

OPEN MEETING ITEM



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ARIZONA CORPORATION COMMISSION

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DATE: MARCH 24, 2014  
DOCKET NO.: W-01445A-11-0310

TO ALL PARTIES:

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Enclosed please find the recommendation of Administrative Law Judge Dwight D. Nodes. The recommendation has been filed in the form of an Opinion and Order on:

ARIZONA WATER COMPANY  
(REHEARING OF DECISION NO. 73938, PURSUANT TO A.R.S. §40-253, AND  
REOPENING OF DECISION NO. 73736, PURSUANT TO A.R.S. §40-252)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and thirteen (13) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

APRIL 2, 2014

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Open Meeting to be held on:

APRIL 8, 2014 AND APRIL 9, 2014

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602) 542-4250. For information about the Open Meeting, contact the Executive Director's Office at (602) 542-3931.

JODI JERICH  
EXECUTIVE DIRECTOR

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**BEFORE THE ARIZONA CORPORATION COMMISSION**

**COMMISSIONERS**

BOB STUMP - Chairman  
GARY PIERCE  
BRENDA BURNS  
BOB BURNS  
SUSAN BITTER SMITH

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

DOCKET NO. W-01445A-11-0310

DECISION NO. \_\_\_\_\_

**OPINION AND ORDER ON  
REHEARING OF DECISION NO.  
73938, PURSUANT TO A.R.S. §40-253,  
AND REOPENING OF DECISION  
NO. 73736, PURSUANT TO A.R.S.  
§40-252**

DATES OF HEARING: November 25 and 26, 2013  
PLACE OF HEARING: Phoenix, Arizona  
ADMINISTRATIVE LAW JUDGE: Dwight D. Nodes  
APPEARANCES: Mr. Steven A. Hirsch, BRYAN CAVE, L.L.P., on behalf of Arizona Water Company;  
Mr. Daniel W. Pozefsky, Chief Counsel, on behalf of the Residential Utility Consumer Office;  
Mr. Jay L. Shapiro, FENNEMORE CRAIG, P.C., on behalf of Liberty Utilities;  
Mr. Timothy J. Sabo, ROSHKA, DEWULF & PATTEN, P.L.C., on behalf of Global Water;  
Mr. Garry D. Hayes, LAW OFFICES OF GARRY D. HAYES, P.C., on behalf of the City of Globe;  
Mr. Michael T. Hallam, LEWIS AND ROCA, L.L.P., on behalf of EPCOR Water Arizona, Inc.; and  
Ms. Bridget Humphrey and Mr. Wesley C. Van Cleve, Staff Attorneys, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

1 **BY THE COMMISSION:**2 **Procedural History**

3 On August 5, 2011, Arizona Water Company ("AWC" or "Company") filed with the Arizona  
 4 Corporation Commission ("Commission") an application requesting adjustments to its rates and  
 5 charges for utility service provided by its Eastern Group water systems, including its Superstition  
 6 (Apache Junction, Superior, and Miami); Cochise (Bisbee and Sierra Vista); San Manuel; Oracle;  
 7 SaddleBrooke Ranch; and Winkelman water systems. AWC also requested several other  
 8 authorizations in the application.

9 On February 20, 2013, the Commission issued Decision No. 73736 ("Phase 1"), granting  
 10 AWC a rate increase for its Eastern Group systems and, among other things, keeping the docket open  
 11 for purposes of further consideration of AWC's proposed Distribution System Improvement Charge  
 12 ("DSIC"). Additional hearings were conducted and, on June 27, 2013, the Commission issued  
 13 Decision No. 73938 ("Phase 2") which approved a System Improvement Benefits ("SIB")  
 14 mechanism for AWC.<sup>1</sup>

15 On July 17, 2013, RUCO filed an Application for Rehearing of Decision No. 73938, pursuant  
 16 to Arizona Revised Statutes ("A.R.S.") § 40-253. RUCO requested rehearing on two issues: that the  
 17 Commission should have reduced AWC's cost of equity when the SIB mechanism was approved; and  
 18 that the SIB mechanism does not qualify as an adjustor mechanism and is therefore illegal under  
 19 Arizona law.

20 On August 1, 2013, AWC filed a Response in Opposition to RUCO's Application for  
 21 Rehearing.

22 On August 5, 2013, the Commission voted in a Staff Open Meeting to grant RUCO's  
 23 Application for Rehearing "for the sole purpose of extending the time for the Commission to further  
 24 consider the application...."

25 On August 15, 2013, the Commission passed the following motion made by Commissioner  
 26

27 <sup>1</sup> Intervention was granted in Phase 1 to the Residential Utility Consumer Office ("RUCO"). Additional interventions  
 28 were granted in Phase 2 to Rio Rico Utilities, Inc. dba Liberty Utilities ("Liberty Utilities"); EPCOR Water Arizona, Inc.  
 ("EPCOR"); Global Water Utilities ("Global Water"); the Arizona Investment Council ("AIC"); the Water Utility  
 Association of Arizona ("WUAA"); and the City of Globe ("Globe").

1 Bitter Smith during a Staff Open Meeting:

2 ...[to] grant RUCO's Application for Rehearing of Decision No.  
3 73938, and also [re]open Decision No. 73736, under A.R.S. § 40-252,  
4 for consideration of modifying the Decision [73736] concerning the  
5 determination made related to the return on equity, and that these  
6 matters shall be consolidated. Further, as part of my motion, the  
7 Hearing Division is directed to hold proceedings on these consolidated  
8 matters and prepare a Recommended Order for the Commission's  
9 consideration.

10 On August 26, 2013, a Procedural Order was issued scheduling a procedural conference for  
11 September 4, 2013, to discuss scheduling and procedural issues regarding the rehearing ("Rehearing  
12 Phase").

13 On August 30, 2013, AIC filed a Notice of Waiver of Appearance stating that it would not be  
14 participating in the Rehearing Phase of the proceeding.

15 The procedural conference was held on September 4, 2013, as scheduled, during which the  
16 parties tentatively agreed to a hearing on November 25 and 26, 2013; filing of direct testimony by  
17 October 4, 2013; and filing of rebuttal testimony by October 31, 2013.

18 On September 11, 2013, AWC filed a Notice of Acceptability of Hearing Dates, confirming  
19 that the Company agreed with the tentative schedule established at the September 4, 2013, procedural  
20 conference.

21 On September 13, 2013, AWC filed a Status Report of all SIB-Eligible Projects.

22 On September 13, 2013, Commissioner Bitter Smith filed a letter to the docket regarding an e-  
23 mail she received from RUCO in response to a newspaper article she wrote.

24 On September 16, 2013, a Procedural Order was issued scheduling a hearing to commence on  
25 November 25, 2013, and establishing other testimony filing deadlines.

26 On September 18, 2013, RUCO filed transcripts of the February 12, 2013, and June 12, 2013,  
27 Open Meeting discussions regarding Phase 1 and Phase 2 of this proceeding.

28 On October 4, 2013, AWC filed the Rehearing Direct Testimony of Joel Reiker; Liberty  
Utilities and Global Water filed the Rehearing Direct Testimony of Paul Walker; RUCO filed the  
Rehearing Direct Testimony of Robert Mease, David Parcell, and Ralph Smith; and Staff filed the

1 Rehearing Direct Testimony of Steven Olea.

2 On October 31, 2013, AWC filed the Rehearing Rebuttal Testimony of Joel Reiker and  
3 Pauline Ahearn; Liberty Utilities and Global Water filed the Rehearing Rebuttal Testimony of Paul  
4 Walker and Greg Sorenson; RUCO filed the Rehearing Rebuttal Testimony of David Parcell and  
5 Ralph Smith; and Staff indicated that it would not be filing Rehearing Rebuttal Testimony.

6 On December 20, 2013, RUCO filed its Opening Rehearing Brief.

7 On January 17, 2014, AWC, Staff, EPCOR, and Liberty Utilities/Global Water filed  
8 Rehearing Responsive Briefs.

9 On January 24, 2014, RUCO filed its Reply Rehearing Brief.

10 **Background of DSIC/SIB Mechanisms Related to This Proceeding**

11 As described in the Phase 1 Order in this proceeding (Decision No. 73736), and again in  
12 Phase 2 (Decision No. 73938), AWC originally proposed implementation of a DSIC mechanism that  
13 would “allow it to recover, through abbreviated proceedings between general rate cases, the costs of  
14 the infrastructure necessary to replace its aging infrastructure, thereby ensuring the continued  
15 reliability of its service in the Eastern Group.” (Decision No. 73736, at 84.) AWC claimed that a  
16 substantial investment in replacement of infrastructure was necessary to enable the Company to  
17 comply with Commission directives to reduce water losses on various systems to acceptable levels.  
18 (*Id.* at 84-85.)

19 In Decision No. 73736, we did not authorize AWC’s proposed DSIC mechanism but indicated  
20 that “we are supportive of the DSIC mechanism and therefore we will leave this Docket open to  
21 allow the parties the opportunity to enter into discussions regarding AWC’s DSIC proposal and other  
22 DSIC like proposals Staff may wish to introduce.” (*Id.* at 104.) We also allowed an opportunity for  
23 other parties to intervene, and directed the Hearing Division to schedule further proceedings and issue  
24 a proposed Order. (*Id.* at 105.)

25 As described in Decision No. 73938, a Phase 2 Settlement Agreement signed by all parties  
26 except RUCO and Globe was filed on April 1, 2013; testimony was filed on April 2, 2013, by AWC,  
27 Staff, Liberty Utilities, Global Water, EPCOR, and AIC in support of the Phase 2 Settlement  
28 Agreement, and by RUCO in opposition to the Settlement Agreement; and an evidentiary hearing

1 was conducted on April 8 and 11, 2013. A Phase 2 Recommended Opinion and Order was issued on  
2 May 28, 2013; the matter was discussed by the Commission at its June 11 and 12, 2013, Open  
3 Meeting, during which an amended Opinion and Order was approved; and Decision No. 73938 was  
4 docketed on June 27, 2013.

5 In order to provide additional background for this Rehearing Phase of the proceeding, and  
6 because RUCO's Application for Rehearing seeks to eliminate the SIB mechanism approved in  
7 Decision No. 73938, we will summarize the positions of the parties in support of the Phase 2  
8 Settlement Agreement, as described in Decision No. 73938.

9 **Key Provisions of Phase 2 Settlement Agreement**

10 The Phase 2 Settlement Agreement ("Settlement Agreement," "Settlement," or "Agreement")  
11 includes a number of provisions related to the SIB mechanism and surcharge that the signatory  
12 parties claimed contain significant compromises compared to AWC's Phase 1 DSIC proposal, as  
13 revised during the course of the Phase 1 proceedings.

14 The Settlement provides, among other things for: Commission pre-approval of SIB-eligible  
15 projects; SIB project eligibility criteria; a limit on SIB surcharge recovery to the pre-tax rate of return  
16 and depreciation expense associated with SIB-eligible projects; an "efficiency credit" of five percent;  
17 a cap on the SIB surcharge of five percent of the Phase 1 revenue requirement; separate line items on  
18 customer bills reflecting the SIB surcharge and the efficiency credit; Commission approval of the SIB  
19 surcharge prior to implementation and adjustments; a limit of five SIB surcharge filings between  
20 general rate cases; an annual true-up of the SIB surcharge; and notice to customers at least 30 days  
21 prior to SIB surcharge adjustments.

22 **SIB Mechanism**

23 As defined in the Settlement, the SIB mechanism "is a ratemaking device designed to provide  
24 for the timely recovery of the capital costs (depreciation expense and pre-tax return on investment)  
25 associated with distribution system improvement projects meeting the requirements contained herein  
26 and that have been completed and placed in service and where costs have not been included for  
27 recovery in Decision No. 73736." (Phase 2 Ex.A-1, ¶2.3.)

28 The SIB surcharge is applicable only to plant replacement investments needed to provide

1 adequate and reliable service to existing customers and that “are not designed to serve or promote  
2 customer growth.” (*Id.* at ¶2.1.)

### 3 Approval of SIB-Eligible Projects

4 Under the terms of the Settlement Agreement, all of the SIB-eligible projects must be  
5 reviewed by Staff and approved by the Commission prior to being included by AWC in the SIB  
6 surcharge. For purposes of eligibility, the specific projects proposed for inclusion in the initial  
7 surcharge are described in Exhibit A to the Settlement. On a going-forward basis, all of the projects  
8 must be completed and placed into service prior to being included in the SIB surcharge. (Phase 2 Ex.  
9 A-1, ¶2.5.) AWC is also required to file a report with the Commission every six months  
10 summarizing the status of all SIB-eligible projects. (*Id.* at ¶4.8.)

