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BEFORE THE ARIZONA CORPORATION CO.....

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8 IN THE MATTER OF THE APPLICATION OF
 9 LITCHFIELD PARK SERVICE COMPANY,
 10 AN ARIZONA CORPORATION, FOR A
 11 DETERMINATION OF THE FAIR VALUE OF
 ITS UTILITY PLANTS AND PROPERTY AND
 FOR INCREASES IN ITS WASTEWATER
 RATES AND CHARGES BASED THEREON
 FOR UTILITY SERVICE.

Docket No. SW-01428A-13-0042

Arizona Corporation Commission

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 14 AN ARIZONA CORPORATION, FOR A
 15 DETERMINATION OF THE FAIR VALUE OF
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 FOR INCREASES IN ITS WATER RATES
 AND CHARGES BASED THEREON FOR
 UTILITY SERVICE.

Docket No. W-01427A-13-0043

RUCO'S OPENING BRIEF

INTRODUCTION

21 The Residential Utility Consumer Office ("RUCO") submits this Brief in the matter of the
 22 rate application of Litchfield Park Service Company ("LPSCO" or the Company). RUCO
 23 supports the Settlement and believes approval of the Settlement is in the public interest. RUCO
 24 opposes the System Improvement Benefit Surcharge/("SIB") and the Collection System

1 Improvement Benefit Surcharge ("CSIB") and believes approval of the SIB/CSIB would not be in
2 the public interest.

3 **1) THE COMMISSION SHOULD APPROVE THE SETTMENT AGREEMENT**

4 The Commission should approve the Settlement Agreement ("Settlement") entered into
5 between RUCO and the Company. The Settlement resolves the outstanding disputes
6 associated with the return on equity, rate design, corporate cost allocations, achievement pay,
7 customer meter deposits, declining usage and post-test year plant. A hearing on the
8 unresolved issues would have likely been lengthy, expensive and neither party is as likely to
9 have done as well as by the terms reached in the Settlement. The Settlement is in the public
10 interest.

11 Under the terms of the Settlement, the revenue increase for the water division will be
12 \$1,421,511. A-16 at Schedule A-1, Water Division¹. The Wastewater Division will see a
13 revenue increase of \$341,225. A-16 at Schedule A-1, Wastewater Division. Residential
14 customers on the 5/8 to 3/4 meters will see on average a monthly increase of \$3.06. Water
15 customers will see their bill increase from \$10.20 to \$13.26 or 30%. Id. Proposed Water
16 Division Schedule H-3 at 1. The Wastewater customers will see on average a monthly increase
17 of \$1.36. Wastewater customers will see their bill increase from \$38.99 to \$40.35 or 3.49%. Id.
18 Proposed Wastewater Division Schedule H-3 at 1

19 The Settlement also settles each party's right to object to the admission of certain
20 documents that were offered into evidence as part of the SIB related portion of this matter. The
21 SIB hearing in this matter was contentious to begin with - the Settlement goes far in reducing
22 some of that contention in the hearing. RUCO, however, has not waived its claim that the
23

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

1 Company and Staff have failed to make their case on the SIB/CSIB which will be discussed
2 further below.

3 In sum, the Settlement is a fair solution to the outstanding unresolved issues.
4 Ratepayers will benefit under the terms of the Settlement and the Settlement is in the public
5 interest. The Commission should approve the Settlement.

6 **2) THE COMMISSION SHOULD REJECT THE SIB/CSIB.**

7 **A) THE SIB/CSIB SHIFTS RISK FROM THE COMPANY TO THE RATEPAYER**
8 **WITHOUT ADEQUATE FINANCIAL CONSIDERATION TO THE**
9 **RATEPAYER**

10 RUCO opposes the SIB/CSIB mechanism because ratepayers are not adequately
11 compensated for the additional risk associated with the SIB/CSIB and because it is illegal. R-9
12 at 10. The SIB/CSIB mechanism reduces regulatory lag in favor of LPSCO because the
13 Company will not have to wait until new rates go into effect to recover a return on SIB/CSIB
14 eligible plant or the depreciation expense associated with it. Id. However, any actual cost
15 savings, such as lower operating and maintenance expenses, attributable to the new plant are
16 not truly captured by the mechanism and are not adequately flowed through to ratepayers. Id.
17 The reason for the mismatch is the SIB/CSIB filings will consider eligible plant placed in service
18 after the time period considered in the rate case. Transcript at 102. Hence, the operating
19 expenses associated with the SIB/CSIB plant as well as all of the other rate case elements
20 normally considered in a rate case will not be factored into the calculation. Id. at 108. This
21 mismatch works against the ratepayer's interests and assures that ratepayers will not pay their
22 actual cost of service and will pay more over time.

