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Arizona Corporation Commission
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IN THE MATTER OF THE APPLICATION OF CHAPARRAL CITY WATER COMPANY FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASE IN ITS RATES AND CHARGES BASED THEREON	DOCKET NO. W-02113A-13-0118 **NOTICE OF FILING TESTIMONY SUMMARIES**

Attached are the testimony summaries for the following witnesses:

1. Sheryl L. Hubbard
2. Jeffrey W. Stuck
3. Candace Coleman
4. Jake Lenderking
5. Thomas J. Bourassa
6. Pauline M. Ahern
7. Sandra L. Murray

RESPECTFULLY SUBMITTED this 13th day of February, 2014.

LEWIS ROCA ROTHGERBER, LLP

By ______________________
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of the foregoing filed
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Testimony Summary of Sheryl L. Hubbard

Direct Testimony - Broderick

Ms. Hubbard adopts the pre-filed direct testimony of Thomas M. Broderick, as follows:

Chaparral City Water Company ("CCWC" or "Company") requests a rate increase of $3,141,028, or 34.8%, as displayed in Schedule A-1.

CCWC requests that its fair value rate base equal its original cost rate base.

CCWC proposes to change its low income program and low income tariff to match the features of its successful program in Sun City, Agua Fria, Mohave, and Havasu.

CCWC is eligible for and requests a DSIC-like mechanism (also known in Arizona as the System Improvement Benefits Mechanism). This allows the Company to more quickly undertake distribution system replacements and, consequently, to reduce regulatory lag and the frequency of rate cases; and to introduce rate gradualism.

CCWC'S cost of capital is not less than 10.21%.

Schedule D-1 displays an end of projected test year long term debt balance of $4,545,000 and an average cost of long-term debt of 5.97%. If a pending refinancing application is timely approved, then a slightly lower cost of debt can be reflected in the D Schedules. Likewise after refinancing, approximately $46,000 for the cost of an annual external audit would be cut from the requested O&M expenses, and the costly bank balance would be removed from working capital.

CCWC's capital structure consists of 16.60% long-term debt and 83.40% equity based on the Company's end of projected test year long-term debt and equity balances.

CCWC requests recovery of $91,668 in annual rate case expense; this amount is lower than the expenses approved in the Company's previous rate case.

CCWC requests approval of a 24-month deferral of capital expense related financing costs and depreciation, as recommended by Staff of the Arizona Corporate Commission ("Commission" or "ACC") in its March 2012 report.

Direct Testimony - Hubbard

Supports CCWC's proposed Rate Base and sponsors several adjustments to its Operating Income.

Sponsored Adjustments:

- Adjustments to Plant In Service:
  - Adjustment SLH-1 – Post Test Year Plant Additions
  - Adjustment SLH-2 – 24-Month Deferral Balance
  - Adjustment SLH-3 – Deferred CAP M&I Charges
  - Adjustment SLH-4 – Removal of CIAC Not in Plant in Service
  - Adjustment SLH-5 – Remove Acquisition Adjustment

- Adjustments to Operating Income:
  - Adjustment SLH-1 – Unbilled Revenue
  - Adjustment SLH-2 – Normalized Over-collection of Temporary Surcharge
  - Adjustment SLH-3 – Annualize Year End Customers
  - Adjustment SLH-4 – Conservation Expense
  - Adjustment SLH-5 – Declining Usage
  - Adjustment SLH-19 – Annualize Depreciation & Amortization of CIAC
  - Adjustment SLH-20 – Depreciation on Post Test Year Plant Additions
  - Adjustment SLH-24 – Remove Gain / Loss on Sale of Fixed Assets
  - Adjustment SLH-25 – Reclassify Reconnection Revenue
  - Adjustment SLH-26 – Correct Classification of Customer Adjustments

Also supports the following:

- Rate Design
- Revisions to service charges
- Compliance with requirement to file lead/lag study

<u>Rebuttal Testimony - Hubbard</u>

The Company's total revised requested annual revenue increase is $3,089,039, or a 34.3% increase.

