debt expense, i.e., $7,688/3 = $2,563, and recommends decreasing the bad debt expense by $5,125.[139]

Staff would also like to further point out that, at the hearing, the Administrative Law Judge asked the Company to file certain late-filed exhibits including, without limitation, the amount of bad debt expense for New River for the 2012 calendar year.[140] On September 30, 2013, New River filed its Notice of Filing Affidavit Of Ray L. Jones In Support of Late-Filed Exhibits. In paragraph 12 of his affidavit, Mr. Jones asserts that he reviewed the books and records of the Company which reportedly reflected bad debt expense for the 2012 calendar year of $12,699.60.[141] However, Staff would like to note that no supporting documentation to evidence such amount was provided. This lack of documentation echoes the Company's above-referenced failure to document its bad debt expense for the years 2009 and 2010. Staff would submit that, absent such supporting evidence, the Commission should adopt Staff's normalized bad debt expense and direct the Company to maintain such records in the future.

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[134] *Id.* at 28:19-21.
[135] *Id.* at 28:22-24.
[136] *Id.* at 29:2-4.
[137] *Id.* at 29:4-5.
[138] *Id.* at 29:5-7.
[139] *Id.* at 29:12.
[140] Tr. Vol. II at 376:7-11.
[141] Jones Affidavit at 3.

7. **Depreciation Expense.**

Staff recommends decreasing the Company's depreciation expense by $148,150; New River proposes a $138,004 reduction.[142] The $10,146 difference reflects the parties' disparate positions on the above-discussed applicable depreciation method ($3,635) and the depreciation on disallowed plant ($6,511).[143] Staff submits that this issue will be resolved once a decision is made regarding the appropriate depreciation method to be applied.

8. **Income Tax.**

Staff and the Company are in agreement regarding the methodology to be applied in calculating the applicable income tax, as with the depreciation expense discussed in section (3) (h) above, the actual income tax allowance to be applied is dependent upon the depreciation method adopted by the Commission and its effect on the adjusted test year taxable income. Staff recommends an increase in income tax allowance of $84,196; New River proposes an increase of $33,302.[144]

9. **Taxes Other Than Income.**

New River proposes an adjustment of $3,600 in taxes other than income based on its proposal to add another employee as an accounting analyst as previously discussed in section (B)(1). Staff opposes the hiring of such additional employee and, therefore, does not agree with this adjustment.

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

Staff and New River recommend the adoption of the Company's actual capital structure of 100% equity and 0.0% debt.[145] Staff's initial recommended cost of equity ("COE") and return on equity "(ROE") were 8.2 percent and 8.8, respectively.[146] However, in this matter, Staff updated its analysis of the COE to include more recent market data.[147] As a result, Staff's final recommended

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[142] Ex. S-6 at 4.
[143] Ex. S-6 at 4.
[144] Ex. A-6 at 4.
[145] Cassidy Surrebuttal, Ex. S-5 at 2:4-5; Ex. A-6 at 1.
[146] Cassidy Direct, Ex. S-4 at 34.
[147] Cassidy Surrebuttal, Ex. S-5 at 2.

COE is 8.3 percent and the final recommended ROE is 8.9 percent.[148] Staff's recommended ROE continues to include the 60 basis point (0.6 percent) upward economic assessment adjustment recommended in its direct testimony.[149] Staff considered application of the economic assessment adjustment appropriate in this instance given the relatively uncertain status of the current economy and market.[150] The Company has not changed its original recommended ROE of 10.0 percent.

Staff's cost of capital recommendations are based on sound and reasonable financial analyses using the discounted cash flow ("DCF") model and capital asset pricing model ("CAPM") which are market-based financial models consistently accepted by this Commission.[152] Staff selects the inputs to these models by identifying available market date and then determining whether investors are expected to rely on that data. These models utilize both historical and forecasted economic information which result in a balanced methodology. As a result, Staff's recommendations concerning cost of capital are objectively reasonable.[153]

1. COE Is Determined by Investors in the Marketplace.

The COE is the rate of return that investors expect to earn on their investment in a business entity given its risk or, otherwise stated, the investors' expected return on other investments of similar risk.[154] In essence, the market determines an entity's COE because they are widely-recognized mark-based and have been used extensively to estimate the COE.[155] Because New River is not a publicly traded entity, Staff was unable to directly estimate COE due to a lack of firm-specific market data.[156] Given this, Staff estimated the Company's COE indirectly using a representative sample group of publically traded water utilities as a proxy.[157]

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[148] *Id.* at 2:12; 3:2.
[149] *Id.* at 2:21.
[150] Ex. S-4 at 34.
[152] Cassidy Direct, Ex. S-4 at 13.
[153] *Id.*
[154] Ex. S-4 at 7:15-17.
[155] *Id.* at 13:18-24.
[156] *Id.* at 13:4-5.
[157] *Id.* at 13:5-7.