23 Ratepayers will be paying for the recovery of and return on routine plant placed into
24 ratebase in between rate cases that the ratepayer would not otherwise pay until the next rate
case. To the extent the ratepayer receives a benefit through the efficiency credit on the return

1 associated with the SIB/CSIB related plant that paltry benefit will only accrue until the next rate
2 case filing when the relevant plant is rolled into the ratebase and subject to the COE awarded in
3 the next rate case. Id. at 103

4 While no one will know the true value of the efficiency credit until the Company actually
5 makes its first SIB/CSIB filing, RUCO's witness Mr. Mease addresses its value to the ratepayer.
6 R-1 at 44. In a recent case there was a Company that estimated SIB eligible infrastructure
7 improvements at \$900,000 which the Company expected would increase its revenues by
8 approximately \$100,000. Id. The efficiency credit, at 5% would result in a \$5,000 credit to the
9 ratepayers. It is likely that \$900,000 in improvements would reduce the associated O&M
10 expenses by more than \$5,000. Id. That bet definitely favors the shareholders over the
11 ratepayers and likely by a lot - if that were not the case, there would be a real question why the
12 plant would need to be improved in the first place.

13 Another financially related argument advanced in support of the SIB/CSIB is that the
14 SIB/CSIB will promote rate gradualism. Transcript at 166. While the SIB/CSIB may promote
15 rate gradualism, it comes at a cost. Ratepayers are likely to pay higher rates over time because
16 of the failure to consider all of the rate case elements at each SIB/CSIB filing. Transcript at
17 217-218. Gradualism will also come at the expense of rate stability. Id. Ratepayer's rates will
18 change yearly as the result of each SIB/CSIB filing. Transcript at 166.

19 Each filing will also result in a rate increase. For reasons which will be addressed below,
20 the SIB/CSIB is not an adjustor. Ratepayers will see no actual cost savings that might
21 otherwise be realized without extraordinary ratemaking and will no longer benefit from the rate
22 stability that exists under traditional ratemaking. The Commission should reject the SIB/CSIB.

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1 **B) THE SIB/CSIB IS ILLEGAL IN ARIZONA**

2 **1) THE SIB/CSIB IS NOT AN ADJUSTOR MECHANISM**

3 The Arizona Constitution protects consumers by generally requiring that the Commission
4 only change a utility's rates in conjunction with making a finding of the fair value of the utility's
5 property.² However, Arizona's courts recognize that, "in limited circumstances," the
6 Commission may engage in rate making without ascertaining a utility's rate base.³ One of those
7 circumstances exists where the Commission has established an automatic adjustor mechanism.
8 *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616; *Residential Util.*
9 *Consumer Office v. Arizona Corp. Comm'n ("Rio Verde")*, 199 Ariz. 588, 591 ¶ 11, 20 P.3d
10 1169, 1172. An automatic adjustor mechanism permits rates to adjust up or down "in relation to
11 fluctuations in certain, narrowly defined, operating expenses." *Scates* at 535, 578 P.2d 616. An
12 automatic adjustor permits a utility's rate of return to remain relatively constant despite
13 fluctuations in the relevant expense. An automatic adjustor clause can only be implemented as
14 part of a full rate hearing. *Rio Verde* at 592 ¶ 19, 20 P.3d 1173, *citing Scates* at 535, 578 P.2d
15 616.

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

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

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

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

1 The Commission went on to discuss the undesirability of such adjustors because they can
2 cause piecemeal regulation that is inefficient and undesirable. *Id.* at 8. See also *Scates* at 534,
3 578 P.2d 615.

4 In the subject case, the SIB/CSIB clearly is not an adjustor mechanism – its purpose is
5 not to account for fluctuating operating expenses. Its purpose is to allow for recovery of plant
6 costs which increases rate base and thereby increases operating income – not operating
7 expenses. Unlike an adjustor, the SIB/CSIB does not allow for rates to adjust “in relation to
8 fluctuations in certain, narrowly defined, operating expenses.” Moreover, the SIB/CSIB only
9 permits rates to adjust up, not down as the result of allowing for the SIB/CSIB related plant
10 recovery. Transcript at 166.

11 Even if one could set aside the argument that Arizona’s courts have only recognized
12 adjustors for very limited operating expenses and not for operating income, the SIB/CSIB
13 mechanism still would not qualify as an adjustor because the justification for the mechanism is
14 not the volatility in the price of the plant. As explained, the concern here is the amount of the
15 investment, and no case law parities the need for an adjustor mechanism with the magnitude of
16 investment in plant. The SIB/CSIB is not an adjustor mechanism nor should the exception be
17 expanded in any manner to treat it as such.

18 2) THE COMPANY HAS NOT REQUESTED INTERIM RATES

19 The only other circumstance where the Commission may engage in rate making without
20 ascertaining a utility’s rate base involves requests for interim rates.⁴ The Commission’s
21 authority to establish interim rates is limited to circumstances in which 1) an emergency exists;
22 2) a bond is posted guaranteeing a refund if interim rates are higher than final rates determined
23 by the Commission; and 3) the Commission undertakes to determine final rates after making a
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⁴ *Scates v. Ariz. Corp. Comm’n*, 118 Ariz. 531, 533-35, 578 P.2d 612, 614-16 (App. 1978).