Sponsored Exhibits:

- Exhibit SLH-Rl - Summary of the Parties Positions
- Exhibit SLH-R2 - Recalculation of the ACC Staffs UPIS and Accumulated Depreciation
- Exhibit SLH-R3 - Response to Data Request RUCO 8.04

The Company has reviewed Staff's accumulated depreciation adjustments and provides additional adjustments to Staff's recommendation.

The Company updates its post-test year plant additions, which now total $4,579,953.

CCWC disagrees with RUCO's adjustment to customer deposits.

CCWC continues to support its 24-month deferral request, an approach recommended by Commission Staff in prior proceedings, and an approach that is not duplicative of its SIB Mechanism request.

CCWC does not accept RUCO's position regarding the deferral of CAP capital charges.

The Company accepts certain adjustments to cash working capital recommended by Staff and RUCO and continues to disagree with other adjustments.

The Company does not accept RUCO's position regarding the deferral of CAP capital charges.

The Company accepts certain adjustments to cash working capital recommended by Staff and RUCO, and continues to disagree with other adjustments.

The Company continues to support its declining usage adjustment, which Staff accepts. If a compliance filing requirement is ordered as recommended by RUCO, the timing needs to be adjusted.

The Company agrees with some adjustments to the corporate allocation as proposed by Staff and RUCO, and disagrees with other adjustments. Particularly, the Company continues to support inclusion of incentive compensation - the At-Risk Cost Pool.

The Company disagrees with Staff's adjustment to accumulated depreciation in which Staff removes certain assets its finds fully depreciated.

The Company continues to support its modifications to fees for certain miscellaneous services; it proposes fees that more closely align with actual costs of those services.

The Company does not accept Staff's rate design, which includes a very large discount on the first tier of usage.

Rejoinder Testimony - Hubbard

The Company maintains its total revised requested annual revenue increase at the filed rebuttal request figure of $3,089,039, or a 34.3% increase.

Sponsors the following exhibit:

- Exhibit SLH-R1 – Summary of the Parties' Positions

Testimony Summary of Jeffrey W. Stuck

Direct Testimony

The Company provides service within the Town of Fountain Hills. The overall service area is approximately 19 square miles, has approximately 13,800 customers, with a topography that ranges in elevation from 1,500 feet to 2,575 feet.

Production facilities consist of the Shea Water Treatment Plant, a 15 million gallon per day (MGD) surface water treatment plant; and a groundwater well, referred to as Well 10, with a production capacity of 1,700 gallons per minute (GPM).

The Company's unaccounted for water ratio is 14.5%; CCWC actively works to address and reduce this ratio.

The Company proposes a tank maintenance program spanning 18 years for its storage reservoirs. Maintenance frequency over these 18 years will balance the timing necessary to extend the life of the assets while not overly burdening the customers. Cost estimates for the 18-year reservoir maintenance plan are $3,639,307, resulting in an annual expense of $202,184 (as displayed in Schedule C-2 ADJ SM-17.)

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Mr. Stuck adopts portions of the pre-filed direct testimony of Ian C. Crooks, as follows:

The Company requests that the following post test year projects be included in rate base:

- Well #10 Arsenic Removal Facility
- Reservoir #2 Structural Improvements
- Comprehensive Planning Study
- Telephone System Upgrade
- Distribution System Improvements
- Shea Water Treatment Plant Filter Media
- Tools and Equipment
- Vehicles
- 2013 Recurring Projects - Distribution
- 2013 Recurring Projects – Facilities

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Rebuttal Testimony

Updates the post-test year plant projects completed by the Company in 2013.

Responds to the testimony of ACC Staff regarding water loss adjustments. Upon acquisition of CCWC in October 2012, EPCOR Water (USA) Inc. ("EPCOR") began water loss reduction efforts that positively affect the water loss ratio of the CCWC. The Company's 2013 water loss ratio stands at 13.37%, a 1.13% reduction. The Company agrees with filing periodic compliance updates with ACC Staff on its water loss reduction program.