2. The Commission Should Adopt Staff's Recommended Return on Equity of 8.9 Percent Because It Is Based on Proven Financial Models Involving Balanced and Reasonable Inputs.

To determine a just and reasonable ROE, Staff utilized the DFC and CAPM models. Staff first averaged the DCF results (8.6 percent)[158] and then calculated an average for the CAPM results (7.7 percent).[159] Staff then took the average of both models (8.2 percent)[160] and made the aforementioned 60 point basis point upward economic assessment adjustment to account for the current economic environment.[161] Staff's adjustment resulted in a just and reasonable ROE of 8.9 percent.[162]

3. The Commission Should Reject New River's 10.0 Percent COE Because It Is Not Supported By Any Market-based COE Estimation Analysis.

Unlike Staff's cost of capital analysis, New River's initial cost of capital recommendation was based upon a review of returns authorized by the Commission in six recent rate cases and is not supported by any market based analysis of the cost of equity.[177] In his Rebuttal testimony, Company witness Jones expanded his review to include authorized returns of from ten recent dockets, four of which were of the original six dockets.[178] However, as Staff witness Cassidy explained, it is appropriate for the estimated COE to be market based because COE can only be determined in the marketplace, wherein it manifests itself as the investors' *expected* return. [Emphasis in original.][179] As noted by Mr. Cassidy, the COE varies over time and is dependent upon capital structure that should be adjusted to reflect differences among the sample companies.[180] Moreover, as Mr. Cassidy reiterated in Surrebuttal, financial risk is proportional to the level of debt financing employed in a firm's capital structure, i.e., the higher the percentage of debt, the greater the exposure to financial risk.[181] Given New River's 100 percent equity structure in this instance, the Company has no

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[158] *Id.* at 25:21-23.
[159] *Id.* at 30:2-4.
[160] *Id.* at 32:19-23.
[161] *Id.* at 34:9-19.
[162] *Id.* at 34:23-35:3.
[177] *Id.* at 37:12-16; Tr. Vol. II at 210:1-4, 21-24, 221:15-25.
[178] Cassidy Surrebuttal., Ex. S-4 at 4; Jones Rebuttal, Ex. A-3 at 29.
[179] Cassidy Surrebuttal., Ex. S-4 at 4; Tr. Vol. II at 214:23 to 216:17.
[180] Cassidy Direct S-4 at 37:14-16.
[181] Cassidy Surrebuttal., Ex. S-4 at 5:7-9.

exposure to financial risk.[182] In contrast, the average capital structure of the ten sample companies in Mr. Jones' COE calculation is more highly leveraged, i.e., 66.49 percent equity and 33.51 percent debt.[183] Despite having no exposure to financial risk, Mr. Jones proposes as higher COE for New River (10.0 percent) than the average ROE of his samples (9.85 percent).[184] Thus, contrary to what may be inferred from the Company's argument for its COE, authorized returns on equity are not the equivalent of the cost of equity and should not be relied upon.[185]

4. Fair Value Rate of Return.

Staff recommends that the Commission adopt Staff's updated fair value rate of return ("FVROR") of 7.8 percent for the Company.[186] Staff's updated FVROR calculation represents the Company's weighted average cost of capital less an inflation adjustment/accretion return of 1.1 percent (8.9% - 1.1% = 7.8%).[187] The Company is seeking a FVROR of 8.72 percent which represents its requested 10.0 percent COE less a fair value inflation adjustment of 1.28 percent.[188]

Both Staff and the Company calculated its FVROR using the methodology previously adopted by the Commission in Decision No. 71308 for Chaparral City Water Company.[189] This methodology deducts from the weighted average cost of capital an inflation adjustment/accretion return.[190] However, in this matter, the method used by Staff differed from the prior method in that the yield from 30-year, rather than 20-year, United States Treasury bonds were used to calculate the portion of the return required by an investor due to inflation.[191] As Staff witness Cassidy points out, the preferred term for calculating the accretion term is that which most closely matches the weighted average expected life of the plant included in the fair value rate base.[192]

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[182] *Id.* at 5:10-12.
[183] *Id.* at 5:12-15.
[184] *Id.* at 5:15-17.
[185] *Id.* at 5:1-2.
[186] *Id.* at 3:17.
[187] *Id.* at 3:18-20; Ex. A-6 at 1.
[188] Ex. A-6 at 1.
[189] Cassidy Direct, Ex. S-4 at 35:16-17.
[190] *Id.* at 35:17-19.
[191] *Id.* at 35:19-36:3.
[192] *Id.* at 36:3-5.