### 11 Costs Eligible for SIB Recovery

12 Cost recovery under the SIB mechanism is allowed for the pre-tax return on investment and  
13 depreciation expense for projects meeting the SIB-eligible criteria and for depreciation expense  
14 associated with those projects, net of associated plant retirements. (*Id.* at ¶3.2.) The Settlement  
15 provides that the rate of return, depreciation rates, gross revenue conversion factor and tax multiplier  
16 are to be the same as those approved in Phase 1 in Decision No. 73736. (*Id.* at ¶3.2.1, 3.2.2, 3.2.3.)

### 17 Efficiency Credit

18 The Phase 2 Settlement provides that the SIB surcharge will include an “Efficiency Credit”  
19 equal to five percent of the SIB revenue requirement. (*Id.* at ¶3.3.)

### 20 Surcharge Cap

21 The Agreement caps the amount that is permitted to be collected annually by each SIB  
22 surcharge filing to five percent of the revenue requirement authorized in Decision No. 73736. (*Id.* at  
23 ¶3.4.)

### 24 Timing of SIB Surcharge Filings

25 Under the Settlement, AWC: may file up to five SIB surcharge requests between rate case  
26 decisions; may make no more than one SIB surcharge filing every 12 months; may not make its  
27 initial SIB surcharge filing for the Eastern Group prior to 12 months following the effective date of  
28 Decision No. 73736 (*i.e.*, February 20, 2014); must make an annual SIB surcharge filing to true-up its

1 surcharge collections; and must file a rate case application for its Eastern Group no later than August  
2 31, 2016, with a test year ending no later than December 31, 2015, at which time any SIB surcharges  
3 then in effect would be reviewed for inclusion in base rates in that proceeding and the surcharge  
4 would be reset to zero. (*Id.* at Sections 4.0 and 5.0.)

#### 5 **SIB Rate Design**

6 The Settlement Agreement states that the SIB surcharge will be a fixed monthly charge on  
7 customers' bills, with the surcharge and the efficiency credit listed as separate line items. The  
8 surcharge will increase proportionately based on customer meter size. (*Id.* at Section 8.0.)

#### 9 **Commission Approval of SIB Surcharge**

10 The Agreement provides that each SIB surcharge filing must be approved by the Commission  
11 prior to implementation. Upon filing of the SIB surcharge application, Staff and RUCO would have  
12 30 days to review the filing and dispute and/or file a request for the Commission to alter the  
13 surcharge or true-up surcharge/credit. AWC is also required to provide a proposed order with each  
14 SIB filing for the Commission's consideration, and if no objection is filed to the SIB surcharge  
15 request, the request shall be placed on an Open Meeting agenda at the earliest practicable date. (*Id.* at  
16 Section 9.0.)

#### 17 **Public Notice**

18 Under the terms of the Settlement, at least 30 days prior to a SIB surcharge becoming  
19 effective, AWC is required to provide public notice to customers in the form of a bill insert or  
20 customer letter. The notice must include: the individual surcharge amount by meter size; the  
21 individual efficiency credit by meter size; the individual true-up surcharge/credit by meter size; and a  
22 summary of the projects included in the current surcharge filing, including a description of each  
23 project and its cost. (*Id.* at ¶7.2.)

#### 24 **Positions of the Parties Regarding Phase 2 Settlement Agreement**

##### 25 **Arizona Water Company**

26 In Phase 1, AWC asserted that its proposed DSIC was modeled after, and would operate in  
27 the same manner as, an ACRM, which has been accepted by the Commission and others as being  
28 consistent with Arizona law. (Phase 1 AWC Br. at 23.) AWC also claimed that the Commission has

1 substantial discretion to adopt ratemaking methodologies and approaches as necessary to address  
2 particular issues and that the Commission has used this discretion previously to include CWIP within  
3 rate base (to set rates for plant not yet completed at the end of a historical test year) because the  
4 public interest is served by rate stability, not by constant rate hearings. (*Id.* at 23-24.) AWC argued  
5 that the Court of Appeals' decision in *Scates v. Arizona Corp. Comm'n* acknowledged the  
6 Commission's ability to adjust rates outside of a general rate case setting in exceptional  
7 circumstances, but expressly did not decide whether the Commission could authorize a partial rate  
8 increase without requiring completely new submissions or "whether the Commission could have  
9 referred to previous submissions with some updating or whether it could have accepted summary  
10 financial information." (Phase 1 AWC Br. at 23-25 (quoting *Scates*, 118 Ariz 531, at 537, 578 P.2d  
11 612, at 618 (App. 1978).) In response to RUCO's arguments in Phase 1, AWC asserted that RUCO  
12 had ignored that the DSIC was modeled on the ACRM, which the Commission has determined to be  
13 constitutional. AWC also argued that the Arizona Supreme Court in *Arizona Cmty. Action Ass'n v.*  
14 *Arizona Corp. Comm'n* authorized step increases between rate cases under certain conditions. (Phase  
15 1 AWC Reply Br. at 14-15, citing *Arizona Cmty. Action*, 123 Ariz. 228, 599 P.2d 184 (1979).)

16 AWC contended in Phase 2 that the SIB, which is a DSIC-like mechanism, is a necessary  
17 remedy for the Company's inability to recover its cost of service for the past 16 years, resulting in  
18 AWC's shareholders subsidizing the Company's operations by more than \$41 million since 1996.  
19 (Phase 2 Tr. 63-64.) The Company asserted that its inability to earn authorized returns has  
20 undermined the ability to finance critical infrastructure replacement and improvement projects,  
21 resulting in detrimental impacts on customers due to frequent line breaks on aging distribution lines.  
22 (Phase 1 Tr. 329, 370.)

23 AWC claimed that thousands of breaks occur every year in the Eastern Group systems but  
24 current ratemaking policies hinder the Company's ability to make necessary infrastructure  
25 replacements and improvements. The Company pointed out that its Eastern Group contains over 3.5  
26 million lineal feet (600 miles) of water mains and over 33,000 service connections, of which 371,000  
27 lineal feet and 4,915 service connections need to be replaced over the next ten years. (Water Loss  
28 Reduction Report, at 7, 18; Phase 1 Exs. A-10, at 8, and A-28, at 35.)

1 In response to criticisms from RUCO in Phase 2, AWC asserted that although it regularly  
2 replaces failing infrastructure, and has a rigorous water loss reduction program, those ongoing efforts  
3 are not sufficient to replace the large portions of infrastructure that are at or beyond their useful lives.  
4 (Phase 1 Exs. A-9, at 14, and A-28, at 43-49.) According to AWC, the scale of the needed  
5 replacement program dwarfs the resources available to the Company, thereby requiring  
6 implementation of a ratemaking tool to assist in those efforts. (Phase 1 Exs. 9, at 15-16, and A-29, at  
7 FKS-RB8.) The Company argued that RUCO presented no evidence disputing the impending water  
8 infrastructure replacement crisis facing the Company; nor did RUCO present any credible evidence  
9 that a SIB mechanism is not fully justified under these circumstances.

10 AWC claimed that its infrastructure replacement program would require the expenditure of  
11 approximately \$67 million over the next ten years, which is nearly twice the amount of capital that  
12 was required to comply with the federal arsenic standards. (Phase 1 Exs. A-9, at 14-25, A-10, at 4-5,  
13 and A-28, at 73, 81.) The Company contended that spending \$67 million over the next ten years is an  
14 extraordinary expense that it does not have the resources to fund. (Phase 1 Ex. A-9, at 15-16; Phase 1  
15 Tr. at 370.) AWC asserted that its shareholders recently infused over \$10 million in equity, that the  
16 Company is not able to fund the needed replacements internally, and that its ability to finance those  
17 projects through issuance of additional long-term bonds is compromised by the Company's weakened  
18 financial state. (Phase 1 Tr. 332, 365-371.)

19 The Company argued that the SIB mechanism would provide credit support that will assist its  
20 efforts to attract capital to finance the infrastructure projects. AWC pointed out that the water  
21 industry is among the most capital intensive industries, and the SIB mechanism will help mitigate  
22 regulatory lag and add stability to cash flows, thereby helping to support the Company's credit  
23 quality, bond rating, and ability to attract capital. (Phase 1 Ex. A-34, at 21-22, 26; Phase 1 Tr. at 329-  
24 332.) AWC also contended that a DSIC-like mechanism, such as the SIB, would be viewed by credit  
25 rating agencies as credit supportive. (Phase 1 Ex. A-34, at 22-26.) AWC further claimed that the SIB  
26 mechanism will help the Company's ability to recover its cost of service and will reduce regulatory  
27 lag for the critical replacement projects. (Phase 2 Tr. 64; Ex. A-2, at 22.)  
28

1 AWC also argued that the SIB mechanism, like the ACRM that was approved previously,  
2 would provide significant benefits to customers by allowing the Company to replace and upgrade  
3 aging infrastructure while implementing more gradual and smaller rate increases. (Phase 1 Exs. A-5,  
4 at 4-5, and A-34, at 26-27.) The Company asserted that the SIB-eligible projects would be limited to  
5 aging infrastructure used to serve existing customers, and for which there is no disagreement  
6 regarding the need for replacement. (Phase 2 Ex. A-1, at Ex. A; Phase 2 Tr. 72-73, 127-128; Phase 1  
7 Exs. A-9, at 17-20, and A-28, FKS-13.)

8 AWC disputed RUCO's contention that a DSIC, or SIB, would shift risks to ratepayers  
9 because, according to the Company, absent approval of a SIB-like mechanism, the continued lag in  
10 recovery of infrastructure capital investment would leave the Company unable to recover its cost of  
11 service in a timely manner. (Phase 1 Exs. A-5 and A-34, at 6.) AWC contended that an ongoing  
12 inability to earn its authorized return on investment would ultimately result in higher rates to  
13 customers due to higher borrowing costs and more frequent rate cases. (Phase 1 Ex. A-5, at 6.) The  
14 Company claimed that rather than shifting risks to customers, the SIB would more closely align cost  
15 recovery with the customers that benefit from the infrastructure replacement projects. AWC also  
16 asserted that the SIB mechanism would promote rate stability by imposing more gradual, and smaller  
17 rate increases, while at the same time allowing the Company a better opportunity to recover its cost  
18 of service, resulting in a healthier company. (Phase 2 Tr. 64-65, 303; Ex. A-2, at 12-13.) AWC  
19 claimed that RUCO's Director agreed that, overall, rate gradualism and a healthy utility company  
20 provide benefits to customers. (Phase 2 Tr. 423, 453-455.)

21 AWC also opposed RUCO's suggestion that if a DSIC-like or SIB mechanism is approved,  
22 the Commission should reduce the Company's return on equity ("ROE"). The Company's witness in  
23 Phase 1, Ms. Ahern, testified that it was important for purposes of raising capital that AWC receive a  
24 sufficient ROE in conjunction with a DSIC mechanism, because even with such a mechanism  
25 investors' expected returns are not diminished. (Phase 1 Ex. A-34, at 29; Phase 1 Tr. 997-998.) Ms.  
26 Ahern stated that none of the other states that have adopted DSIC-like mechanisms have reduced the  
27 utility's ROE as a result. (*Id.*) The Company also cited to Staff witness Mr. Olea's testimony at the  
28 hearing that the 10.55 percent ROE authorized by the Commission in Phase 1 should not be reduced

1 as a result of the SIB Settlement Agreement because of the five percent efficiency credit built into the  
2 Agreement. (Phase 2 Tr. 272-273, 275-276.) According to AWC, Mr. Olea added that because the  
3 SIB-eligible plant is only a small portion of AWC's rate base, the authorized ROE and SIB should be  
4 considered separately. (*Id.* at 317-319.) AWC asserted that RUCO did not present evidence as to  
5 what an appropriate ROE adjustment should be as a result of a SIB, and presented no studies to  
6 support its claim that a ROE adjustment should be made. (Phase 2 Tr. 427, 487-489.)