1 finding of fair value.⁵ The Arizona Attorney General has opined that an emergency exists when
2 “sudden change brings hardship to a company, when a company is insolvent, or when the
3 condition of the company is such that its ability to maintain service pending a formal rate
4 determination is in serious doubt.”⁶

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

10 **C) THE SIB/CSIB WOULD NOT QUALIFY UNDER THE ‘THIRD EXCEPTION’**

11 The Eastern Division Phase II Decision (No. 73938) lists what it refers to as a “third
12 exception” contemplated by the Arizona Courts to the fair value requirement. Citing *Scates*,
13 Decision No. 73938 references the following:

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

(118 Ariz. 531, at 537, 578 P.2d 612, at 618) R-7 at 44.

21 RUCO believes that an unabridged gap exists between a conclusion that a third
22 exception exists and that the Arizona courts have determined that a third exception exists.
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24 ⁵ 199 Ariz. at 591, ¶12, citing *Scates*.

⁶ 71-17 Opinion Arizona Attorney General at 50. (1971).

1 Scates did define what was needed for interim rates – an emergency which is far more tangible
2 than a mere directive. *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616
3 (App. 1978). Scates also explained that an automatic adjustor is a device that permits rates to
4 adjust as explained above. RUCO is unaware of any case⁷ in Arizona that specifically identifies
5 and sets forth the criteria for a third exception. Moreover, the Commission, if anything should be
6 looking to narrow, not expand the exception to Arizona's Constitutional requirement that fair
7 value be found. The provisions of Arizona's Constitution should be liberally construed to carry
8 out the purposes for which they were adopted. *Laos v. Arnold*, 141 Ariz. 46, 685 P.2d 111
9 (1984). Conversely, exceptions to a constitutional requirement should be narrowly construed.
10 See *Spokane & I.E.R. Co. v. U.S.*, 241 U.S. 344, 350, 36 S.Ct. 668, 671 (1916) (an "elementary
11 rule" that exceptions from a general policy embodied in the law should be strictly construed).
12 The Commission should not use the "emergency" exception or the adjustor mechanism
13 exception liberally or create a "third exception" to set aside the rule of finding fair value when
14 setting rates.

15 If a third exception does exist, the SIB/CSIB in this case should not qualify. There has to
16 be some meaning to the notion of a fair value finding and that meaning should not be
17 sidestepped by simply providing narrow updates to a previously determined ratebase. There is
18 hardly anything extraordinary about a utility that needs to replace aging infrastructure. In fact it
19 is normal and usually the reason why a utility files a rate case. The SIB/CSIB will be precedent
20 for any utility to seek extraordinary ratemaking to include routine plant for recovery in between
21 rate cases.

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⁷ Clearly Scates does not define a third exception.

1 **D) THE SIB/CSIB WILL INCREASE THE COMPANY'S FAIR VALUE RATE**
2 **BASE WITHOUT ANY DETERMINATION OF FAIR VALUE**

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

9 The SIB/CSIB mechanism itself will be established as part of the pending rate case.
10 Within 12 months of the date of the Commission's final decision, LPSCO will be able to file a
11 request to implement the SIB/CSIB surcharge. A-25 and A-26 at 5. The Company will be able
12 to file for the SIB/CSIB surcharge no more than five times between rate case decisions. Id. The
13 Commission will ultimately consider and then may approve each surcharge filing. The
14 Commission, however, will not be making a new FVRB finding as part of each surcharge filing.
15 Transcript at 107-108. It will be updating the prior fair value finding with the new SIB related
16 plant and associated depreciation expense. Id. It will not consider other expenses and revenues
17 in the calculation. Id. The SIB/CSIB will do far more than simply pass on increasing costs to
18 the Company - it will allow for increasing rates in between rate cases based on the costs of
19 routine plant effectively increasing the fair value rate base without a meaningful consideration of
20 fair value. The fact that the Company will be subject to an annual earnings test and will have to
21 file balance sheets, income statements and other financial information does not cure the
22 constitutional infirmity.

23 The financial filings are covered in SIB Schedule D which appears to be the answer to
24 the fair value issue from the proponents' perspective. RUCO's perspective is different– the

1 facts are the facts and the fact is that each SIB/CSIB filing will not result in a meaningful FVRB
2 finding nor will there be any finding by the Commission of what fair value is:

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

12 Schedule D will show an analysis of the impact of the SIB/CSIB plant on the fair value
13 rate base, revenue, and the fair value rate of return. A-25 and A-26 at 5. This provision was
14 obviously put in to satisfy *Scates*, but it does not go far enough:

15 We do not need to decide in this case whether as a matter of law
16 there must be a de novo compliance with all provisions of the order in
17 connection with every increase in rates. The Commission here not only
18 failed to require any such submissions, but also failed to make any
19 examination whatsoever of the company's financial condition, and to
20 make any determination of whether the increase would affect the
21 utility's rate of return. There may well be exceptional situations in which
22 the Commission may authorize partial rate increases without requiring
23 entirely new submissions. We do not decide in this case, for example,
24 whether the Commission could have referred to previous submissions
with some updating or whether it could have accepted summary
financial information. *We do hold that the Commission was without
authority to increase the rate without any consideration of the overall
impact of that rate increase upon the return of Mountain States, and
without, as specifically required by our law, a determination of Mountain
States' rate base. Simms v. Round Valley Light & Power Co., 80 Ariz.
145, 294 P.2d 378 (1956); Ariz. Const. Art. 15, section 3; A.R.S. section
40-250.* The Commission not only failed to make any findings to support
its conclusion that the increases were just and reasonable, but it
received no evidence upon which such findings could be based. *Scates*
at 537, 578 P.2d 618. (Emphasis added).