Responds to RUCO testimony regarding tank maintenance expenditures, disagreeing with its proposed reductions in operating expense. The Company's approach allocates the necessary time to correct the operational issues contributing to current water loss levels. Provides additional information in response to RUCO's recommended disallowance of tank maintenance expenses. References Commission decisions that approve this approach with successful implementation.

Rejoinder Testimony

Responds to RUCO's opposition to CCWC's inclusion of the tank maintenance expense.

Testimony Summary for Candace Coleman

Ms. Coleman adopts the following:

1) Portions of the pre-filed direct testimony of Ian C. Crooks, as follows:

   The Company requests a SIB mechanism, in part, to reduce the harmful impact of regulatory lag between rate cases, to reduce the frequency of future rate cases, to reduce the magnitude of increase in customer bills following rate cases, and to maintain and improve the performance of CCWC's water system for customers. The Company seeks the SIB mechanism to address replacements of valves, service lines, meters, and hydrants.

2) SIB Eligibility Report dated August 7, 2013, and filed August 22, 2013

3) SIB Table I dated August 21, 2013, and docketed August 22, 2013

4) SIB Table II docketed December 6, 2013

Rebuttal Testimony - Coleman

The Company requests a System Improvement Benefit (SIB) Mechanism in order to reduce regulatory lag and introduce rate gradualism.

CCWC believes that the SIB process allows for proper scrutiny of a project's prudency, and its used and useful status. While the SIB initially may increase the workload on Commission Staff, this should decrease as the process is streamlined. CCWC will keep detailed records on SIB projects in order to increase the efficiency of the project review process.

Testimony Summary of Jake Lenderking

Direct Testimony

CCWC requests inclusion in rates of the previously deferred CAP M&I Charges and the on-going payments that CCWC makes to the Central Arizona Water Conservation District ("CAWCD") for its use of Central Arizona Project ("CAP") water. Including these amounts in rates supports the policy of the State of Arizona for the use of renewable resources and sends a clear signal to other Commission-regulated water utilities that good water management is important to the Commission.

The Company proposes a Sustainable Water Surcharge ("SWS") to recover the cost of water purchased from CAP and charges related to water storage with the Replenishment District and/or credits for water storage with MWD GSF. The SWS allows for the exact recovery of this known and essential expense. Since the surcharge matches the expense, ratepayers will realize more quickly any decreases in the CAP water price.

CCWC seeks approval of a *pro forma* adjustment relating to conservation program expenses.

Rebuttal Testimony

CCWC requests recovery of costs associated with the deferred CAP charges.

CCWC agrees with the ACC Staff, and disagrees with RUCO, on their respective adjustments to purchased water expense.

Includes a Plan of Administration that calculates the proposed Sustainable Water Surcharge for cost recovery of CAP expenses.

CCWC files Best Management Practices ("BMPs") relating to water conservation and attaches the BMPs.

Testimony of Thomas J. Bourassa

Direct Testimony

The cost of service study provides a starting point for determining how proposed revenues should be allocated to the residential, commercial, irrigation, and hydrant customer classes based on their respective costs of service. These results provide meaningful information in the determination of cost of service based rates for the customers of CCWC.