7       Regarding the legal arguments associated with the SIB mechanism, AWC argued that  
8 although the Arizona Supreme Court requires that a utility's fair value rate base must be utilized  
9 when setting rates,<sup>2</sup> the Commission has substantial discretion to adopt methodologies and  
10 approaches necessary to address particular issues, such as the impending infrastructure crisis the  
11 Company claims is facing Arizona's investor owned water companies. (*Arizona Corp. Comm'n v.*  
12 *Arizona Pub. Serv. Co.*, 113 Ariz. 368, 370, 555 P.2d 326, 328 (1976).) AWC asserted that in  
13 *Arizona Public Service*, the Arizona Supreme Court found that the Commission has discretion to  
14 consider post-test year events and it is in the public interest to have stability in the rate structure  
15 rather than a constant series of rate cases. (*Id.*)

16       AWC also cited *Arizona Community Action* in support of its contention that approval of the  
17 SIB mechanism is within the Commission's ratemaking discretion. In *Arizona Community Action*,  
18 the Arizona Supreme Court found that a two-step process for including CWIP in rate base, and  
19 increasing rates accordingly, was reasonable. Although the court struck down the Commission's use  
20 of the utility's ROE as the sole criterion for adjusting rates, it found that adding CWIP to the  
21 determination of fair value was reasonable under constitutional requirements if used only for a  
22 limited period of time. (123 Ariz. at 230-231, 599 P.2d at 186-187.)

23       The Company also argued that the holding in *Scates* supports the Commission's ability to  
24 adjust rates outside of a general rate case if exceptional circumstances exist, such as the Company  
25 believes are presented in this proceeding. In *Scates*, the Arizona Court of Appeals held that the  
26 Commission was required to determine the utility's fair value prior to authorizing adjustments to a  
27

28 <sup>2</sup> *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956).

1 telephone provider's charges for all installation, moving and changing of telephones. The court  
2 struck down the Commission's approval of rate increases for those charges because the Commission  
3 had not inquired as to whether the increased revenues received by the company resulted in a rate of  
4 return greater or lesser than the return established during the prior rate case hearing. (*Id.* at 534, 578  
5 P.2d at 615.) However, the court in *Scates* stated that there may be exceptional circumstances in  
6 which the Commission could authorize partial rate increases without the submission of an entirely  
7 new rate case. (*Id.* at 537, 578 P.2d at 618.)

8 AWC asserted that the SIB mechanism is consistent with the cited court cases because the  
9 SIB surcharges would be based on specific, identifiable, quantifiable plant additions that are reviewed  
10 by Staff, and approved by the Commission, before they are implemented. The Company also  
11 claimed that it would be required to file annual summary schedules of infrastructure costs, and how  
12 those costs would affect customer rates. AWC argued that the five percent annual revenue cap, the  
13 limit of five SIB surcharge filings between rate cases, the requirement to file a rate case within five  
14 years to seek recovery of all of the SIB surcharge infrastructure costs, as well as notice requirements  
15 and other checks and approvals, are all factors that reflect consistency with the public interest,  
16 Arizona laws, and court cases interpreting the Arizona Constitution and applicable statutes. (Phase 2  
17 AWC Br. at 22.)

### 18 EPCOR

19 EPCOR argued in Phase 2 that the Commission should adopt the proposed SIB mechanism as  
20 set forth in the Settlement Agreement as a means of improving the fairness of water company  
21 regulation in Arizona and encouraging water utilities to make necessary replacements of water  
22 infrastructure. (Phase 2 EPCOR Ex. 1, at 2-3.) EPCOR witness Mr. Broderick stated that the SIB  
23 mechanism would reduce regulatory lag and increase the likelihood that utilities will undertake  
24 "earlier, well-paced and necessary improvements" to replace infrastructure in order to maintain or  
25 improve service to customers. (*Id.* at 3.)

26 EPCOR claimed that the open and transparent negotiation process that led to the Settlement  
27 Agreement, and the diverse interests involved, required compromises that resulted in an agreement  
28 that is in the public interest. EPCOR contended that the SIB mechanism provides benefits to utilities

1 and customers alike because it will allow surcharges only for replacement of existing plant and will  
2 allow for smaller, more gradual increases for customers, as well as an efficiency credit. (Phase 2  
3 EPCOR Br. at 2.)

4 **Arizona Investment Council**

5 AIC witness Mr. Yaquinto testified in support of the Phase 2 Settlement Agreement, stating  
6 that the SIB mechanism would provide AWC with an important tool for acquiring the capital needed  
7 to finance needed repairs to, and replacement of, infrastructure in the Company's aging systems.  
8 (Phase 2 AIC Ex. 1, at 4.) He indicated that the SIB surcharge would be permitted only for narrowly  
9 defined criteria, but would allow AWC the opportunity for more timely recovery of plant investments  
10 thereby reducing regulatory lag that he believes penalizes investors. (*Id.*) Mr. Yaquinto stated that  
11 AIC supported SIB-like mechanisms for all water and wastewater companies and, as set forth in the  
12 Settlement, the SIB is expected to serve as a template for other companies. (*Id.*)

13 AIC supported the Settlement Agreement because it believes the SIB mechanism will position  
14 AWC to compete for needed capital on better terms and conditions than would otherwise be available  
15 to replace critical infrastructure. (*Id.* at 5.) According to AIC, approval of ratemaking mechanisms  
16 like the SIB will signal to investors that there is an improved regulatory environment in Arizona,  
17 which will further enhance the ability of utilities in Arizona to compete for scarce capital. (*Id.*) Mr.  
18 Yaquinto claimed that the SIB mechanism will also benefit customers by enabling water companies  
19 to make infrastructure improvements to ensure safe and reliable service, and due to efficiencies from  
20 those infrastructure investments that will flow to customers through the five percent efficiency credit.  
21 (*Id.* at 5-6.) Finally, AIC contended that customers will benefit from the SIB mechanism because  
22 there will be smaller rate increases associated with plant investments that will be spread more  
23 gradually. (*Id.* at 6.)

24 **Liberty Utilities/Global Water**

25 Liberty Utilities and Global Water (jointly "Liberty/Global") contended in Phase 2 that the  
26 SIB is in the public interest because it provides a needed mechanism for funding infrastructure  
27 replacements for aging facilities. They claimed that the level of needed infrastructure investment is  
28 substantial and even if AWC and other water utilities were able to raise the necessary capital to fund

1 such projects, the result for customers would be massive and sudden rate increases once those  
2 investments are recognized in rate base. Liberty/Global stated that the better way to address these  
3 infrastructure needs is to adopt a mechanism like the SIB, citing to the testimony of Mr. Olea that  
4 companies have to have the funds to provide adequate, safe, and reliable service – and the SIB will  
5 provide a better opportunity for the Company to do so. (Phase 2 Tr. 375.) Liberty/Global also  
6 referred to Mr. Olea’s claim that the SIB will benefit both the Company and customers by having a  
7 company that is capable of making necessary replacements and improvements so that customers can  
8 receive safe and reliable water service. (*Id.* at 304.)

9 Liberty/Global contended that a key benefit of the SIB is that smaller, more gradual rate  
10 increases are preferable to customers. (Phase 2 Global Ex. 2, at Attach. 2; Phase 2 EPCOR Ex. 1, at  
11 3; Phase 2 Liberty Ex. 1, at 2.) They claimed that with more gradual rate increases it is likely that  
12 full, contested rate cases seeking large increases will become less frequent, and that gradualism is  
13 built into the Settlement by virtue of the five percent annual cap on SIB surcharge increases. (Phase 2  
14 Global Ex. 2, at Attach. 2; Phase 2 Ex. A-1, at ¶3.4.) Another benefit cited by Liberty/Global is the  
15 five percent efficiency credit, which they claim has not been adopted in any other state that has  
16 approved a DSIC-like mechanism. (Phase 2 Global Ex. 2, at 3-4.) They pointed to Mr. Olea’s Phase  
17 2 testimony that the efficiency credit represents an actual dollar benefit to ratepayers that the  
18 Company will never get back. (Phase 2 Tr. 265, 330.) Liberty/Global further contend that the SIB  
19 will enhance the Company’s financial stability by improving earnings and cash flow, and thereby its  
20 ability to raise funds. (Phase 2 Ex. A-2, at 11-12.)

21 Liberty/Global asserted that the Phase 2 Settlement Agreement’s indication that it may be  
22 used as a template for other companies furthers the public interest by providing uniformity of  
23 administration, and potentially reduces Staff’s workload in reviewing SIB filings. (Phase 2 Tr. 208,  
24 248.) Liberty/Global claim that the SIB was carefully designed because it is intended to be used as a  
25 template that would place more of the administrative burden on utilities, rather than Staff, to allow  
26 for quicker processing. (*Id.* at 288, 291-292.)

27 With respect to the legal arguments raised by RUCO, Liberty/Global claimed that the SIB  
28 mechanism was specifically tailored to comply with all applicable legal requirements regarding

1 ratemaking, including the fair value requirement of the Arizona Constitution. They asserted that the  
2 SIB is a ratemaking adjustor mechanism that is designed to provide for the timely recovery of capital  
3 costs invested for system improvement projects meeting specific defined criteria, within AWC's  
4 general rate proceeding. Liberty/Global contended that Arizona law does not prohibit use of a  
5 ratemaking adjustor mechanism as long as the mechanism is approved in a rate case and it comports  
6 with the fair value requirement in Article 15, § 14 of the Arizona Constitution. They claimed that the  
7 SIB is nearly identical in nature to the Environmental Improvement Surcharge ("EIS") approved for  
8 Arizona Public Service Company ("APS") in Decision No. 73183 (May 24, 2012), pursuant to a  
9 settlement agreement in the last APS rate case. Liberty/Global pointed out that the APS settlement  
10 was signed by APS, Staff, RUCO and a number of other parties without challenge to the legality of  
11 the EIS. Liberty/Global contended that due to the similarities between the EIS and SIB, the  
12 Commission's approval of the EIS effectively approved the legality of the SIB as well. (Phase 2  
13 Liberty/Global Br. at 10-11.)

14 Liberty/Global disputed RUCO's contention that approval of a DSIC (or SIB) is an  
15 extraordinary ratemaking scheme that is legally impermissible. They asserted that approval of the  
16 SIB would be within the structure of AWC's base rate case, and the Commission has approved many  
17 types of adjustors and similar mechanisms in other dockets. Liberty/Global argued that although the  
18 SIB does not fall into the category of an automatic adjustment clause for specific expenses such as  
19 gas and electric fuel costs, it is intended to recover plant investment costs incurred by the utility for  
20 making necessary system improvements and is therefore consistent with the requirements of *Scates*.  
21 Liberty/Global contend that the *Scates* decision, adjustment clauses are generally acceptable if done  
22 within the framework of a utility's rate structure, in accordance with all statutory and constitutional  
23 requirements, and are "designed to insure that, through the adoption of a set formula geared to a  
24 specific readily identifiable cost, the utility's profit or rate of return does not change." (*Scates, supra*,  
25 118 Ariz. 531, 535, 578 P.2d 612, 616 (App. 1978).) According to Liberty/Global, the SIB satisfies  
26 these requirements because the surcharge would apply only to projects meeting specific criteria, and  
27 applies a set formula to readily identifiable and defined plant, using the rate of return established in  
28

1 Phase 1, thereby ensuring the Company's authorized rate of return does not change. (Phase 2 Ex. A-  
2 1, at ¶¶ 3.0, 3.2, 6.3.)

3 Liberty/Global asserted that even if the Commission were to determine that the SIB is not a  
4 ratemaking adjustor mechanism, it is still a lawful surcharge authorizing rate increases based on a  
5 determination of AWC's fair value rate base, pursuant to the holding in *Residential Utility Consumer*  
6 *Office v. Arizona Corp. Comm'n*, 199 Ariz. 588, 20 P.3d 1169 (App. 2001) ("*Rio Verde*").  
7 Liberty/Global claimed that contrary to RUCO's contention (Phase 2 Tr. 501), the Arizona  
8 Constitution does not require that the Commission take all ratemaking elements into consideration as  
9 would be done in a general rate case, but rather only requires that the fair value of a utility's property  
10 be ascertained when setting rates. (Arizona Constitution, Article 15, § 14.) They contended that once  
11 fair value is ascertained, as would be done each time a SIB surcharge adjustment is approved, the  
12 Commission has ample discretion to use the fair value in setting rates or adjusting a surcharge.

