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BEFORE THE ARIZONA CORPORATIC

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IN THE MATTER OF THE APPLICATION OF PAYSON WATER CO., INC. AN ARIZONA CORPORATION, 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-03514A-13-0111
IN THE MATTER OF THE APPLICATION OF PAYSON WATER CO., INC. FOR AUTHORITY TO ISSUE EVIDENCE OF INDEBTEDNESS IN AN AMOUNT NOT TO EXCEED $1,238,000 IN CONNECTION WITH INFRASTRUCTURE IMPROVEMENTS TO THE UTILITY SYSTEM; AND ENCUMBER REAL PROPERTY AND PLANT AS SECURITY FOR SUCH INDEBTEDNESS.	DOCKET NO. W-03514A-13-0142

ORIGINAL

STAFF'S INITIAL CLOSING BRIEF

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby files its closing brief in the above-captioned matter. On any issue not specifically addressed in this brief, Staff maintains its position as presented in its testimony.

I. INTRODUCTION

Payson Water Co. ("Payson" or "Company") is an Arizona Class C utility engaged in the business of providing potable water service in portions of Gila County, Arizona. Payson serves approximately 1,114 customers. Payson's current rates were approved in Decision No. 62320, dated February 17, 2000, and Decision No. 62401, dated March 30, 2013.

Payson is currently comprised of 8 systems: MDC ("MDC"), Gisela, East Verde Park Estates, Flowing Springs, Deer Creek, Whispering Pines, Geronimo Estates and Meads Ranch. One other system, Quail/Star Valley, was condemned by the Town of Star Valley in 2012. These systems were part of the old United Utilities and acquired by Brooke Utilities in 1996. Brooke

Utilities also acquired the systems that were a part of C&S Water Company, Inc. ("C&S Water"). C&S Water was comprised of two systems, Gisela and Triple T, which are interconnected and the rates of which were consolidated in 2000. At the time of the acquisition by Brooke Utilities, the Commission had issued a complaint and order to show cause against United Utilities and C&S water.[1]

Payson has experienced water shortages in its MDC system since the 1990s. At one point, the Commission placed a moratorium on hook ups to the MDC system.[2] On other occasions, the Company sought a water augmentation surcharge for MDC, as well as its other systems, which was denied by the Commission.[3] The Commission, did, however, approve a Curtailment Plan Tariff for all of Payson's system, except Gisela.[4]

In 2010, the Company filed an emergency request for a water augmentation surcharge. The Company indicated that it could no longer afford to absorb the cost of water hauling which was necessary because of shortages. The Commission, in approving a Water Augmentation Surcharge, found that "[t]he primary problem which the Company's MDC System faces is its well capacities since the water production of the Company's nine wells total 59 gallons a minute at peak capacity and fluctuate down to 19 gallons a minute when production slows". However, even when the wells are producing at maximum capacity, there is insufficient water available for the customers during the peak summer months.[5] The Commission, in approving an emergency surcharge as well as a curtailment plan, ordered Payson to file a rate application within one year of the effective date of the order.[6]

After one extension of time, Payson, on April 22, 2013, filed a request for a permanent rate increase with the Commission. In addition, on May 17, 2013, Payson filed a request for approval of $1,238,000 financing. On August 15, 2013, the Company filed a motion to consolidate the rate case and financing applications and to expedite the processing of those applications. According to the

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[1] Decision No. 59779 (July 30, 1996). The Complaint was dismissed in Decision No. 59855 (October 9, 1996).
[2] Decision No. 58333 (June 30, 1993). The moratorium was lifted in 1998, Decision No. 60734 (March 23, 1998).
[3] *See* Decision No. 67819 (May 5, 2005).
[4] Ex. S-4, Decision No. 67821.
[5] Decision No. 71902 at 10.
[6] *Id.* at 14.

Company's motion, the Company is requesting expedited processing "so that it will be able to pursue an opportunity to build an interconnection between the Town of Payson and the Company's MDC water system.[7]" The Company anticipates completing construction by May 2014 at a cost of approximately $275,000.

The financing application and rate case were consolidated. The Company's request for approval to borrow approximately $275,000 was bifurcated and a hearing thereon was held September 25, 2013 ("Phase 1"). The Commission, in Decision No. 74175, approved the financing application, granted the Company interim rates in the form of a debt recovery surcharge, and approved a purchased water adjustor mechanism.