25 While the SIB/CSIB Schedule (D) may show the impact of the SIB/CSIB plant on the rate
26 base, the revenue and the fair value rate of return, the Commission will not, as required by law,

1 make a meaningful finding of fair value and use that finding as a rate base for the purpose of
2 establishing rates. In the Phase II Eastern Division case, Schedule D shows the rate base
3 (O.C.L.D.) but it only shows the capital costs and the depreciation expense associated with the
4 plant additions. R-7, Schedule D. Hence, the SIB/CSIB filings will only consider one piece –
5 the SIB/CSIB plant (and depreciation expense). It will not consider the operating expenses
6 associated with that plant, the working capital, etc. in the calculation. The operating expenses
7 that will be included in the rates that the Commission will approve after each SIB/CSIB filing will
8 be the operating expenses approved in Decision No. 73736 - operating expenses from a
9 completely different period than the SIB/CSIB plant under consideration. In sum, there is no tie
10 back to fair value and the SIB/CSIB raises the specter of single issue ratemaking which was a
11 concern of the *Scates* Court. *Scates* at 534, 578 P.2d. 615, R-5 at 5. The SIB/CSIB
12 mechanism is single issue ratemaking; it is not fair value ratemaking.

13 Decision No. 73736 added an earnings test calculation. R-7 at 51. While an earnings
14 test will provide the Commission with a measure of the Company's earnings at a designated
15 point in time, it will not cure the constitutional fair value infirmity. The earnings test is an after-
16 the-fact indicator of whether the Company's actual rate of return exceeded its authorized rate of
17 return looking back over a designated time period. *Id.* An earnings test is not relevant to an
18 actual finding of fair value. There are other provisions of the Eastern Division Settlement
19 ("Eastern Division Settlement") which will assure Commission oversight and approval of the
20 SIB/CSIB filings but nothing that requires a meaningful finding of fair value as required by
21 Arizona's Constitution. The SIB/CSIB is illegal and should be rejected.

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1 **E) THE COMPANY AND STAFF DID NOT MAKE THE CASE FOR EITHER THE**
2 **WATER SIB OR THE WASTEWATER CSIB**

3 The burden is on the Company to make its case for the SIB/CSIB. The only filed
4 testimony on the SIB⁸ from the Company is from Mr. Krygier who addresses it in his rebuttal
5 and rejoinder testimony from a public policy perspective. A-5 at 21-24, A-12 at 6-8. Staff's
6 prefiled testimony on the subject amounted to Staff's engineer; Dorothy Haines' summary
7 approval of LPSCO's engineering report for both the water SIB and the wastewater CSIB. S-2,
8 engineering report –Water/ Wastewater at 11. The Plan of Administration ("POA") for both the
9 Water SIB and the Wastewater CSIB was written by Staff and according to Mr. Krygier the
10 Company did not receive a copy of it until sometime within a few weeks of the hearing.
11 Transcript at 89-90. Mr. Krygier further explained that the Company had been working with
12 Staff on the POA for "the last week or two" prior to the hearing. Id. at 91. Prior to the hearing
13 there had been no pre-filed testimony on the terms and the conditions of the SIB and CSIB POA
14 from anything other than a public policy perspective⁹.

15 At the hearing the Company presented Mr. Krygier as its witness on the SIB and CSIB
16 POA. Despite the fact that Staff apparently wrote the SIB and CSIB POA, Staff did not present
17 a witness aside from Ms. Haines, its engineering witness who did not offer any testimony on the
18 terms and conditions of the SIB and CSIB POA. This is the first CSIB that the Commission has
19 been asked to approve. R-2 at 30. Neither the Company or Staff appears to be concerned with
20 what to RUCO appears to be a SIB, and in particular, a CSIB record devoid of evidentiary
21 support. In fact, the Company suggests that the two (SIB and CSIB) can be viewed in tandem
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23 ⁸ Mr. Krygier refers to the "Water and Wastewater SIB" in his testimony – at some point thereafter the Wastewater
24 SIB was referred to as the CSIB. Rebuttal testimony Krygier

⁹ RUCO is not suggesting that the Company acted improperly or below-board in the way it presented its case. On
the contrary, RUCO's impression is that the Company was diligent and filed its SIB/CSIB case promptly as it
evolved. The issue simply concerns whether the Company made its case from an evidentiary standpoint.

1 because functionally and materially they will work the same and the terms are materially the
2 same between the Eastern Group agreement and the POAs in this case. Transcript at 98-99.