The study also includes the monthly minimum and commodity rate for a customer on a ¾-inch meter when the allocations for expenses and plant for the functions of demand, customer, meters and services. Comparing those rates to the Company's current and proposed rates, the Company's proposed monthly minimum of $22.20 for a ¾inch residential customer is about 37 percent of the actual fixed costs of $59.50. Assuming 45 percent of the fixed costs are recovered through the commodity rates rather than the monthly minimum, the Company's proposed minimum is approximately 94.5 percent of the indicated monthly minimum. This means a greater than 45 percent recovery of the fixed costs from the commodity rates rather than the monthly minimum. As a result of recovery of a substantial portion of the fixed costs through the commodity rates, the proposed first tier, second tier and third tier commodity rates are greater than the cost to produce the water. Additionally, because a substantial portion of the fixed costs must be recovered through the commodity rates, the proposed rate design contains substantial risk to achieving full recovery of the cost of service through rates; particularly under an inverted tier conservation- oriented rate design as proposed by the Company. The break-even point for a ¾-inch meter is nearly 9,000 gallons (the second break-over point) for the ¾-inch residential customers. So, profitability is not achieved until customers use more than 9,000 gallons. Inverted multi-tiered rates designs as proposed in this case encourage conservation. If conservation is actually achieved, usage will decline and it will cause a substantial shortfall in the revenues the Company collects, which means it will be impossible, all else constant, to actually achieve the requested return.

Rebuttal Testimony:

Updated results of the cost of service study for CCWC using CCWC's rebuttal proposed rate base, revenue, and expenses, and rate design. Also reports of the results using the Commission Staff's and RUCO's proposed rate bases, revenue and expenses, and rate designs.

Testimony Summary for Pauline M. Ahern

Direct Testimony

Assesses the market-based common equity cost rates of companies of relatively similar, but not necessarily identical risk to recommend a common equity cost rate of 11.05% on the common equity financed portion of the Company's jurisdictional rate base. (See summary on page 2 of Schedule PMA-1.) Uses this proxy approach for rate determination because the Company's common stock is not publicly traded and, therefore, no market-based common equity cost rate exists.

Consistent with the Efficient Market Hypothesis ("EMH"), the Company used market-based cost of common equity models - the Discounted Cash Flow ("DCF") approach, the Risk Premium Model ("RPM"), and the Capital Asset Pricing Model ("CAPM") - to analyze the market data of a proxy group of nine water companies similar to CCWC. Reviewing the cost rates based upon these models indicates a common equity cost rate of 10.48%. Further adjusting this rate upward by 0.18% to reflect the Company's credit risk, and by 0.40% to reflect its greater business risk, the common equity cost rate reaches 11.06%. Rounded to 11.05%, this is the Company's common equity cost rate.

Rebuttal Testimony

Rebuts the direct testimony of ACC Staff Witness John A. Cassidy and RUCO Witness David C. Parcell on the following issues:

Capital Structure

Mr. Cassidy's recommended hypothetical capital structure of 40% debt and 60% equity is inappropriate for ratemaking purposes for the Company because:

1) it is inconsistent with the capital structure ratios upon which the Company's current rates are based;

2) use of Mr. Cassidy's capital structure ratios and recommended return on common equity of 9.3% results in an insufficient and punitive return on common equity of 7.65%; and

3) a common equity cost rate of 7.65% implies a financial risk premium of 1.65 basis points, significantly lower than the average downward financial risk adjustments proposed (92 basis points) and/or adopted (46 basis points) in representative Commission decisions since 2006.

Provides evidence that the Company's proposed capital structure ratios and financial metrics are consistent with Standard & Poor's (S&P) guidelines for a public utility with bonds rated in the BBB category (Moody's Baa).

Common Equity Cost Rate

Provides evidence that both Mr. Cassidy's and Mr. Parcell's Discounted Cash Flow model results, 9.3% and 8.70% respectively, significantly understate the investors' required return when applied to an original cost less depreciation rate base, *i.e.*, book value. Supports exclusive reliance upon security analysts' forecasts of growth in earnings per share as reasonable and more accurate indicators of investor expectations. Contrasts this approach to the various historical and projected growth rates used by both Mr. Cassidy and Mr. Parcell.

Credit Risk Adjustment

Explains that neither Mr. Cassidy nor Mr. Parcell includes an adjustment to reflect the greater credit risk of the Company, with a likely bond rating of Moody's Baa1/S&P BBB+ as indicated by its financial metrics (notwithstanding the level of common equity.) The magnitude of such an adjustment is 0.32 basis points.