In its Rejoinder, the Company proposed an original cost rate base ("OCRB") of $932,837.[8] The revenue requirement being proposed was $713,624 which constituted an increase in revenues of $393,099 or 122.64 percent over adjusted test year revenues of $320,525.[9] The Company had proposed a capital structure of 20.71 percent debt and 79.29 percent equity. The debt included in the proposed capital structure was related to the Water Infrastructure Finance Authority ("WIFA") loan to finance the Town of Payson-MDC line. The Company requested a cost of equity of 11 percent. The weighted average cost of capital proposed by the Company was 9.88 percent.[10]

Payson, in its Rejoinder, altered several of its initial requests that appeared in its rate application. As Company witness Jason Williamson testified, Payson withdrew its request for approval of Phase 2 financing for the Cragin Pipeline Project, withdrew its request for an O&M Cost Recovery surcharge, and requested termination of the Phase 1 surcharge and sought recovery of the project cost through rates by including the TOP-MDC line in rate base.[11] Because of these requested changes, Staff proposed new adjustments and clarified its position on several matters such as the request for a Water Augmentation Tariff for the East Verde Park system and the Purchase Water Adjustor Mechanism.

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[7] Page 1, line 23 of motion to consolidate filed on August 15, 2013.
[8] Ex. A-10, Bourassa Rejoinder; Rejoin. Schedule A-1.
[9] Ex. A-10 at 1, Bourassa Rejoin.; Rejoin. Schedule A-1.
[10] Ex. A-11 at 2-3, Bourassa Rejoin (Cost of Capital).
[11] Ex. A-15 at 3, Williamson Rejoin.

As a result, in its Supplemental Surrebuttal Staff proposed several recommendations in response.

II. RATE BASE

Staff recommended OCRB is $504,684. The increase from Staff's recommendation in its direct testimony was the result of an adjustment related to Accumulated Deferred Income Taxes ("ADIT").

In its Surrebuttal testimony, Staff witness Crystal Brown testified that ADIT are the accumulated computed tax differences between income taxes calculate for rate-making purposes and the actual income taxes a company pays to the federal and state authorities.[12] Staff proposed ADIT of $23,339. The Company in its Rejoinder testimony suggested that, because of the higher contribution in aid of construction ("CIAC") balance, Staff's ADIT calculation would result in an ADIT asset of $56,216. The Company also provided schedules showing that the CIAC plant costs that created the ADIT asset were placed in service prior to the date the Internal Revenue Service rules (upon which Staff relied for its analysis) were in effect. As Ms. Brown noted, the cost of CIAC plant placed in service during the years the previous Internal Revenue Service rules were in effect could have resulted in an ADIT asset.[13] Because of the difficulties the Company was likely to encounter in obtaining tax information and documents and because the amount was not unreasonable, Staff accepted the Company's Rejoinder position. Staff recommends decreasing the ADIT by $79,555 to reflect an ADIT asset of $56,216.[14] The Company testified at the hearing that it was in agreement with the Staff's ADIT recommendation.[15]

A. CIAC adjustment.

The Company did not present source documentation for $233,733 in plant costs. Staff recommended that 30 percent of those costs be treated as CIAC and the remaining 70 percent be

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[12] Ex. S-15 at 7, Brown Surrebut.
[13] Ex. S-16 at 3, Brown Supp. Surrebut.
[14] *Id.* at 4.
[15] Tr. at 42:5-6.

treated as if the Company had paid for the plant.[16] The Company testified at the hearing that it agreed with the Staff recommendation.[17]

B. Rate Base resolution.

During the hearing, Company witnesses Bourassa and Williamson accepted Staff's recommendations regarding rate base, ADIT and CIAC.[18] There are no disputed issues between the Company and Staff regarding rate base.

III. OPERATING INCOME

In its application, the Company had requested $197,722 as central office allocation. This amount was categorized by the Company along with miscellaneous expense. Staff made a number of adjustments to the Company's requested central office allocation which total $154,462. In its Rebuttal, the Company argued that, because of the change in ownership, the overhead allocation from Brooke Utilities is no longer a recurring expense.[19] Further, the Company proposed to reflect management fees of $173,903 from JW Water Holdings as contractual services.[20] In its Rejoinder testimony, the Company continued to advocate for management fees of $173,903. Staff reviewed its previous recommendation and accepted the Company's proposed administrative oversight billing rates related to the Company's agreement with JW Water Holdings of $173,903.[21]