13 Liberty/Global disputed the RUCO witness' claim that the Commission would not be making  
14 a new fair value determination as part of each surcharge filing. (Phase 2 RUCO Ex. 12, at 13.)  
15 Liberty/Global pointed out that the Settlement Agreement requires a FVRB finding for AWC as  
16 established in Decision No. 73736, plus the additional SIB plant, along with the rate of return as  
17 applied to that FVRB and related revenue. (Phase 2 Tr. 332-333.) Citing *Simms v. Round Valley*  
18 *Light & Power Co.*, 80 Ariz. 145, 294 P.2d 378 (1956), Liberty/Global argued that the SIB fully  
19 complies with the fair value standard because the SIB requires a determination of the fair value of the  
20 Company's rate base, as well as the SIB plant, at the time the surcharges are proposed. (80 Ariz. 145,  
21 151, 294 P.2d 378, 382.) Liberty/Global asserted that all the Arizona Constitution requires is that the  
22 Commission determine and consider fair value in setting rates, as reinforced in the Arizona Supreme  
23 Court's decision in *US West Comm., Inc. v. Arizona Corp. Comm'n*, 201 Ariz. 242, 245-246, 34 P.3d  
24 351, 354-355 (2001) ("*US West II*") and the Court of Appeals' decision in *Phelps Dodge Corp. v.*  
25 *Arizona Elec. Power Co-op., Inc.*, 207 Ariz. 95, 106, 83 P.3d 573, 584 (App. 2004) ("*Phelps*  
26 *Dodge*"). According to Liberty/Global, both *US West II* and *Phelps Dodge* confirm that the  
27 Commission has broad discretion in using the fair value determination, as long as the fair value is  
28 ascertained as part of the analysis. They claimed that the Commission has the discretion to adopt

1 mechanisms necessary to address particular ratemaking issues, including matters subsequent to a  
2 historic test year and construction projects contracted and commenced during the test year (*Arizona*  
3 *Public Service, supra*, at 371, 555 P.2d at 329), as well as construction work in progress that is not  
4 yet in service (*Arizona Comty. Action, supra*, at 230, 599 P.2d at 186.) Liberty/Global also pointed to  
5 the Commission's adoption in prior cases of an ACRM, without a legal challenge, that enabled water  
6 utilities to comply with federal arsenic standards, as an example of a mechanism that supports  
7 approval of the SIB in this case.

8 Liberty/Global contended that, as a matter of law, the SIB mechanism falls within the  
9 Commission's broad discretion and is consistent with relevant court decisions. They asserted that the  
10 Commission had already determined the fair value of AWC's rate base in Phase 1; that any SIB  
11 surcharge will be based on specific infrastructure added to the approved rate base; and that AWC will  
12 be required to file annual summary schedules of the actual plant addition costs, along with FVRB  
13 information that will enable the Commission to determine, in accordance with *Scates*, how the  
14 proposed surcharge would impact the Company's rate of return. Liberty/Global claim that, following  
15 that analysis, under the terms of the Settlement, the SIB surcharge would only be permitted to the  
16 extent that AWC's return on rate base for a particular system does not exceed the rate of return  
17 authorized by Decision No. 73736. (Phase 2 Liberty/Global Br. at 17-18.)

18 Liberty/Global also argued that the SIB mechanism satisfies all required ratemaking elements  
19 under Arizona law because the SIB revenue requirement is based on the established rate of return, as  
20 well as the Phase 1 authorized gross revenue conversion factor/tax multiplier and depreciation rates,  
21 less the five percent efficiency credit, which thereby effectively reduces the SIB plant return on  
22 equity and ensures that AWC's rate of return does not increase. Other requirements cited by  
23 Liberty/Global included: the limitation of SIB surcharge filings to once every 12 months, and no  
24 more than 5 filings between general rate cases; annual true-up filings; submission of detailed  
25 information showing an analysis of the effect of the SIB plant on FVRB, revenue, and the fair value  
26 rate of return approved in Decision No. 73736; and a 30-day review period for Staff and RUCO, as  
27 well as review and approval by the Commission. (*Id.* at 20-21.) Finally, Liberty/Global contended  
28 the EIS approved in the most recent APS rate case, pursuant to a settlement signed by RUCO and a

1 number of other parties, is very similar to the proposed SIB and therefore if the EIS is legal, the SIB  
2 must likewise be legal.

3 **Staff**

4 In Phase 1, Staff asserted that the DSIC, as proposed by AWC, did not comply with the  
5 Arizona Constitution. (Phase 1 Staff Br. at 26.) Staff stated that the Arizona Constitution requires  
6 the Commission to determine the fair value of a utility's property in order to set just and reasonable  
7 rates, but allows the Commission to make adjustments to rates outside of a rate case through rate  
8 adjustors under very limited circumstances. (*Id.*) Staff added that this authority was limited to  
9 exceptional situations and that to remain in compliance with the Arizona Constitution, the  
10 Commission is still required to determine fair value and to consider the overall impact of the  
11 adjustment on the rate of return. (*Id.* (citing *Scates*, 118 Ariz. at 533.)) Staff also asserted in Phase 1  
12 that AWC had not provided sufficient detail to allow for a determination that the proposed DSIC  
13 would meet the constitutional requirements. (*Id.* at 26-27.) For example, Staff expressed doubt in  
14 Phase 1 concerning the extent or nature of Staff's evaluation of the new plant and its prudence,  
15 Staff's ability to evaluate the overall impact of the rate increase, whether the DSIC would apply only  
16 to projects specifically listed in the DSIC Study, and how due process would be ensured. (*Id.*) Staff  
17 concluded in Phase 1 that without all of these details, the constitutionality of the DSIC cannot be  
18 determined and, thus, the DSIC must be denied.

19 Staff further asserted in Phase 1 that the scope of the DSIC was so broad that the "DSIC  
20 crosses over from the realm of an adjustor mechanism into a rate case." (*Id.* at 28.) Staff claimed in  
21 Phase 1 that the DSIC would not be used to recover costs, but instead to increase rate base; that the  
22 increased rate base would be included for all future calculations of rates; and that the surcharge  
23 would continue for the life of the asset in question, with the revenue generated to be treated as  
24 income rather than as a separate fund to be used to acquire the plant or pay the cost of the plant. (*Id.*)  
25 Staff also argued in Phase 1 that there were no exceptional circumstances that would justify the DSIC  
26 because AWC always knew that the infrastructure would need to be replaced someday and could and  
27 should have prepared for that day but failed to do so. (*Id.* at 27.)  
28

1           However, Staff stated in its Phase 1 reply brief that: “Staff does not believe that a DSIC, per  
2 se, would violate the Arizona Constitution so long as its methodology meets the constitutional  
3 mandate,” but that Staff was concerned that the proposed DSIC did not meet the mandate. (Phase 1  
4 Staff Reply Br. at 19.) Staff agreed with AWC’s contention that judicial interpretation of the Arizona  
5 Constitution is the origin of the requirement for a finding of fair value and the formula for ratemaking  
6 in which a rate of return is applied to that fair value. (*Id.* at 19-20 (citing *US West II*, 201 Ariz. 242,  
7 245-46, 34 P.2d 351, 354-355).) Staff acknowledged that exceptions have been created for matters  
8 after the historic test year, including construction projects commenced during the test year and CWIP;  
9 for interim rates and automatic adjustment clauses; and for the ACRM. (*Id.* at 20-21.) Staff asserted,  
10 however, that the DSIC proposed in Phase 1 did not qualify as any of these—that it could not be  
11 justified as an interim rate because there was no emergency, and it could not be justified as an  
12 adjustor mechanism because it was designed to pass on the cost of new plant rather than changes in  
13 specific and segregated costs. (*Id.* at 21-22.) Staff indicated that, unlike an ACRM, the proposed  
14 Phase 1 DSIC would apply to more than one plant, would not be limited to only two step increases,  
15 and would not impose a requirement for a rate case application to be filed by a specific date with a  
16 rate case (including a true-up) to follow. (*Id.* at 22.)

17           In Phase 2, Staff negotiated and signed the Settlement Agreement that Staff asserted remedies  
18 the issues identified by Staff in Phase 1 as being legally problematic. Staff contended that the record  
19 supported a finding that AWC’s infrastructure replacement needs are extraordinary in scope, and that  
20 customers will benefit from timely replacement of aging plant through decreased water losses, fewer  
21 outages, and improved quality of service. (Phase 2 Staff Br. at 2.) Staff disputed RUCO’s assertion  
22 that rate setting methods must be limited to those traditionally employed in general rate cases. Staff  
23 pointed to the ACRM as a mechanism initially employed by the Commission a decade ago, without  
24 legal challenge, to address an extraordinary situation presented by more stringent arsenic limits  
25 imposed by the USEPA, which adversely affected a number of water companies in Arizona. (*See*,  
26 *e.g.*, Decision No. 66400 (October 14, 2003).)

27           According to Staff, the SIB mechanism comports with the requirements of the Arizona  
28 Constitution because it would require the Commission to ascertain AWC’s fair value rate base each

1 time a surcharge adjustment is made. Staff pointed out that Section 7 of the Phase 2 Settlement  
2 specifically requires the Company to provide a schedule (Schedule D) with each adjustment filing  
3 that would enable the Commission to update the fair value rate base determined in Phase 1 to reflect  
4 additional SIB-eligible plant, which updated fair value finding would be set forth in a Commission  
5 Order approving each surcharge request. Staff asserted that it is not reasonable to suggest that the  
6 Commission would not use the updated fair value information “to aid it in the proper discharge of its  
7 duties...” as required by the Constitution. (Arizona Constitution, Article 15, § 14.) Staff also noted  
8 that the Commission may terminate the SIB at any time. (Phase 2 Ex. A-1, at ¶10.1.)

9 Staff argued that the Commission has broad discretion in employing appropriate rate setting  
10 methodologies. Staff cited *Simms, supra*, wherein the Arizona Supreme Court stated that “[t]he  
11 commission in exercising its rate-making power of necessity has a range of legislative discretion and  
12 so long as that discretion is not abused, the court cannot substitute its judgment as to what is fair  
13 value or a just and reasonable rate.” (80 Ariz. 145, 154, 294 P.2d 378, 384, internal citation omitted.)  
14 Staff claimed that the SIB would allow the Commission to implement a series of step rate increases,  
15 only after making an updated fair value finding, as a means of enabling AWC to undertake  
16 substantial infrastructure replacements without having to file a series of rate cases – which the courts  
17 have found would not be in the public interest. (*Arizona Public Service, supra*, 113 Ariz. 368, 371,  
18 555 P.2d 326, 329.) Staff also cited *Arizona Community Action*, wherein the Arizona Supreme Court  
19 upheld the Commission’s approval of step increases associated with CWIP additions (although the  
20 court rejected using APS’ ROE as the sole criterion for triggering an increase). (123 Ariz. 228, 229-  
21 231, 599 P.2d 184, 186-187.) In that case, the court stated that it did not find fault with the  
22 Commission’s attempt to avoid a constant series of extended rate hearings by allowing step increases  
23 based on the updated CWIP adjustments. (*Id.* at 230-231, 599 P.2d at 186-187.) Staff contended that  
24 the SIB does not suffer from the “sole criterion” deficiency rejected by the court because the SIB  
25 does not employ an earnings test, or any other test, that would be subject to control by the Company.

26 Staff pointed out that the SIB has a number of protections built in, including that: it was  
27 developed within the context of a full AWC rate case; it is limited to replacement projects used to  
28 serve existing customers, less retirements; each SIB surcharge would be capped at five percent of the

1 Phase 1 revenue requirement, subject to true-up; AWC is required to file a full rate case by August  
2 31, 2016, thus ensuring that the SIB adjustments will be of limited duration; each step increase will  
3 be approved by Commission Order; the SIB may be suspended by the Commission; and the  
4 Commission will make a fair value finding prior to approval of each SIB adjustment, based on  
5 detailed schedules verifying the plant additions that are SIB-eligible. (Phase 2 Staff Br. at 6-7.)

6 Staff disputed RUCO's "single issue ratemaking" arguments, claiming that contrary to  
7 RUCO's assertions, the Arizona Constitution does not include that terminology, and under the  
8 holding in *Scates* a full rate case is not required for every rate adjustment given the court's statement  
9 that "[t]here may well be exceptional situations in which the Commission may authorize partial rate  
10 increases without requiring entirely new submissions." (*Scates*, 118 Ariz. at 537, 578 P.2d at 618.)  
11 The court in *Scates* stated that it was not deciding "whether the Commission could have referred to  
12 previous submissions with some updating or whether it could have accepted summary financial  
13 information." (*Id.*) Staff claimed that the SIB requires updated information to be submitted by the  
14 Company and there is no reason to assume that the Commission would not consider that information  
15 in its evaluation of each SIB surcharge filing. Staff pointed to Mr. Olea's testimony that if objections  
16 were filed regarding the specific SIB schedules submitted by the Company, "Staff's expectations  
17 would be that the SIB would not go forward and such proceedings as the Commission or Hearing  
18 Division may order would ensue...." (Phase 2 Tr. 250.)

19 Staff also contended that, contrary to RUCO's claims, Staff's position regarding AWC's  
20 proposed DSIC in Phase 1 was not inconsistent with its support for the SIB in Phase 2. Staff asserted  
21 that its concerns in Phase 1 were that the DSIC provided benefits only to the Company, and that the  
22 DSIC lacked certain features that were necessary to comply with Arizona law. Staff claimed that  
23 those issues were resolved by the Settlement Agreement because the SIB provides for a five percent  
24 efficiency credit that directly benefits ratepayers, and the SIB contains elements that comply with  
25 Arizona law regarding fair value, step increases, and the corresponding impact on rate of return.  
26 (Phase 2 Staff Br. at 9.)