In determining the inflation adjustment/accretion return, Staff first calculated the difference between the nominal yield on the 30-year U.S. Treasury bond and the real yield on the same 30-year treasury security.[193] This difference reflects the additional return required by investors for the loss of purchasing power due to inflation over the same 30-year period.[194] Since the OCRB, which does not include inflation, represents 50 percent of the FVRB, Staff reduced the accretion return by 50 percent which resulted in a modified inflation adjustment/accretion return to deduct from the WACC for purposes of calculating the FVROR.[195]

D. Amount Outstanding From Owners.

During the course of Staff's audit of the Company, Staff witness Brown determined that the Company had loaned funds to its owners, Mr. and Mrs. Fletcher.[196] At the end of the test year the outstanding amount was $1,018,247. By the end of 2012, the balance had increased by $142,457 to $1,160,704.[197] It is Staff's position that this transaction constitutes a "loan" from the Company to the Fletchers given that the Company itself denotes it in its records as a "note receivable"[198] and, as such, expects the funds to be repaid.[199] Staff further posits that, if not a note receivable, this transaction should be considered: (a) a distribution of income to its shareholders, the Fletchers, for which they would be liable for income taxes;[200] or (b) a stock buyback.[201]

Staff also contends that this loan has adversely affected the Company's ability to provide timely maintenance to its plant.[202] Company witness Jones admitted in his Direct testimony that the Company was "forced to postpone recoating" of a storage tank and hydro pneumatic tank at the 78th [sic] Lane Booster plant due to insufficient available funds.[203] Under these circumstances, Staff recommends that the Company (1) discontinue making loans to the owner and (2) amortize the loan

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[193] *Id.* at 36:12-14.
[194] *Id.* at 36:14-17.
[195] *Id.* at 36:17-20.
[196] Brown Direct, Ex. S-1 at 30:19; Tr. Vol. II at 305:17-20.
[197] Brown Direct, Ex. S-1 at 30:22-23.
[198] Tr. Vol. II. at 305:25-306:8.
[199] Tr. Vol. II at 306:2-3; 1-15.
[200] Tr. Vol. II at 306:17-18.
[201] Tr. Vol. II at 306:23 to 307:1.
[202] Brown Direct, Ex. S-1 at 31:2-3; Tr. Vol. II at 381:19 to 382:2.
[203] Brown Direct, Ex. S-1 at 31:6-12; Jones Direct, Ex. A-1 at 12.

for a term of no less than 30 years and require the owner to begin to re-pay the loan according to the amortization schedule within 60 days of the decision resulting from this proceeding.[204] In the event the owner fails to comply with the repayment schedule, Commission recommends that the Commission impute the payments as revenue to the Company.[205]

New River disputes Staff's contention that it made loans to the owners and asserts that such amount is an intercompany balance transfer.[206] Staff submits that this is a distinction without a difference. It is undisputed that New River and its owners, Mr. and Mrs. Fletcher, constitute two separate legal entities and affiliates.[207] In this scenario, the Company chose to record the transaction as a notes receivable.[208] A note receivable is "an account containing evidence of indebtedness"[209] or written promise to receive a sum of money from another party on one or more future dates.[210] Given this, Staff asserts that it is incompatible with the public interest and sound financial practices for the owner not to repay the subject notes receivable.[211] This is especially true where the Company seeks a rate increase, in part, for maintenance expenses on plant it claims it cannot afford to pay. Arguably, if even one thirtieth of the loan, or roughly $38,690 according to a 30 year amortization schedule, is repaid each year, the Company would have ample funds to cover a significant portion of its general maintenance expenses and, thereby, partially alleviate the need for a rate increase.

E. <u>Rate Design</u>.

The rate designs of both Staff and the Company share three characteristics: both distinguish customer class by meter size, the monthly minimum charges vary by meter size and include no gallons and the commodity rates are based on an inverted three-tier rate design.[212] However, the similarities cease there. The Company's proposed rates increase a typical residential 5/8 x ¾-inch meter bill with a median usage of 8,762 gallons from $18.01 to $30.69, for an increase of $12.67 or

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[204] Brown Direct, Ex. S-1 at 31:15-18.
[205] *Id.* at 31:22-23.
[206] Tr. Vol. II at 310:10-11.
[207] Brown Surrebuttal, Ex. S-2 at 29:22.
[208] *Id.* at 29:25.
[209] Black's Law Dictionary, Sixth Edition, 1990.
[210] Brown Surrebuttal, Ex. S-2 at 29:26 to 30:1.
[211] *Id.* at 30:1-3.
[212] Brown Direct, Ex. S-1 at 50-51.

70.34 percent.[213] Staff's recommended rates would increase the typical 5/8 x ¾-inch meter bill from $18.01 to $23.52, for an increase of $5.51 or 30.58 percent.[214]

III. CONCLUSION.

Staff respectfully requests that the Commission adopt its recommendations on the disputed issues for the reasons stated above and the testimony provided.

RESPECTFULLY SUBMITTED this 25th day of October, 2013.

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[213] *Id.* at 51; Brown Direct, Ex. S-1 at Schedule CSB-42.
[214] Brown Direct, Ex. S-1 at 51.