IV. COST OF CAPITAL

Staff has proposed a pro forma capital structure of 52.8 percent debt and 47.2 percent equity, adjusted to reflect the inclusion of a $1,179,650 WIFA loan requested by the Company for Phase 2.[22] Staff recommended a cost of debt of 4.2%.[23] Staff's recommended cost of equity is 9.0 percent. Staff's recommended cost of equity is based on the 8.4 percent average of its discounted cash flow method ("DCF") and capital asset pricing model ("CAPM"). Staff's DCF for the sample companies

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[16] Ex. S-15 at 3, Brown Surrebut.
[17] Tr. at 42:2-4.
[18] Tr. at 42.
[19] Ex. A-8 at 9-10, Bourassa Rebut.
[20] *Id.*
[21] Ex. S-16 at 6, Brown Supp. Surrebut.
[22] Ex. S-10 at 7, Cassidy Dir.
[23] *Id.*

was 8.8 percent[24] and 8 percent for the CAPM.[25] Staff's recommended cost of equity includes an upward economic assessment adjustment of 60 basis points.[26]

In response, the Company changed its initial proposal and withdrew its request for approval of both the Phase 2 financing and the associated surcharge.[27] The Company then proposed a capital structure of 20.71 percent debt and 79.29 percent equity. The debt included in the proposed capital structure was related to the WIFA loan to finance the Town of Payson-MDC line. The Company requested a cost of equity of 11 percent. The weighted average cost of capital proposed by the Company was 9.88 percent.[28]

Staff, in response to the Company's Rejoinder testimony, revised its cost of capital recommendations. Staff had recommended approval of the Company's financing request[29] and thus had included the debt in its pro forma capital structure. Because of the withdrawal of the Phase 2 financing request, Staff now recommends a capital structure of 100 percent equity. Staff excluded the $275,000 debt authorized in Decision No. 74175 because the Commission indicated that only MDC customers should be responsible for repayment of the Phase 1 debt. Staff's recommended capital structure excludes the Phase 1 debt in order to isolate that component from the capital structure to be used for the setting of rates for all Payson customers.[30] Staff's recommendation did not change regarding the cost of equity or overall rate of return.[31]

At the hearing, the Company testified that it accepted the Staff recommendations on cost of capital.[32]

V. ENGINEERING ISSUES

Staff witness Jian Liu[33] proposed a number of recommendations centering on water loss. Staff recommends that the Company prepare and docket a plan to reduce water loss to 10 percent in

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[24] *Id.* at 25.
[25] *Id.* at 29.
[26] *Id.* at 33.
[27] Ex. A-15 at 3-5, Williamson Rejoin.
[28] Ex. A-11 at 2-3, Bourassa Rejoin. (Cost of Capital).
[29] Ex. S-11 at 7-8, Cassidy Dir. (Financing).
[30] Ex. S-13 at 3-4, Cassidy Supp. Surrebut.
[31] *Id.* at 5.
[32] Tr. at 46:19-21, Tr. at 46:22-24; Tr. at 47:14-16.

its Geronimo Estates, Meads Ranch, and Whispering Pines water systems.[34] The water loss reduction report should be docketed as a compliance item within 90 days of the effective date of the Commission decision in this matter.[35] Staff also recommended that the Company conduct a study regarding the East Verde Park Estates water system supply situation and file in the docket documentation showing the Company's long term plan 12 months from a decision in this matter.[36] Because of the water supply issues in East Verde Park, Staff has recommended a moratorium on hook-ups.[37] The Company is in agreement with this recommendation.[38]

The Company was also found to be out of compliance with the Arizona Department of Environmental Quality ("ADEQ").[39] Staff had initially recommended that rates should not become effective until the Company is in compliance with ADEQ. Staff now recommends that rates become effective the first day of the month following the filing by the Company of either an updated ADEQ Drinking Water Compliance Report indicating that the Company is in compliance with ADEQ requirements or the Company enters into a consent agreement with ADEQ to address its current Notice of Violation.[40] On March 4, 2014, Staff received a copy of a consent order between the Company and ADEQ.