27 According to Staff, the SIB provides an equitable balance between the interests of the  
28 Company and ratepayers because the SIB will enable AWC to attain timely recovery of capital

1 investments for needed repairs and replacements while, at the same time, benefitting customers by:  
2 providing better service; imposing a five percent efficiency credit on SIB plant; and providing for  
3 smaller and more gradual rate increases. (*Id.* at 10.) With respect to RUCO's suggestion that AWC's  
4 authorized ROE of 10.55 percent should be reduced, Staff contended that RUCO did not present  
5 evidence in either Phase 1 or 2 to support its arguments. Staff claimed that "as part of a DSIC-type  
6 mechanism, the parties and the ALJ could consider an *adjustment* to the ROE set by the  
7 Commission." (*Id.* at 11, emphasis original.) However, Staff argued that the 10.55 percent ROE  
8 approved in Decision No. 73736 should not be modified in Phase 2 because there was no evidence  
9 that AWC's overall risk would be reduced by adoption of the SIB, and the negotiated five percent  
10 efficiency credit is effectively a surrogate for a ROE adjustment because it reduces the ROE on SIB-  
11 eligible plant by approximately 87 basis points. (Phase 2 Staff Br. at 12-13.)

## 12 RUCO

13 RUCO argued in Phase 1 that there was no legal basis for the proposed DSIC in Arizona.  
14 RUCO stated that the Arizona Constitution generally requires the Commission to ascertain the fair  
15 value of a utility's property in Arizona when it engages in ratemaking, but that Arizona courts have  
16 allowed for two situations when the Commission may engage in ratemaking without making a fair  
17 value finding: (1) when the Commission has established an automatic adjustor mechanism, or (2)  
18 when the Commission approves interim rates. (Phase 1 RUCO Br. at 11-13 (citing, *inter alia*, *Scates*  
19 and AZ AG Op. 71-17).) RUCO asserted in Phase 1 that the DSIC was not an adjustor mechanism  
20 because it was not designed to be used to account for fluctuations in specified operating expenses  
21 caused by price volatility, but instead to recover the cost of replacing plant for which there is no  
22 allegation of price volatility. (*Id.* at 11-12.) RUCO further argued that the DSIC could not be  
23 authorized as an interim rate because AWC did not meet the criteria for obtaining interim rates (as  
24 provided in Arizona Attorney General Opinion No. 71-17), and the Company had not requested  
25 interim rates. (*Id.* at 13.) RUCO claimed in Phase 1 that the other states that have DSIC-type  
26 mechanisms have different laws than Arizona, and that Arizona law protects ratepayers from the  
27 piecemeal ratemaking and unfair rates that would result if the DSIC were approved. (*Id.* at 13-14.)

28

1           In its Phase 1 Reply Brief, RUCO addressed AWC's assertion that the DSIC proposed in  
2 Phase 1 must be constitutional because the ACRM is constitutional. RUCO claimed that the ACRM  
3 resulted from various stakeholders coming together to address a one-time event (the USEPA's  
4 adoption of a more stringent MCL for arsenic) that would impact dozens of Arizona water companies  
5 simultaneously; that the ACRM has been and is now treated as an adjustor mechanism, which is one  
6 of the limited exceptions to the constitutional fair value requirement as per Arizona case law; that the  
7 legality of the ACRM had never been called into question or reviewed by any Arizona court; and that  
8 whether the ACRM would satisfy the legal standard for an adjustor mechanism is "questionable and  
9 should not be presumed." (Phase 1 RUCO Reply Br. at 2.) RUCO added that the constitutionality of  
10 the ACRM was not at issue in this case and was irrelevant in considering the legality of the Phase 1  
11 DSIC. (*Id.* at 2-3.) RUCO reiterated that the Commission must find fair value when setting rates  
12 except in limited circumstances, which were not satisfied by the DSIC, and that the proposed DSIC  
13 was therefore not authorized under Arizona law. (*Id.* at 5.)

14           With respect to the Phase 2 Settlement Agreement, RUCO argued that the Agreement and  
15 proposed SIB were not in the public interest because they did not provide sufficient benefits and  
16 protections for ratepayers. RUCO also reiterated many of the same legal arguments it made in Phase  
17 1, contending that like AWC's proposed DSIC, the SIB would violate Arizona law.

18           RUCO did not dispute AWC's substantial infrastructure replacement needs; however, RUCO  
19 contended that those needs have long been known to the Company; that the Commission in Decision  
20 No. 73736 granted AWC an increase to its ROE to compensate the Company for those infrastructure  
21 needs; that the SIB fails to adequately recognize reduced operating expenses associated with the  
22 replacement plant; that ratepayers will pay more in the long run under the SIB; and that the five  
23 percent efficiency credit on SIB plant was inadequate compensation for the shifting of risk to  
24 ratepayers associated with reduced regulatory lag. (Phase 2 RUCO Br. at 1-3.)

25           RUCO argued that the SIB was not an adjustor mechanism or an interim rate, which it  
26 claimed are the only exceptions recognized by the courts to the constitutional requirement of  
27 ascertaining and employing a company's fair value rate base in setting rates. RUCO cited the *Scates*  
28 and *Rio Verde* decisions by the Court of Appeals to support its contention that adjustor mechanisms

1 may only be used to adjust narrowly defined operating expenses, such as fuel costs, and that an  
2 adjustor clause may only be implemented as part of a full rate hearing. (*Scates*, 118 Ariz. 531, 535,  
3 578 P.2d 612, 616; *Rio Verde*, 199 Ariz. 588, 592, 20 P.3d 1169, 1173.) RUCO claimed that the  
4 proposed SIB mechanism was not an adjustor mechanism because its purpose is not to make  
5 automatic adjustments for fluctuating operating expenses, but instead only serves to increase the  
6 Company's rate base and thus its operating income. RUCO asserted that the SIB only allows rates to  
7 adjust upwards as a result of permitting recovery of SIB-eligible plant costs, and that the SIB is not  
8 the type of adjustment mechanism contemplated by the court in *Scates*.

9         According to RUCO, the only other exception to a fair value finding in a full rate case is when  
10 interim rates are implemented, which would require that the Commission find the existence of an  
11 emergency; the posting of a bond by the utility; and an undertaking by the Commission to determine  
12 final rates after a valuation of the utility's property. (*Rio Verde, supra*, at 591, 20 P.3d at 1172.)  
13 RUCO stated that AWC did not assert that an emergency exists; nor did the Company request  
14 implementation of interim rates. RUCO cited Arizona Attorney General Opinion No. 71-17, which  
15 defined an emergency as when "sudden change brings hardship to a company, when a company is  
16 insolvent, or when the condition of the company is such that its ability to maintain service pending a  
17 formal rate determination is in serious doubt." RUCO claimed that AWC did not present evidence  
18 that it would meet any of the criteria to satisfy an emergency finding under that definition.

19         RUCO asserted in Phase 2 that the Arizona Constitution's fair value requirement would not  
20 be satisfied if rate increases were granted under the proposed SIB mechanism. According to RUCO,  
21 the SIB is not an adjustor mechanism but is simply a method to enable AWC to recover additional  
22 revenue based on capital investments made between rate cases. (Phase 2 RUCO Br. at 8.) RUCO  
23 contended that there were no exceptional circumstances presented in this case that would warrant  
24 approving the SIB. RUCO pointed to Mr. Olea's testimony at the Phase 2 hearing wherein he stated  
25 that the only extraordinary circumstance that developed between Phase 1, when Staff opposed the  
26 DSIC, and Phase 2, in which Staff supported the SIB, was the Commission's directive to the parties  
27 to negotiate regarding the DSIC issue. (Phase 2 Tr. 301.) RUCO claimed that a directive from the  
28 Commission is not the type of event that would constitute an extraordinary or exceptional situation.

1 RUCO argued that the Commission would not be making a new fair value finding each time  
2 the Company applies for a surcharge adjustment, citing to Mr. Rigsby's testimony. (Phase 2 RUCO  
3 Ex. 12, at 13.) Therefore, RUCO claimed, the SIB would not meet the constitutional fair value  
4 requirements under Arizona law. In its Phase 2 Brief, RUCO quoted a passage from *Simms*, wherein  
5 the Arizona Supreme Court stated:

6  
7 It is clear, therefore, that under our constitution as interpreted by this  
8 court, the commission is required to find the fair value of the  
9 company's property and use such finding as a rate base for the purpose  
10 of calculating what are just and reasonable rates....While our  
11 constitution does not establish a formula for arriving at fair value, it  
12 does require such value to be found and used as the base in fixing rates.  
13 The reasonableness and justness of the rates must be related to this  
14 finding of fair value.

15 (*Simms, supra*, 80 Ariz. at 151, 294 P.2d at 382.) RUCO contended that the Schedule D analysis that  
16 the Company would be required to file with each SIB adjustment request, and which would show the  
17 impact of plant additions on the Company's fair value rate base, revenue, and fair value rate of return  
18 established in Decision No. 73736, "does not go far enough." (Phase 2 RUCO Br. at 10.)

19 Citing the claims made in Mr. Rigsby's testimony (Phase 2 RUCO Ex. 12, at 13-15), RUCO  
20 suggested that although the Schedule D analysis was included in order to satisfy *Scates*, "the  
21 Commission will not, as required by law, make a meaningful finding of fair value and use that  
22 finding as a rate base for the purpose of establishing rates." (Phase 2 RUCO Br. at 11.) RUCO  
23 contended that *Scates* requires that all parts of the ratemaking equation must be evaluated – "at least a  
24 mini-type rate case" – before rate adjustments could be made, and the SIB is deficient because it  
25 examines only one part of the equation. (*Id.*) Therefore, according to RUCO, the SIB would  
26 constitute "single issue ratemaking" and would render the fair value requirement "meaningless." (*Id.*)

27 RUCO asserted that there were a number of other problems with the Settlement Agreement  
28 and the SIB mechanism, including: the five percent efficiency credit is insufficient to compensate  
ratepayers for shifting of risk; the Settlement does not explain what happens to the SIB after the next  
rate case; the SIB expands eligibility of recoverable costs to almost every kind of plant; the 10  
percent water loss criterion could be gamed and would create an incentive for the Company to

1 neglect certain systems near the 10 percent threshold so that plant replacements would become SIB-  
2 eligible; the SIB does not address the relationship between infrastructure replacement needs and use  
3 of depreciation expense funds or dividend payouts; the Settlement is unclear as to what will happen if  
4 a party objects to a SIB surcharge filing within the allotted 30-day period; the SIB does not include  
5 an earnings test; the SIB could generate revenues by serving new customers, despite language to the  
6 contrary in the Settlement; and there is no provision in the Settlement for adjusting the ROE to reflect  
7 adoption of the SIB. (Phase 2 RUCO Br. at 13-17.)

8 RUCO concluded that there were numerous reasons why the Settlement Agreement was not in  
9 the public interest. According to RUCO, the SIB is illegal under Arizona law; there is no tying of the  
10 SIB and authorized ROE; and the Commission specifically granted AWC a higher ROE in Phase 1 to  
11 address the Company's infrastructure needs. RUCO claimed that adoption of the Settlement would  
12 establish a dangerous precedent and encourage companies to seek both a SIB and higher ROE to  
13 address infrastructure needs, resulting effectively in double recovery for the same purposes.  
14 Therefore, RUCO requested that the Commission reject the Settlement Agreement. (*Id.* at 18-19.)