3 Actually, the SIB and the CSIB are quite different. The NARUC accounts for water and
4 wastewater infrastructure are different – perhaps because the infrastructure itself is, for the
5 most part, different. Transcript at 98. The wastewater division does not have hydrants. Id.
6 There are manholes and clean-outs in sewer which are not part of the water infrastructure. R-5
7 at 13-17, R-6 at 18-21. While there are some similarities in the infrastructure (main lines), much
8 of the sewer infrastructure is different than the water infrastructure.

9 The Eastern Division Settlement was the result of many parties that came together.¹⁰ It
10 included other water companies who had a stake in the outcome. At the very least, most of the
11 interests of the larger water companies and water investment groups in Arizona interests were
12 represented¹¹. In the present case, the CSIB POA appears to have been written by Staff with
13 the collaboration of the Company shortly before the hearing in this matter and there are still
14 questions as to the finality of the proposed CSIB POA – for example, there are no attachments,
15 Decision Numbers and the document itself has “Draft” written on each page (See A-25). The
16 same is true of the Water SIB. (See A-26). Regardless, the CSIB is not the result of a
17 collaborative effort of the wastewater industry and appears to have been put together hastily.

18 The circumstances supporting the SIB/CSIB are different from those in the Eastern
19 Division case. The Settlement itself in the Eastern Division points this out - §12.3 of the
20 Settlement starts “This case presents a unique set of circumstances...” R-7, Eastern Division
21 Settlement at 12. Aside from the obvious factual differences such as the infrastructure in
22 question is different, the Company’s financial circumstances are different, among many other

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¹⁰ RUCO was not a signatory.

24 ¹¹ Signatories included Global Water, Valencia Water Company, Water Utility of Greater Tonopah, Willow valley
Water Co., Water Utility of Northern Scottsdale, Epcor, the Arizona Water Utility Association, Liberty Utilities,
Arizona Investment Council, R-7, Eastern Division Settlement at 13-15.

1 factual differences, the terms and conditions of the Eastern Division Settlement and the POAs
2 are different in several ways. The following examples make the point:

3 First, the process for adding/modifying projects has changed under the POAs. The
4 process under the Eastern Division Settlement was set forth in Section 6 of the Eastern Division
5 Settlement. R-7, Eastern Division Settlement at 6. Under the Eastern Division Settlement the
6 Company could request Commission authority to add a project during the period that the SIB
7 applies. Id., Section 6.1. The Company would make the request and Staff and RUCO would
8 have 30 days to object to the project. Id., Section 6.5. One of the flaws of the Eastern Division
9 Settlement is that it did not provide a procedure if there was an objection. Id.

10 Under the POA, this section has changed – now, projects can only be added under
11 “emergency circumstances”. A-25, and A-26 §5. Neither POA explains or defines what
12 qualifies as “emergency circumstances”. Nor does either POA establish a procedure other
13 than there must be Commission approval. The Company witness, when asked, did not know
14 why the terms had changed, whose idea it was to change the terms or the intent of the person
15 who made the change. Transcript at 121. It’s odd to think that shortly after an annual filing is
16 approved, the Company could have an “emergency” and would then have to wait until its next
17 SIB filing before it could seek recovery of the infrastructure – RUCO hopes under such
18 circumstances a Company would not be dissuaded in any way to address the emergency given
19 the procedure.

20 The Earnings test requirement under the POA is similar in construct to what the
21 Commission authorized in Decision No. 73938. A-25 and A-26 at 7, Decision No. 73938 at 51.
22 The Earnings test is covered under §IV (C) of the POAs. A-25 and A-26 at 7. The Earnings
23 test described in Decision No. 73938 was not in the Eastern Division Settlement. R-7.
24 Moreover, the Decision, in addition to describing the mechanics of the Earnings test, describes

1 in detail the consequences of the test. There is no parallel discussion of the consequences in
2 the POAs. Like most things, it is the Commission that ultimately decides the consequences,
3 however, without the language in the POAs there is not a written understanding of the
4 consequences. The Company's witness did testify that these same conditions do apply to the
5 SIB/CSIB and RUCO would hope that if the SIB/CSIB is approved that these same conditions
6 be spelled out in the Decision. Transcript at 161.

7 What definitionally passes for SIB eligible plant appears to have been categorically pared
8 down from the Eastern Division Settlement. The fact remains, however, that what is eligible for
9 recovery is very broad and contemplates far more than what the Commission envisioned when
10 it originally considered a DSIC type mechanism. The Commission was originally concerned
11 with Arizona Water Company's water loss and looked at DSIC's designed to implement leak
12 detection devices and make conservation-based repairs. Decision No. 73736 at 15. The
13 objective was to replace/repair/improve the infrastructure specifically to address the water loss.
14 Id. The wastewater POA in this case falls outside the realm of the original concern of excessive
15 water loss without a showing why we need to go there and why the Commission needs to
16 address it with extraordinary ratemaking.

17 The SIB/CSIB expands the purpose to include almost every type of plant. For example,
18 the SIB includes upgrades whose sole purpose is for fire flow improvement.