Business Risk Adjustment

Explains that both Mr. Cassidy and Mr. Parcell base their recommended common equity cost rates on the market data of water utilities larger than CCWC. Neither witness recommends an adjustment to reflect the greater business risk of the Company due to its smaller size. Supports a conservative adjustment of 40 basis points based on the size of the Company.

Mr. Cassidy's Common Equity Cost Rate

Mr. Cassidy exclusively relies upon the common equity cost rate Discounted Cash Flow Model ("DCF"), which is inconsistent with the Efficient Market Hypothesis ("EMH") upon which the DCF is predicated. Reliance upon multiple cost of common equity models is consistent with the EMH.

Mr. Cassidy's exclusion of the Capital Asset Pricing Model ("CAPM") is not only inconsistent with Staff's previous position but also with the EMH upon which his DCF analysis is predicated. Ms. Ahern provides evidence that the rationale Mr. Cassidy uses for not relying upon a CAPM analysis in this proceeding is applicable as well to the DCF model when he states that "forecasted dividend yield [have] fallen to new lows" resulting in abnormally low DCF cost of common equity estimates.

Mr. Cassidy's rationale for using a group of sample utilities - that a group of utilities can reduce the sampling error in the estimation of common equity cost rate - also can be applied to the use of multiple models that also reduces the sampling error from the application of a single cost of common equity model, *e.g.* the DCF.

The Company provides evidence that upward credit risk and business risk adjustments to the common equity cost rate based upon the market data of the sample utilities is necessary, due to CCWC's likely bond rating and small size. Mr. Cassidy does not include such adjustments.

Properly including these adjustments, coupled with a properly applied CAPM analysis and a properly applied DCF analysis based upon Mr. Cassidy's DCF, results in a 10.42% common equity cost rate, only slightly lower than the updated common equity cost rate of 10.50%.

Mr. Parcell's Common Equity Cost Rate

The Company provides evidence that indicates Mr. Parcell's application of the Capital Asset Pricing Model ("CAPM") is flawed in several respects and, therefore, should not be relied upon. Mr. Parcell's CAPM is flawed because:

1) He incorrectly relies upon an historical risk-free rate despite the fact that both ratemaking and the cost of capital are prospective.

2) He incorrectly calculates his market equity risk premium by relying upon:

   a. The actually achieved, or non-market based, rates of return on book common equity for a proxy for the market, the S&P 500;
   b. A geometric mean historical market equity risk premium;
   c. The historical total return on U.S. Treasury securities; and
   d. Not employing a prospective or forward-looking equity risk premium.

3) He does not incorporate an empirical CAPM (ECAPM) analysis despite the fact that empirical evidence indicates that the low-beta securities earn returns higher than the CAPM predicts and high-beta securities earn less.

The Company states again that upward credit risk and business risk adjustments to the common equity cost rate based upon the market data of the sample utilities is necessary, due to CCWC's likely bond rating and small size as discussed below. Mr. Parcell does not include such adjustments.

Properly including these adjustments, coupled with a properly applied CAPM analysis as well as Mr. Parcell's DCF and Comparable Earnings ("CE") analyses, results in a 10.59% common equity cost rate, only slightly higher than the updated common equity cost rate of 10.50%.

Updated Common Equity Cost Rate

The Company provides an updated common equity cost rate of 10.50% applicable to the Company in the current economic and capital market environment.

<u>Rejoinder Testimony</u>

Responds to certain aspects of the surrebuttal testimonies of ACC Staff Witness John A. Cassidy and RUCO Witness David C. Parcell on the following issue:

Capital Structure

Provides evidence that Mr. Cassidy's and now Mr. Parcell's recommended hypothetical capital structure of 40% debt and 60% equity remains inappropriate for ratemaking purposes for CCWC for the reasons previously explained.

Addresses the concept of double leverage, which Mr. Cassidy introduced in his surrebuttal testimony, as an additional reason for recommending a hypothetical capital structure for the Company.