15 **Adoption of Phase 2 Settlement Agreement in Decision No. 73938**

16 We indicated in Decision No. 73938 that AWC had provided compelling evidence in Phase 1  
17 that its Eastern Group systems, most notably the Miami and Bisbee systems, have areas in which the  
18 pipes have corroded or otherwise degraded so as to become very fragile and to have leaks and breaks  
19 occurring at an excessive rate. (Decision No. 73938, at 41.) We also stated that AWC had established  
20 that the frequency of leaks and breaks in Eastern Group systems is generally increasing, and that no  
21 party had presented evidence effectively refuting AWC's assertion that it needed to begin replacing  
22 large amounts of infrastructure in its Eastern Group systems in an attempt to ensure system reliability  
23 and reduce excessive water loss. (*Id.*) We also found that no party had effectively refuted AWC's  
24 assertion in Phase 2 that its proposed three-year plan was a reasonable and appropriate plan to initiate  
25 the replacement of infrastructure on a much larger scale than has historically been performed, or  
26 AWC's position that it currently lacked the financial means to complete the infrastructure  
27 replacements in the timeframe it is proposing without obtaining additional funding in some manner.  
28 (*Id.*)

1 As described in Decision No. 73938, the Commission generally must determine a fair value  
2 rate base and apply a rate of return to that rate base when it develops rates. The case law interpreting  
3 the Commission's constitutional duties state that the Commission may diverge from this ratemaking  
4 method when authorizing interim rates in the event of an emergency (*i.e.*, interim rates), and when  
5 the Commission authorizes (in a rate case) an automatic adjustor mechanism to address specific costs  
6 occurring subsequent to the rate case. (*Id.*) However, *Scates* suggests that there may be exceptional  
7 situations that warrant a departure from the usual method. In Phase 2, RUCO took issue with AWC's  
8 comparison of its current situation to its need to construct arsenic treatment plants to come into  
9 compliance with the USEPA MCL standard for arsenic, and asserted that AWC's current  
10 infrastructure replacement needs do not rise to the level of an exceptional situation.

11 After considering all of the evidence and legal arguments presented at the Phase 2 hearing, we  
12 concluded that the Phase 2 Settlement Agreement, and the SIB mechanism incorporated therein,  
13 together with the required financial information and analysis, satisfied the fair value concerns  
14 addressed by various court decisions. (Decision No. 73938, at 50.) We stated that, from a practical  
15 perspective, the SIB would operate very similarly to the ACRM, with which the Commission now  
16 has extensive experience, and which the Commission has determined to be lawful. In approving the  
17 Settlement, we required the Company to include with its surcharge adjustment filings the following  
18 information: (1) the most current balance sheet at the time of the filing; (2) the most current income  
19 statement; (3) an earnings test schedule; (4) a rate review schedule (including the incremental and pro  
20 forma effects of the proposed increase); (5) a revenue requirement calculation; (6) a surcharge  
21 calculation; (7) an adjusted rate base schedule; (8) a CWIP ledger (for each project showing  
22 accumulation of charges by month and paid vendor invoices); (9) calculation of the three factor  
23 formula (as requested by Staff); and (10) a typical bill analysis under present and proposed rates. (*Id.*  
24 at 50-51.)

25 We also required AWC to perform an earnings test calculation for each initial filing and  
26 annual report filing to determine whether the actual rate of return reflected by the operating income  
27 for the affected system or division for the relevant 12-month period exceeded the most recently  
28 authorized fair value rate of return for the affected system or division, with the earnings test to be:

1 based on the most recent available operating income, adjusted for any operating revenue and expense  
2 adjustments adopted in the most recent general rate case; and based on the rate base adopted in the  
3 most recent general rate case, updated to recognize changes in plant, accumulated depreciation,  
4 contributions in aid of construction, advances in aid of construction, and accumulated deferred  
5 income taxes through the most recent available financial statement (quarterly or longer). (*Id.* at 51.)

6 We stated in Decision No. 73938 that, with this additional information, the SIB allows for a  
7 consideration of all of AWC's costs at the time a surcharge adjustment is made, and is therefore  
8 permissible under *Scates*. (*Id.*) We also indicated that the SIB mechanism addressed the concerns  
9 cited in *Scates* in that the SIB: is an adjustment mechanism established within a rate case as part of a  
10 company's rate structure; adopts a set formula that would allow only readily identifiable and  
11 narrowly defined plant to be recovered through the surcharge; and applies the rate of return  
12 authorized in Decision No. 73736 to SIB plant (less the five percent efficiency credit). (*Id.* at 52.)

13 In addition, we found that the SIB mechanism embodied in the Settlement Agreement,  
14 together with the additional financial information and analysis required, was compliant with the  
15 Commission's constitutional requirements, as well as the case law interpreting the Commission's  
16 authority and discretion in setting rates, because: the SIB surcharge would be based on specific,  
17 verified, and in-service plant additions that are reviewed by Staff and approved by the Commission  
18 prior to being implemented; and AWC would be required to submit annual summary schedules  
19 showing the actual cost of the infrastructure, and supporting documentation that will enable Staff and  
20 the Commission to determine how the proposed surcharge adjustments would impact the fair value  
21 rate of return for each affected system. (*Id.* at 53.)

22 We also indicated in Decision No. 73938 that the SIB mechanism was analogous to the step  
23 increases for CWIP plant that the court found to be a reasonable ratemaking device in *Arizona*  
24 *Community Action* (except for tying the increases solely to return on equity) because, although the  
25 SIB-eligible plant differs from CWIP to the extent that the SIB would not necessarily be under  
26 construction during the historical test year in the rate case, the requirement that the SIB plant must be  
27 fully constructed, and used in the provision of utility service (with verification that such is the case)  
28 prior to inclusion in a surcharge, provided the Commission with an even greater assurance (compared

1 with CWIP) that the SIB plant is used and useful and therefore serves as a proper basis for approving  
2 just and reasonable rates. (*Id.*)

3 By allowing up to five surcharge adjustments between full rate case applications, we  
4 concluded in Phase 2 that the SIB takes into account the court's observation in the same case that a  
5 constant series of rate hearings is not necessary to protect the public interest. (*Id.* at 230-231, 599  
6 P.2d at 186-187.) Further, by requiring the filing of a full rate case at least every five years (with a  
7 review in the subsequent case of all SIB plant that was included in the surcharge during the interim  
8 between rate cases), we found that the SIB also addressed the concern that the interim rate  
9 adjustments would only be in place for a limited period of time because, in addition to the five  
10 percent efficiency credit, the SIB mechanism also includes notice requirements to customers, a  
11 review period for Staff and RUCO (and an opportunity for other parties or customers to express  
12 opposition), and an Order by the Commission evaluating and approving the appropriateness of the  
13 SIB-eligible plant, including AWC's fair value rate base and rate of return. (*Id.* at 54.)

14 We therefore concluded in Decision No. 73938 that, "[w]ith these provisions and protections,  
15 as well as others discussed herein, we find that the Settlement Agreement represents a reasonable  
16 compromise of contested issues, is in accord with Arizona law and, as a whole, is consistent with the  
17 public interest." (*Id.*)

#### 18 **Return on Equity Adjustment**

19 Another issue raised during the Phase 2 hearing was whether the 10.55 percent ROE  
20 authorized in Decision No. 73736 should be modified if a DSIC or DSIC-like mechanism were to be  
21 adopted by the Commission. The signatory parties to the Phase 2 Settlement Agreement agreed that  
22 the rate of return, and thus the ROE, authorized in Phase 1 (Decision No. 73736) should be applied to  
23 the SIB-eligible plant when calculating the surcharge mechanism. (Phase 2 Ex. A-1, ¶3.2.1.)

24 RUCO asserted in Phase 2, as it does in this Rehearing phase, that if AWC was granted a  
25 DSIC-like mechanism, its ROE should be adjusted downward to account for the Company's  
26 decreased risk (Phase 2 RUCO Ex. 11, at 4). RUCO also argued that the Commission granted AWC  
27 a higher ROE in Phase 1 in recognition of the Company's infrastructure replacement needs. (Phase 2  
28 RUCO Ex. 12, at 15.) Specifically, RUCO cited Decision No. 73736, which stated:

1           Additionally, although our decision in the 2012 Western Group Rate  
2           Case<sup>3</sup> adopted a COE of 10.0 percent for the Western Group, we  
3           conclude that the Eastern Group, due to the age of some of its systems  
4           and the resulting increased need for infrastructure replacement and  
5           improvement, necessitates a somewhat higher COE.

6 (Decision No. 73736, at 61.)

7           In Decision No. 73938, we disagreed with RUCO's position, stating that the existence or lack  
8           of a DSIC does not change the risk of the utility, and therefore the existence or lack of a DSIC should  
9           not change the utility's ROE... [and] [a]s Mr. Olea explained, the efficiency credit is a more  
10          appropriate means to provide a financial benefit to the ratepayers." (Decision No. 73938, at 55.).

11          In the Rehearing proceeding, the issue of whether the ROE should be adjusted downward due  
12          to adoption of a SIB is again being considered.

### 13 **Positions of the Parties Regarding an Adjustment to the Return on Equity**

14          At issue in this Rehearing/Reopening is whether the 10.55 percent ROE authorized in  
15          Decision No. 73736 should be adjusted as a result of the Commission's approval of a SIB mechanism  
16          in Decision No. 73938. The positions of the parties in the Rehearing Phase are set forth below.

#### 17 **RUCO**

18          RUCO states that it does not oppose a 10.0 percent ROE and a SIB mechanism under the  
19          circumstances of this particular case because that result is better for ratepayers than approval of a  
20          10.55 percent ROE and a SIB mechanism. (RUCO Rehr. Closing Br., at 1.) RUCO argues that the  
21          10.55 percent ROE combined with the SIB mechanism is unfair to ratepayers. According to RUCO,  
22          the Commission awarded the Company a higher ROE in Phase I to address the Company's increased  
23          need for infrastructure replacement. (*Id.* at 2.) RUCO claims that since the SIB mechanism approved  
24          in Phase 2 also addresses the Company's need for infrastructure replacement, there should be a  
25          downward adjustment to the authorized ROE. RUCO contends that maintaining a higher ROE award  
26          is duplicative of the purpose of the SIB mechanism, and would not result in just or reasonable rates.  
27          (*Id.*)

28          RUCO argues that the 10.55 percent ROE is unfair because, according to its Rehearing  
29          witness David Parcell's analysis, the ROE for AWC should currently be in the range of 8.5 to 10.0

30 <sup>3</sup> Decision No. 73144 (May 1, 2012), at 32.

1 percent, with a mid-point estimate of 9.25 percent. (RUCO Rehr. Ex. 4, at 14-15.) RUCO also  
2 claims that the average authorized return on equity for water utilities in other states has been trending  
3 downward within the past four years, and has trended below 10.0 percent in the last two years. (*Id.* at  
4 16, Attach. DCP-7.) Mr. Parcell further testified that in Arizona, 18 of 20 of the recently authorized  
5 returns on equity for Arizona water utilities were 10.0 percent or less. (*Id.*, Attach. DCP-9.) RUCO  
6 contends that since this is the first case to implement a SIB mechanism, awarding an ROE that is  
7 significantly higher than almost all other water utilities is illogical because the SIB will allow for  
8 expedited recovery of capital investments, thereby increasing cash flow between rate cases and  
9 reducing shareholder risk. (RUCO Rehr. Ex. 2, at 6-7; RUCO Rehr. Closing Br., at 4.)

10 RUCO also asserts that the Commission is required by law to consider whether the ROE  
11 should be modified in conjunction with its consideration of the SIB mechanism. According to  
12 RUCO, the Commission is not allowed to consider the SIB in the absence of the consideration of the  
13 ROE in the same rate case. (RUCO App. for Rehr., at 3-4.)

14 RUCO contends that the SIB mechanism is unlawful in Arizona. Citing the *Scates* and *Rio*  
15 *Verde* cases, RUCO contends that the SIB is not an adjustor mechanism because it does not address  
16 narrowly defined operating expenses. (*Scates*, 118 Ariz. 531, 535, 578 P.2d 612, 616; *Rio Verde*, 199  
17 Ariz. 588, 592, 20 P.3d 1169, 1173.) RUCO further contends that the SIB violates the Arizona  
18 Constitution because it allows the Company to recover the costs of routine plant in between rate cases  
19 without a new fair value finding.

20 In response to the Company's claim that it requires a 10.55 percent ROE in order to fund up-  
21 front construction costs, RUCO argues that AWC is no different from any other water company that  
22 needs to fund up-front construction costs. According to RUCO, nearly all of the other utilities in  
23 Arizona have a COE of 10.0 percent or less, and they also have needs for construction and capital.

24 In its Reply Brief, RUCO acknowledges that the reduction to risk associated with the SIB  
25 mechanism cannot be precisely quantified. However, RUCO argues that it is not necessary to  
26 measure the precise impact of the SIB mechanism to the authorized ROE because the calculation of  
27 cost of capital is more of an art than a science. (RUCO Rehr. Reply Br., at 3.) RUCO states that  
28 many aspects of cost of equity are not quantifiable, including market factors, interest rates, and risk

1 premiums. (*Id.*) According to RUCO, the Commission's decision in Phase I cited the Company's  
2 need for infrastructure replacements as the reason to increase the ROE from 10.0 percent to 10.55  
3 percent. RUCO asserts that a reduction of 55 basis points would correct the mismatch that was  
4 created when the Commission approved the SIB mechanism. (*Id.* at 5.)