19 The following classifications are commonly used to identify the reason that a
20 pipeline asset should be replaced:

21 • **Capacity** – The flows that need to be conveyed by the pipeline are greater
22 than the pipeline capacity. These mains are typically required to deliver flows
23 that are greater than the individual design flows because growth and
24 development is different than was originally planned.

• **Performance Criteria** – *The functional requirements exceed the asset
capability.*

*One example of an asset that can no longer be used due to a change in the
performance criteria is an older, smaller diameter pipe that operates reliably,
but may not deliver a sufficient fire flow according to current standards. In this*

1 *case, the fire flow requirement may have changed since the pipeline was*
2 *installed, so the smaller pipe no longer serves current needs.*

3 A-21 at 8 (Emphasis added). The Commission has made clear that such improvements do not
4 warrant extraordinary ratemaking treatment. See for example Decision No. 70351 at 36. Staff
5 may claim it will be diligent in its review of the plant but Staff's personnel changes as do the
6 Company's personnel and who can say how such data will be reviewed in the future. Moreover,
7 in this case Staff's engineer recommended approval of the Company's SIB without doing any
8 evaluation of the "operating and maintenance" projects, and had no "clue" with regard to what
9 maintenance and repairs were done to the sewer division and could not explain what the
10 Company did in the past which would make it appropriate for the Commission to even approve
11 the SIB/CSIB in this case. Transcript at 202-203. This raises a concern as to the level of
12 scrutiny Staff will require - the SIB/CSIB should never be treated as an automatic pass through
13 of the Company's plant.

14 In sum, RUCO is concerned that the Company and Staff have not made their case for
15 the SIB/CSIB. RUCO understands that the SIB/CSIB is evolving with each case and an
16 argument can be made for some degree of flexibility. The CSIB, however, is completely new
17 and sewer is different than water. The water case is less troubling as the Commission has
18 visited it before – but that should not somehow reduce the requirement to show that it is
19 appropriate and necessary under the circumstances of this case. The Commission should
20 reject the Company's request for the approval of the SIB/CSIB.

21 **F) THE SIB/CSIB IS NOT IN THE PUBLIC INTEREST**

22 There are numerous reasons why RUCO does not believe the SIB/CSIB is in the public
23 interest. The SIB/CSIB is illegal in Arizona, and hence not in the public interest. The SIB/CSIB
24 does not adequately compensate ratepayers for the shift in risk that will result – a five percent
efficiency credit is a paltry quid pro quo. This is the first case that the Commission is

1 considering a DSIC type mechanism for the sewer division of a company and there has been an
2 inadequate evidentiary showing. Moreover, the case for the SIB POA for the water side is also
3 inadequate and should not be approved.

4 For every argument made in support of the SIB, there are counter- points which weigh
5 more heavily to reject the SIB. There is the argument that the SIB mitigates regulatory lag
6 alluded to above. Transcript at 127-128. This is true; however, this benefit to the Company
7 comes at the higher expense of regulatory scrutiny. Elimination of regulatory lag is not in the
8 best interests of ratepayers.

9 First, regulatory lag incents the utility to operate as efficiently and as prudently as
10 possible. Unlike most companies that must compete for customers, a monopoly utility is not
11 subject to the inherent pressures of a competitive marketplace to manage its costs. Regulatory
12 lag addresses this problem. By having a "lag" time between when a regulated utility spends its
13 money and begins recovery of it, regulatory lag exerts pressure on the utility to act efficiently
14 and prudently.

15 Second, regulatory lag evens out over time. While regulatory lag may place pressure on
16 the utility in the beginning, that same regulatory lag provides an economic benefit to the utility in
17 the end. Once plant has been fully depreciated, the utility still earns recovery of (and recovery
18 on) that plant until the next rate case, which may be several years past when the plant was fully
19 depreciated.

20 A SIB eliminates regulatory lag on the front end (to the benefit of the utility) at the risk of
21 reducing pressure to operate prudently and efficiently (to the detriment of the ratepayer).

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1 Perhaps the most complete study on DSICs and DSIC type mechanisms like the
2 SIB/CSIB was completed by the Alaska Attorney General's Office. In comments filed¹² before
3 the Regulatory Commission of Alaska, the Regulatory Affairs & Public Advocacy Section of the
4 Alaska Attorney General's Office ("RAPA") elaborated on the effects of regulatory lag relative to
5 the implementation of the DSIC surcharge. R-10. RAPA noted the following regarding the
6 perverse incentives that would result with the implementation of the DSIC.

7 Regulatory lag performs an important public interest role in the
8 ratemaking process. It provides an incentive for utilities to
9 operate efficiently and contain costs and it is a necessary
10 byproduct of comprehensive regulatory oversight which must
11 be in place to protect captive consumers from public utility
12 monopoly power.¹³ As the Commission put it in 1986, ". . . a
13 reasonable period of regulatory lag which works contrary to a
14 utility's financial interests is proper to impose on a utility in
15 exchange for the benefits of economic insulation . . ." ¹⁴

16 Surcharges (including a DSIC) can easily sidestep the
17 safeguards of adequate regulatory oversight and create a
18 substantial danger that consumers will be saddled with
19 excessive rates:

20 ¹² The date of the RAPA report is May 31, 2012, so while the report may not be completely up to date, it is timely
for the points made herein.