Demonstrates that no equity has been infused into Chaparral City Water Company since its acquisition by EPCOR Water USA which Mr. Cassidy confuses with EPCOR Water Arizona Inc. in his surrebuttal testimony. Therefore, no debt at the parent could have been used to finance a non-existent equity infusion.

Also addresses the concept of double leverage, demonstrating that its several flaws:

1) Double leverage violates the basis financial principle of risk and return;

2) Double leverage is inconsistent with the concept of the opportunity cost of capital;

3) Double leverage discriminates against the investors, *i.e.*, the parent, of the regulated operating utility, thus violating both the concept of fairness and the capital attraction standard;

4) Double leverage is based upon some highly problematic assumptions; and,

5) Double leverage is a tautology - an unnecessary redundancy, *i.e.*, saying the same thing twice.

Testimony Summary of Sandra L. Murrey

Direct Testimony

Supports CCWC's proposed Operating Income.

Sponsored Adjustments:

- Adjustments to Operating Income
  - ADJ SM-6 Annualize Payroll Expense
  - ADJ SM-7 Annualize Fringe Benefits Expense
  - ADJ SM-8 Remove Regulatory Assessment Fee
  - ADJ SM-9 Removal of One-Time / Non-Recurring Items
  - ADJ SM-10 Annualize Purchased Water Expense
  - ADJ SM-11 Annualize Power Expense
  - ADJ SM-12 Annualize Chemicals Expense
  - ADJ SM-13 Amortize Rate Case Expense
  - ADJ SM-14 Annualize Postage Increase
  - ADJ SM-15 Miscellaneous Expense Clean-up
  - ADJ SM-16 Annualize Water Testing Expense
  - ADJ SM-17 Tank Maintenance Expense
  - ADJ SM-18 Annualize Corporate Allocations
  - ADJ SM-21 Annualize Property Tax Expense
  - ADJ SM-22 Federal and State Income Taxes
  - ADJ SM-23 Interest Synchronization

Rebuttal Testimony

Sponsored Rebuttal Schedules:

- Schedule C-1 Rebuttal: Adjusted Test Year Income Statement
- Schedule C-2 Rebuttal: Income Statement Pro Forma Adjustments
- Schedule C-3 Rebuttal: Computation of Gross Revenue Conversion Factor

Adjusted Operating Income and Operating Expense:

- CCWC's rebuttal position for Adjusted Operating Income and Expense is:

	Chaparral City Water Company
Adjusted TY Operating Income	$ 865,297
Adjusted TY Operating Expense	$ 8,149,688

Operating Income Adjustment:

- The Company's position on ACC Staff's proposed recommendations:
  - Oppose Excess Water Loss (Staff Adj #I),
  - Oppose Intercompany Support Services (Staff Adj #2),
  - Accept Purchased Water Expense (Staff Adj #3),
  - Revised Depreciation Expense (Staff Adj #4),
  - Revised Property Taxes (Staff Adj #5),
  - Revised Income Tax (Staff Adj #6)

- The Company's position on RUCO's proposed recommendations:
  - Oppose Declining Usage Expense (RUCO Adj #I),
  - Oppose Incentive Pay (RUCO Adj #2),
  - Oppose Purchased Water Expense (RUCO Adj #3),
  - Revised Corporate Allocation (RUCO Adj #4),
  - Oppose Conservation Expense (RUCO Adj #5),
  - Oppose Tank Maintenance Expense (RUCO Adj #6),
  - Oppose Depreciation Expense (RUCO Adj #7),
  - Revised Property Tax Expense (RUCO Adj #8),
  - Revised Income Tax Expense (RUCO Adj #9)

Company Rebuttal Income Statement Adjustments:

- Adj SM -1R Purchased Water Expense
- Adj SLH-2R Depreciation Expense on Revised PTYP A
- Adj SLH-3R Corporate Allocation Expense
- Adj SLH-4R Annualize Depreciation I CIAC
- Adj SM -5R Annualize Property Tax
- Adj SM -6R Federal and State Income Taxes
- Adj SM -7R Interest Synchronization