Staff and the Company have agreed upon 5 Best Management Practices ("BMPs") for its MDC system.[41] Staff recommends that the Company adopt those 5 BMPs for the remainder of its systems.[42] The Company has indicated agreement.[43]

VI. RATE DESIGN

The Company proposed one set of rates for the United and C&S systems and Staff agreed with the Company's proposal.[44] Under Staff's proposed rates, Staff recommends a monthly charge of

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[33] Mr. Liu filed pre-filed testimony but was unable to participate in the Phase 2 hearing. His prefiled testimony was adopted by Mr. Delbert "Del" Smith.
[34] Ex. S-8 at 3, Liu Surrebut.
[35] *Id.*
[36] *Id.* at 4.
[37] Ex. S-7 at 13, Liu Dir.-Engineering Report.
[38] Tr. 347:7-10.
[39] Ex. S-7 at 3, Liu Dir.
[40] Ex. S-8 at 1, Liu Supp. Surrebut.
[41] Decision No. 74258 (January 7, 2014).
[42] Ex. S-7 at 6-7, Liu Dir.
[43] Ex. A-14 at 7-8. Williamson Rebut.

$23.00 for a 5/8 x ¾ meter.[45] The Company had proposed a consolidated monthly charge of $39.24. For the first 3,000 gallons, Staff recommends a commodity charge of $4.00 for the first tier, $7.66 for the second tier, and $9.62 for the third tier.

VII. PURCHASED WATER ADJUSTOR

In Phase 1, Staff recommended a purchased water adjustor mechanism "(PWAM") to enable the Company to recover the cost of water purchased from the Town of Payson through the proposed pipeline.[46] Staff and the Company could not come to agreement on the mechanics of the PWAM and it was agreed that the mechanics would be addressed during Phase 2.[47]

Staff proposed that avoided production costs i.e., purchased pumping power and chemicals, be subtracted from the additional cost of purchase water because those costs would continue to be recovered through the Company's base rates, even though the Company would not incur those costs when alternative water supplies are purchased.[48] Staff also recommends the simultaneous cancellation of the MDC Water Augmentation tariff which will no longer be needed.[49] The Company testified that it accepted Staff's PWAM.[50]

VIII. EAST VERDE PARK ESTATES WATER AUGMENTATION TARIFF AND PURCHASE WATER ADJUSTOR

The Company requested a Water Augmentation Tariff for its East Verde Park Estates system. Company witness Williamson testified that because of the water supply issues in East Verde Park, such a tariff was necessary.[51] Staff recommended approval of a tariff and a PWAM. Staff witness, Crystal Brown, testified that she revised the tariff and adjustor for East Verde Park after Intervenor, Thomas Bremer, pointed out certain errors.[52] This tariff is similar to the tariff for MDC with the

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[44] Ex. S-14 at 23. Brown Dir.
[45] *Id.*, Schedule CSB-18.
[46] *See* Decision No. 74175 at 10.
[47] *Id.* at 11.
[48] Ex. S-16 at 7, Brown Supp. Surrebut.
[49] *Id.*
[50] Tr. at 48:2-11.
[51] Ex. A-14 at 8, Williamson Rebut.
[52] Tr. at 894:19-25., Ex. S-18.

exception that Staff has recommended that the total amount of purchased water cost the Company can recover during any given year for its East Verde Park system be capped at $10,000.[53]

This is an area of dispute between Staff and the Company. Mr. Williamson testified that the Company would like to see a higher cap, perhaps $12,500.[54] Staff reasoned that the purchased water surcharge is contemplated to be a temporary solution for the East Verde Park's water shortages until the Company can develop a permanent solution. Further, complaints filed in the docket show that there is a customer perception of abuse with regards to the level of water purchased. Consequently, the cap will help to incent the Company to find a permanent solution and, at the same time, help to alleviate customer perceptions and concerns about the proper use of the water purported to be purchased exclusively for the needs of this system.[55] Staff's recommendation of a cap on water hauling expenses is reasonable and should be adopted.

VIV. OTHER RECOMMENDATIONS

Staff recommended that the Company file a permanent rate application using a 2016 test year no later than June 30, 2017.[56] Staff also recommended that the Company develop a record keeping policy and file such policy in this docket within 60 days of the Commission decision in this matter.[57] The Company testified that Staff's recommendation regarding record keeping was reasonable.[58] Staff's recommendations are reasonable and should be adopted.

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[53] Ex. S-16 at 8, Brown Supp. Surrebut.
[54] Tr. at 347-348..
[55] *Id.*
[56] *Id.* at 9.
[57] *Id.* at 10.
[58] Tr. at 346-347.

X. CONCLUSION

For the foregoing reasons, Staff respectfully requests the Commission to adopt its recommendations in this proceeding.

RESPECTFULLY SUBMITTED this 10th day of March, 2014.

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