21 ¹³ See Order U-83-74(7) at 13 (addressing the benefits of adhering to a normal rate review process. The benefits
22 mentioned include creating relatively stable consumer rates, adherence to the matching principle, creating effective
opportunities for affected consumer participation in the rate review process, and "not to be minimized is that under
23 the standard ratemaking approach utilities have a considerable incentive to minimize costs, either to maintain
profits or offset other rising costs under existing rates and, thereby, to avoid the necessity of seeking rate relief in
formal rate proceedings with their unlimited scope of review and uncertain results. Surcharges, on the contrary, are
erratic whenever they are intended to recover on a monthly basis variable current expenses." [Emphasis added].)

24 Note: The footnote numbers in this quote does not paginate with the RAPA Comment's footnote numbers. In the
RAPA Comments the relevant footnote numbers start with 48.

¹⁴ Order U-86-20(3), *reprinted at* 7 APUC 514, 516 (Alaska P.U.C. 1986). This discussion 20 occurred in the
context of the Commission's review of a request for interim rate relief.

1 [A]s a surcharge item, the situation would be
2 lacking the typical dynamic for the utility to
3 minimize costs . . . Indeed, there could be a
4 disincentive to the utility's exploring larger
5 reconfigurations in the event of a mandated
6 reimbursement in order to avoid complications in
7 determining proper allocations to the surcharge
8 account. This is not to suggest that the utility's
9 normal prudence or the Commission's own review
10 efforts would be ineffective checks, or that some
11 sort of notice provision could not be interwoven
12 into an MFRCA surcharge. However, the added
13 value of a utility's traditional incentive to minimize
14 cost is not a factor that should be lightly removed.
15 . . . Moreover, **it should not be forgotten that
16 surcharges even in fuel and wholesale power
17 situations are not well received of late (if ever),
18 principally because their presence reduces
19 incentives to minimize or offset cost
20 increases.**¹⁵ [Emphasis added].
21

22 Regulatory lag therefore plays a very important role in
23 ratemaking, and it is part of the price tag associated with a
24 grant of monopoly power. Other than an after-the- fact review
for prudence,¹⁶ regulatory lag is the only regulatory tool
available to protect captive ratepayers because it creates an
economic incentive for utilities to curtail unnecessary spending:

The delay in recovery between when a company
incurs capital expenditures and when it recovers a
return of and on such expenditures in its base
rates is referred to as regulatory lag. In satisfying
their obligation to provide safe and reliable
service to their ratepayers, companies have the
incentive to invest in capital improvements rather
than O&M expenses, even if a capital
improvement represents a sub-optimal solution as
compared to noncapital production factors. Unlike

¹⁵ Order U-83-74(7) at 15.

¹⁶ Historically, utilities in Alaska do not seek a prudence predetermination for planned infrastructure investment. Instead, Alaska's Commission has generally relied on after-the-fact project reviews conducted in the context of a rate case. See, e.g., Order U-10-29(15). There have been exceptions. See Order U-10-41(5).

1 O&M expenses, capital expenditures provide a
2 return to their shareholders when ultimately
3 included in rate base (as stated above~ this bias
4 toward capital investment is known as the Averch
5 Johnson effect). **The existence of regulatory lag
6 provides an important counterbalance to the
7 Averch Johnson effect because companies
8 will not earn a return on their investments
9 until their next rate case proceeding. As such,
10 regulatory lag provides the incentive for
11 companies to pursue a more balanced
12 strategy between capital expenditures and
13 O&M expenses in their provision of safe and
14 reliable service to their ratepayers.¹⁷
15 [Emphasis added].**

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Regulatory lag therefore serves two important functions. It
serves as a protective shield for ratepayers, and it also
functions as an economic driver used to incent utilities to make
efficient economic decisions which helps utilities migrate
towards their authorized returns.¹⁸ See R-10 at 23-26.

¹⁷ *Petition of Massachusetts Electric Co. and Nantucket Electric Co.*, 2009 WL 4543112 (Mass. D.P.U. 2009). See also, *In re Southern Nevada Water Co.*, 1996 WL 304355 (Nev. P.S.C. 1996) ("Among the potential sources of allocative inefficiencies Bonbright cites is the Averch Johnson effect (AJ). The AJ effect suggests that traditional rate base/rate of return regulation biases a regulated firm toward more capital intensive modes of production because of the ability to earn a return on capital investments included in rate base. For instance, in the electric utility industry, utilities are sometimes believed to be biased in favor of building their own generating capacity, rather than purchasing available capacity from other sources. To the extent that this bias has occurred, it would be consistent with the Averch Johnson effect."); *Popowsky v. Pennsylvania Public Utility Commission*, 869 A.2d at 1160 ("The PUC's belief that there is no limit on its authority to approve the use of a surcharge as the means for any utility to recover its costs for any facility addition is contrary to precedent and to sound principles of statutory construction. It means that utilities can recover their capital costs without any incentive to invest wisely and efficiently. Indeed, when recovery is allowed on a cost-plus basis, the incentive is otherwise because the return factor is calculated as a %age of the capital cost.")