5 **Arizona Water Company**

6 AWC contends that the 10.55 percent ROE is just and reasonable because it will allow the  
7 Company to attract the capital necessary to fund the costs of replacing the aging infrastructure for its  
8 Eastern Group system. Citing Decision No. 73736, the Company claims that the Eastern Group  
9 system has unique and extraordinary infrastructure needs that are different than the Company's  
10 Northern Group and Western Group systems. (Decision No. 73736, at 61.) As a result, the Company  
11 maintains that it is appropriate for the Commission to recognize a higher cost of equity and, in turn, a  
12 higher ROE, for the Eastern Group system.

13 The Company disagrees with RUCO's assertion that the authorized ROE should be adjusted  
14 downward as a result of the SIB mechanism. According to the Company, the SIB mechanism does  
15 not reduce the risk of an equity investment beyond what may be reflected in the market-based models  
16 relied upon in setting the authorized ROE. (Decision No. 73938, at 55.) The Company states that  
17 Decision No. 73938 specifically determined that "the existence or lack of a DSIC does not change the  
18 risk of the utility, and therefore the existence or lack of a DSIC should not change the utility's ROE."  
19 (*Id.*)

20 The Company disputes RUCO's characterization that the 10.55 percent ROE and the SIB  
21 mechanism are duplicative of one another. According to the Company, the SIB mechanism addresses  
22 separate and distinct issues that have no impact on a utility's ROE. The Company cites the testimony  
23 of its witness, Joel Reiker, who testified that the SIB mechanism only addresses the capital costs  
24 arising from future infrastructure replacements constructed between rate cases. (AWC Rehr. Ex. 1,  
25 at 16-18.) Mr. Reiker further testified that the SIB mechanism does not address the up-front capital  
26 costs needed to fund those infrastructure replacements. (Rehr. Tr. 161-163.) The Company argues  
27 that its ability to raise the capital to pay for infrastructure replacements depends upon an adequate  
28

1 ROE and that a downward adjustment to the authorized ROE will impair the Company's ability to  
2 fund the up-front construction costs. (Phase 1 Exs. A-32, at 42-43, and A-34, at 29.)

3 The Company contends that the witness testimonies of RUCO, Staff, and Global support  
4 leaving the authorized ROE unchanged. The Company argues that RUCO witnesses Ralph Smith  
5 and David Parcell conceded at the hearing that the ROE addresses infrastructure replacement needs  
6 that the SIB does not address. (Rehrg. Tr. 118, 148.) In addition, the Company cites the testimony of  
7 Staff's witness, Steve Olea, who testified that the SIB mechanism is not germane to the ROE because  
8 the SIB is related to future plant and future changes in plant. (*Id.* at 256.) The Company also cites the  
9 testimony of Global's witness, Paul Walker, who testified that the Commission set a higher ROE for  
10 APS while, at the same time, authorizing multiple adjustor and surcharge mechanisms to address the  
11 issues facing APS. (*Id.* at 233.)

12 The Company argues that the testimony of RUCO's expert witness, Ralph Smith, should be  
13 disregarded because Mr. Smith did not conduct any mathematical analysis or study of the authorized  
14 ROE. (*Id.* at 89-92.) The Company contends that it is inappropriate for Mr. Smith to rely on the  
15 ROEs authorized in the Northern Group and Western Group rate cases because the Company agreed  
16 to those ROEs as part of fully negotiated settlement agreements. (*Id.* at 91-92.) The Company further  
17 contends that Mr. Smith's analysis is irrelevant because he did not address or quantify the differences  
18 between the Eastern Group system and the Company's Northern Group and Western Group systems.  
19 (*Id.* at 96.)

20 The Company further argues that the testimony of RUCO's expert witness, David Parcell,  
21 should be given no weight because his updated cost of equity analysis did not address the impact of  
22 the SIB mechanism on the authorized ROE or examine the specific risks associated with an equity  
23 investment in the Eastern Group system. (*Id.* at 132-133.) According to the Company, Mr. Parcell's  
24 analysis is an inappropriate attempt to reargue the ROE that RUCO originally proposed in Phase 1.  
25 As a result, the Company argues that the adoption of the SIB mechanism does not warrant any  
26 adjustment to the authorized ROE.

27 The Company also asserts that it is inappropriate for RUCO to rely on the settlement  
28 agreements in the Company's Northern Group and Western Group rate cases to support lowering the

1 ROE for the Eastern Group because the ROEs authorized in the Northern Group and Western Group  
2 were the product of compromise and extensive give-and-take negotiations. (AWC Rehg. Br. at 10.)  
3 According to the Company, the Eastern Group is a distinct group of water systems with issues and  
4 circumstances that differ from the Company's other systems. As a result, the Company argues that  
5 the ROEs for the Northern Group and Western Group cannot provide a baseline for establishing an  
6 ROE for the Eastern Group. (*Id.* at 10-11.) Citing Rule 408 of the *Arizona Rules of Evidence*, the  
7 Company further argues that a party should be comfortable in offering a compromise of a position in  
8 the interest of settlement at the Commission without fear that those concessions will later be cited as  
9 precedent and authority against them in unrelated proceedings.

10 The Company contends that its capital costs, including the cost of equity, have increased since  
11 the Commission approved the ROE in Phase 1. (Rehg. Tr. 201-204.) The Company states that  
12 interest rates are increasing which is causing the Company's cost of equity to increase. According to  
13 the Company, the resulting increase in the cost of equity demonstrates that a 10.55 percent ROE is  
14 still reasonable, if not too low. (*Id.* at 203, 222.)

15 The Company argues that SIB mechanism complies with all requirements of Arizona law and  
16 was properly adopted by the Commission. The Company notes that the question of whether the  
17 Commission has the authority to adopt a SIB mechanism has been thoroughly briefed and vetted by  
18 the parties. (AWC Rehg. Br. at 14-15.)

19 **Staff**

20 Staff argues that there should be no adjustment to the authorized ROE based upon the  
21 Commission's adoption of the SIB mechanism. According to Staff, RUCO's expert witnesses, Mr.  
22 Smith and Mr. Parcell, both conceded that the reduction in risk associated with the SIB mechanism  
23 cannot be quantified. (Rehg. Tr. 90, 112.) Staff asserts that if the reduction in risk cannot be  
24 quantified, then there can be no quantification of a corresponding reduction of the ROE. Staff also  
25 contends that even if the impact of the SIB on the ROE could be quantified, any such reduction is  
26 already incorporated into Mr. Parcell's ROE analysis because many of the water utilities in his proxy  
27 group have DSIC or DSIC-like mechanisms in a number of states in which they operate. (*Id.* at 144-  
28 145.)

1 Staff contends that RUCO's ROE analysis relies on two faulty assumptions: that the  
2 authorized ROE was increased from 10.0 to 10.55 percent; and that the 10.55 percent ROE was based  
3 on the SIB not being adopted by the Commission. With respect to the former assumption, Staff  
4 argues that RUCO is inappropriately relying on the following sentence in Decision No. 73736:  
5 "Additionally, although our decision in the 2012 Western Group Rate Case adopted a COE of 10.0  
6 percent for the Western Group, we conclude that the Eastern Group, due to the age of some of its  
7 systems and the resulting increased need for infrastructure replacement and improvement,  
8 necessitates a somewhat higher ROE." (Decision No. 73736, at 61.) Staff argues that this sentence  
9 does not indicate that the ROE would have been 10.0 percent absent the infrastructure needs or that  
10 the Commission was increasing the ROE from 10.0 to 10.55 percent. According to Staff, this  
11 sentence was used only as a means of comparison and was one of many factors that went into the  
12 Commission's cost of equity analysis. (Staff Rehr. Br. at 3-4.)

13 With respect to the latter assumption, Staff argues that the authorized 10.55 percent ROE was  
14 not set on the basis that a DSIC-like mechanism was being denied or that a DSIC-like mechanism  
15 was actually denied. To the contrary, Staff contends that the Commission explicitly anticipated that a  
16 DSIC-like mechanism would be adopted at a later time. According to Staff, the Commission clearly  
17 indicated that it intended to adopt a DSIC-like mechanism to address the Company's infrastructure  
18 needs when it adopted the 10.55 percent ROE. (*Id.* at 4.)

19 Staff disagrees with RUCO's characterization that the 10.55 percent ROE and the SIB  
20 mechanism are duplicative or redundant. Staff argues that due to the Company's aging and  
21 deteriorating infrastructure, it is not unreasonable to expect that the Company will need to replace  
22 infrastructure that will not be included in the SIB surcharge. According to Staff, RUCO's expert  
23 witnesses, Ralph Smith and David Parcell, conceded that the SIB and ROE are not entirely  
24 duplicative and could address different plant. Staff also argues that the SIB and 10.55 percent ROE  
25 have different functions in addressing infrastructure replacement needs. (Rehr. Tr. 119-120, 148.)  
26 According to Staff, the 10.55 percent ROE addresses the higher cost of equity that is required to fund  
27 the construction of infrastructure replacement while the SIB mechanism addresses the carrying costs  
28 or the required annual return and related expenses. (*Id.* at 162-163.)

1 Staff contends that the authorized 10.55 percent ROE is fair and reasonable. Staff states that  
2 the 10.55 percent ROE is within the range of rates of return originally recommended by the parties to  
3 this proceeding, from Staff's low of 9.1 percent to the Company's high of 12.5 percent. (Phase 1 Ex.  
4 S-5, at 43; Phase I Ex. A-32, at 6-8.) According to Staff, there is nothing in the record that would  
5 support a finding that an ROE that is 55 basis points higher than what RUCO is advocating is  
6 unreasonable.

7 Staff argues that the SIB is an adjustor mechanism even though it addresses capital costs, a  
8 characteristic not found in a traditional adjustor mechanism. Staff states that the Commission has  
9 created novel and innovative adjustor mechanisms in the past, including the renewable energy  
10 surcharge, energy efficiency surcharge, energy efficiency demand-side management surcharge, the  
11 environmental improvement surcharge, and the ACRM. (Staff Reg. Br. at 7.) Staff notes that RUCO  
12 has acknowledged that the ACRM, which also addresses a capital cost, is an adjustor mechanism.  
13 (Rehrg. Tr. 22.)

14 Staff suggests that the ACRM and the SIB mechanism are similar in that they both address  
15 public health and safety standards. (Staff Rehrg. Br. at 7-8.) Staff states that the ACRM adjustor was  
16 approved in order to allow water utilities to recover the capital costs associated with complying with  
17 a new arsenic standard for water. According to Staff, the SIB mechanism will allow the Company to  
18 recover the capital costs associated with complying with the drinking water standards established by  
19 ADEQ. Staff argues that the SIB mechanism is critical to meeting ADEQ public health and safety  
20 standards because it will allow the Company to pay for additional plant that will reduce or eliminate  
21 the risk of line breaks. (Rehrg. Tr. 472, 482-483, 483-487.)

22 Staff asserts that even if the SIB were deemed not to be an adjustor mechanism, it is still a  
23 lawful surcharge. According to Staff, the SIB mechanism comports with the requirements of the  
24 Arizona Constitution because it would require the Commission to ascertain the Company's fair value  
25 rate base each time a surcharge adjustment is made. (Staff Rehrg. Br. at 8.) Staff points out that the  
26 SIB mechanism contains numerous protections built in, including that: it was developed within the  
27 context of a full rate case in which the Company's fair value rate base was ascertained; it is limited to  
28 replacement projects used to serve existing customers; replaced plant will be retired and removed

1 from rate base; the SIB surcharge cannot go into effect without a Commission order; the SIB  
2 mechanism may be terminated by the Commission at any time; and the Commission will make a fair  
3 value finding prior to approval of the SIB surcharge. (*Id.*)

4 **Liberty Utilities/Global Water**

5 Liberty Utilities and Global Water (collectively “Liberty/Global”) assert that RUCO failed to  
6 meet its burden of proof in this rehearing proceeding because it has not shown that Decision No.  
7 73938 was “unjust or unwarranted, or should be changed,” as required by A.R.S. § 40-253(E).  
8 Liberty/Global argue that the evidence demonstrates that the Company will require very large capital  
9 expenditures to replace aging water infrastructure. (Phase 1 Exs. A-29, FKS-RB-8 and A-9, JDH-3,  
10 Attach. A.) Liberty/Global contend that the SIB is just, reasonable, and in the public interest because  
11 it provides a needed mechanism for funding these infrastructure replacements and provides for more  
12 gradual rate increases. (Phase 2 Liberty/Global Br., at 3-7; Global Rehr. Ex. 4, at 6; Phase 2 Global  
13 Ex. 2, at Attach. 2.)