¹⁸ The Commission should also be wary about embracing utility claims of under-earning: "[I]n order to test [a utility's] assertion that it did not earn its revenue requirement in the prior years, it would be necessary for Staff to review each of those years and the Commission to resolve disputes for each of those years, essentially holding a complete rate case for each year. Clearly, such a procedure is not feasible." Order U-90-32(4) at 6. See also, *Re Washington Gas Light Co.*, Docket No. 1054, Order20 No. 14391 at~ 9-10 (D.C. P.S.C. 2007)(denying a utility's request for surcharge adoption to remedy the utility's claimed under-recovery of its authorized return.) http://www.dcpsc.org/pdf_files/commorders/21_orderpdf/ordemo_14391_FC1054.pdf.

1 RAPA's comments are directly on point. RAPA cautions that while efficient ratemaking is
2 the optimal goal, it must be carefully engineered. In view of the evidence in this case, RUCO
3 questions whether the SIB/CSIB results in carefully engineered ratemaking.

4 RAPA's Comments also provide an insightful check on the other arguments raised by
5 proponents in support of the SIB/CSIB. At the time of the RAPA report, of the 50 states in the
6 nation, there were only 12¹⁹ states in 15 years that had adopted a DSIC or similar type
7 mechanism. RAPA did a comprehensive analysis of not only the mechanisms in place in each
8 of the states, but also looked at:

- 9 • whether DSIC surcharges reduce rate case frequency;
- 10 • whether DSIC surcharges improve quality of service;
- 11 • Actual utility use of DSIC surcharges.

12 With regard to the claimed benefit of reduced rate case filings, RAPA reviewed the rate
13 case filing practices of ten states that have implemented some sort of DSIC-type program since
14 1997. R-10 at 16. Based on the data available from other jurisdictions, there does not appear
15 to be support for the conclusion that DSIC adoption reduces rate case frequency. Id. at 20.
16 More accurately, as noted by RAPA, the same data shows no reduction or actual increase in
17 rate case frequency among utilities using a DSIC. Id.

18 On the issue of whether the DSIC actually improves the quality of service, RAPA
19 determined that establishing a link between the DSIC and investment is elusive. R-10 at 21.
20 With the possible exception of Connecticut which requires a showing of the link, RAPA noted
21 that no link has been found connecting quality of service with the DSIC surcharge in the
22 remaining jurisdictions. Id. at 22. In Connecticut, the DSIC participant is required to show

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¹⁹ R-10 at 12. Not counting Arizona.

1 replacement projects included for surcharge consideration are incremental to utility's ongoing
2 capital replacement program. Id.

3 In those states that have implemented a DSIC, RAPA found that there has also been
4 very little wide spread usage of the DSIC. Id. Among other things²⁰, RAPA found:

5 In all, eight states have enacted legislation allowing DSIC
6 surcharges, three states have accepted settlement agreements
7 that have allowed utilities to implement DSIC surcharges, one
8 state has recently issued draft regulations for public comment
9 regarding a DSIC, and at least two state commissions have
10 explicitly denied utility requests to use DSIC surcharges. A total
11 of approximately 693 utilities are eligible to implement a DSIC
12 type surcharge, but research to date shows only 34 (4.9%)
13 have done so. Of the 34 utilities that have implemented a
14 surcharge, at least 20 are owned, in whole or in part by one the
15 nation's four largest water companies: Aqua America, American
16 Water Works, United Water Company and Utilities Inc.

17 R-10 at 13-14.

18 The California PUC authorized a DSIC for California-American on a pilot basis.
19 However, California-American has requested the DSIC pilot be discontinued. In 2011, RAPA
20 notes that California American discontinued its DSIC. Id. at 12.

21 In sum, RAPA concludes that the DSIC or similar type mechanisms are in place in a
22 small minority of the states, there is no support or inconclusive support that it reduces rate case
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²⁰ For a more detailed explanation as to the different DSICs, the specifics of the legislation and the DSICs themselves please see the RAPA Comments at 6-13.

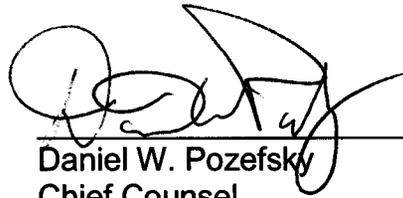
1 filings and/or quality of service and it is not used extensively by those utilities eligible to use it.

2 The SIB/CSIB is not in the public interest in this case and should be rejected.

3 **3) CONCLUSION**

4 For all of the above reasons the Commission should approve the Settlement and reject
5 the SIB/CSIB.

6
7 RESPECTFULLY SUBMITTED this 17th day of January, 2014.

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10 
11 Daniel W. Pozefsky
12 Chief Counsel

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