14 In response to RUCO’s legal arguments, Liberty/Global claim that the SIB mechanism  
15 complies with all applicable legal requirements regarding ratemaking, including the fair value  
16 requirement of the Arizona Constitution. Liberty/Global assert that the SIB mechanism is an adjustor  
17 mechanism that is designed to provide for the timely recovery of plant costs. Liberty/Global contend  
18 that, contrary to RUCO’s position, adjustor mechanisms are not limited to expenses, but may also  
19 include plant costs. Liberty/Global claim that there are numerous examples of other adjustor  
20 mechanisms approved by the Commission that involve plant costs including the ACRM and APS’s  
21 renewable energy, energy efficiency/demand side management, and environmental improvement  
22 surcharge adjustors.

23 Liberty/Global dispute RUCO’s assertion that *Scates* requires adjustor mechanisms to relate  
24 to “narrowly defined, operating expenses.” (118 Ariz. 531, 535, 578 P.2d 612, 616 (App. 1978)).  
25 According to Liberty/Global, the cited language relied upon by RUCO is *dicta* because *Scates* did not  
26 involve a plant-based adjustor mechanism. Liberty/Global contend that the holding of *Scates* is that  
27 the Commission is required to ascertain the fair value of a utility’s property in setting just and  
28 reasonable rates. Liberty/Global assert that the Commission will be able to ascertain fair value in a

1 manner consistent with *Scates* because each SIB surcharge filing is required to include an analysis of  
 2 the impact of the SIB plant on the fair value rate base, revenue, and the fair value rate of return. In  
 3 addition, Liberty/Global note that each SIB filing is required to provide: the most current balance  
 4 sheet at the time of the filing; the most current income statement; an earnings test schedule; a rate  
 5 review schedule (including the incremental and pro forma effects of the proposed increase); a  
 6 revenue-requirement calculation; a surcharge calculation; an adjusted rate base schedule; a CWIP  
 7 ledger for each project showing accumulation of charges by month and paid vendor invoices; a  
 8 calculation of the three factor formula (as requested by Staff); and a typical bill analysis under  
 9 present and proposed rates. (Liberty/Global Rehr. Br. at 4-5)

10 According to Liberty/Global, the SIB is designed to comply with Arizona's fair value  
 11 requirement and all legal ratemaking requirements, including *Scates*. Liberty/Global point out that  
 12 the SIB mechanism has numerous protections built in, including:

- 13 • Commission and Staff review and pre-approval of SIB eligible projects;
- 14 • SIB project eligibility criteria limiting the SIB to projects that are "necessary to provide  
 15 proper, adequate and reliable service to existing customers; are not designed to serve or  
 16 promote customer growth; and will not comprise an upgrade or expansion of existing  
 17 plant;"
- 18 • SIB projects are limited to six specific categories of distribution system plant;
- 19 • Calculation of the SIB surcharge based on the rate of return, depreciation rates and tax  
 20 multiplier approved in AWC's general rate case;
- 21 • Surcharges take effect only upon a Commission order after full review of the surcharge  
 22 request;
- 23 • AWC is limited to making one surcharge request per year;
- 24 • A fair value finding in each surcharge order;
- 25 • A 5 percent efficiency credit;
- 26 • An annual surcharge cap of 5 percent of the revenue requirement in Decision No. 73736;
- 27 • An earnings test; and
- 28 • Commission authority to suspend, terminate or modify the SIB mechanism

(Liberty/Global Rehr. Br. at 7-8.)

Liberty/Global assert that even if the Commission were to determine that the SIB mechanism

1 is not an adjustor mechanism, it is still a lawful surcharge authorizing rate increases based on a  
2 determination of the Company's rate base, pursuant to the holding in *Rio Verde*. (199 Ariz. 588, 20  
3 P.3d 1169 (App. 2001).) Liberty/Global claim that contrary to RUCO's contention, the Arizona  
4 Constitution does not require that the Commission take all ratemaking elements into consideration as  
5 would be done in a general rate case, but rather only requires that the fair value of a utility's property  
6 be ascertained when setting rates. Liberty/Global contend that once fair value is ascertained, as  
7 would be done each time a SIB surcharge adjustment is approved, the Commission has ample  
8 discretion to use the fair value in setting rates or adjusting a surcharge. (Liberty/Global Rehr. Br., at  
9 8-10.)

10 Liberty/Global note that RUCO's legal arguments against the SIB are similar to arguments  
11 raised in the Northern Group case and assert that RUCO's arguments should be rejected for the same  
12 reasons the Commission rejected them in that case. (*Id.* at 10.)

13 **EPCOR**

14 EPCOR argues that RUCO has not provided any evidence to justify a reduction in the  
15 authorized ROE. EPCOR further argues that the SIB mechanism does not violate the Arizona  
16 Constitution. EPCOR joins in the arguments submitted by the Company and other intervening  
17 utilities. (EPCOR Rehr. Br. at 1-2.)

18 **Conclusion**

19 We are not persuaded by RUCO's legal arguments that adoption of the SIB in this proceeding  
20 violates the Arizona Constitution, applicable case law, or holdings in prior court decisions. As  
21 explained in Decision No. 73938, we believe the SIB mechanism contained in the Phase 2 Settlement  
22 Agreement, together with the financial information and analysis required therein, satisfies the fair  
23 value concerns addressed by various court decisions. (Decision No. 73938, at 50.) Although RUCO  
24 continues to assert that the Settlement does not require a fair value finding by the Commission when  
25 the SIB surcharge is adjusted, the Schedule D information that is required to be filed at the time a  
26 surcharge adjustment request is made requires "an analysis of the impact of the SIB Plant on the fair  
27 value rate base, revenue, and the fair value rate of return as set forth in Decision No. 73736." (*Id.*)

28

1 As was stated in Phase 2, with the additional information required by Decision No. 73938,<sup>4</sup>  
 2 the SIB allows for a consideration of all of AWC's costs at the time a surcharge adjustment is made,  
 3 and is therefore permissible under *Scates*. The SIB mechanism also addresses the concerns cited in  
 4 *Scates* in that the SIB: is an adjustment mechanism established within a rate case as part of a  
 5 company's rate structure; adopts a set formula that would allow only readily identifiable and  
 6 narrowly defined plant to be recovered through the surcharge; and applies the authorized rate of  
 7 return to SIB plant (less the five percent efficiency credit). Further, as indicated in Decision No.  
 8 73938, in accordance with the court's holding in *Simms*, which states that the Commission must find  
 9 and use the fair value of the utility company's property at the time of the inquiry, and the  
 10 reasonableness and justness of rates established by the Commission "must be related to this finding of  
 11 fair value" (80 Ariz. at 151, 294 P.2d at 382), the SIB mechanism requires a determination of the  
 12 Company's fair value rate base, including the SIB plant, at the time the surcharges are proposed and  
 13 approved. (*Id.* at 51.)

14 With respect to RUCO's constitutional arguments, as we stated in Decision No. 73938, the  
 15 applicable court decisions have found that the express language in Article 15, §14 of the Arizona  
 16 Constitution requires the Commission to ascertain "fair value." The courts have consistently  
 17 recognized, however, that the Commission has broad discretion in the rate setting formulas and  
 18 techniques that it employs, and the courts will not disturb the Commission's findings absent an abuse  
 19 of that discretion. (*See, Simms, supra*, at 154; *Arizona Public Service, supra*, at 370.) A line of  
 20 decisions establishes that, as long as fair value is determined, the Commission does not abuse its  
 21 discretion in adopting varying ratemaking mechanisms that allow rate recovery for: post-test year  
 22 plant (*Arizona Public Service*); CWIP that is not yet in service (*Arizona Community Action*); interim  
 23 rates or adjustor mechanisms without a fair value finding (*Rio Verde*); and use of fair value as only  
 24 one factor to be considered in setting rates in a competitive regulatory environment (*US West II*;  
 25

26 <sup>4</sup> AWC is required to file: (1) the most current balance sheet at the time of the filing; (2) the most current income  
 27 statement; (3) an earnings test schedule; (4) a rate review schedule (including the incremental and pro forma effects of the  
 28 proposed increase); (5) a revenue requirement calculation; (6) a surcharge calculation; (7) an adjusted rate base schedule;  
 (8) a CWIP ledger (for each project showing accumulation of charges by month and paid vendor invoices); (9) calculation  
 of the three factor formula (as requested by Staff); and (10) a typical bill analysis under present and proposed rates.  
 (Decision No. 73938, at 51-52.)

1 *Phelps Dodge*). An examination of these cases suggests that courts have understood that while a fair  
2 value determination is always required under the plain constitutional language of Article 15, §14, the  
3 Commission must have wide latitude to fashion ratemaking methods necessary to address a number  
4 of circumstances that may not have been anticipated when the Arizona Constitution was enacted. As  
5 long as the fair value finding is related to the rates set by the Commission, and that “just and  
6 reasonable rates” result from the methodologies employed (Article 15, §3), the courts have found that  
7 the Commission does not abuse its discretion in regard to its ratemaking powers. (*Id.* at 52-53.)

8 We therefore find that approval of the SIB mechanism in this case is reasonable and in the  
9 public interest.

#### 10 **Adjustment to Return on Equity**

11 The primary issue raised by RUCO in its Application for Rehearing is whether the ROE  
12 should be adjusted downward to 10.0 percent to be consistent with the ROE established for AWC’s  
13 Northern and Western Groups, and to reflect the finding in Decision No. 73736 that the Northern  
14 Group ROE was increased to 10.55 percent in recognition of aging infrastructure replacement needs.  
15 In the Phase 2 Settlement Agreement, the signatory parties agreed that the rate of return, and thus the  
16 ROE, authorized in Phase 1 (Decision No. 73736) should be applied to the SIB-eligible plant when  
17 calculating the surcharge mechanism.<sup>5</sup> (Phase 2 Ex. A-1, ¶3.2.1.) In Phase 2, the 10.55 percent ROE  
18 was upheld on the basis that implementation of the SIB would not decrease AWC’s risk. (Decision  
19 No. 73938, at 54-55.)

20 RUCO asserts that because a SIB mechanism was approved for AWC in Phase 2, the ROE  
21 should be adjusted downward to account for the Company’s decreased risk (Phase 2 RUCO Ex. 11, at  
22 4), and because the Commission specifically granted AWC a higher ROE in Phase 1 in recognition of  
23 the Company’s infrastructure replacement needs. (Phase 2 RUCO Ex. 12, at 15; Rehrgr. RUCO Ex. 5,  
24 at 4-5.) In the Rehearing Phase, RUCO offered additional expert testimony indicating that ROE  
25 awards have been declining, both nationally and in Arizona, since Decision Nos. 73736 and 73938  
26 were issued.

27 <sup>5</sup> Decision No. 73736 authorized a cost of debt of 6.82 percent and a cost of equity of 10.55 percent which, when applied  
28 to a capital structure of 49.03 percent debt and 50.97 percent equity, results in an overall weighted average cost of capital  
of 8.72 percent. (*Id.* at 60-62.)

1 After reviewing the entire record in this proceeding, we conclude that AWC's Eastern  
 2 Group ROE should be adjusted to 10.0 percent to reflect more recent cost of capital determinations;  
 3 for consistency with ROEs approved in recent cases for the Company's Northern and Western  
 4 Groups; and due to the duplicative purpose of the increased ROE in Decision No. 73736 (from 10.0  
 5 to 10.55 percent) to recognize "the age of some of its systems and the resulting increased need for  
 6 infrastructure replacement and improvement..." (Decision No. 73736, at 61.)

7 In the Rehearing proceeding, RUCO witness David Parcell testified that "the current cost of  
 8 common equity for regulated water utilities is no greater than 10.0 percent" and, based on his updated  
 9 cost of equity analysis, AWC's current cost of equity estimate is 9.25 percent. (Rehrg. RUCO Ex. 5,  
 10 at 3.) Mr. Parcell based his determination of AWC's current ROE of 9.25 percent on updated  
 11 Discounted Cash Flow ("DCF"), Capital Asset Pricing Model ("CAPM"), and Comparable Earnings  
 12 ("CE") analyses, which produced the following results:

13	DCF	8.5 – 8.6%	8.55% midpoint
14	CAPM	7.1%	
15	CE	9.0 – 10.0%	9.50% midpoint

16 Mr. Parcell stated that authorized ROEs for water utilities throughout the United States "have  
 17 been less than 10.0 percent over the past few years and were about 9.8 percent in 2012." (*Id.* at 3-4.)  
 18 He added that most of this Commission's water company ROE determinations in the past few years  
 19 have been 10.0 percent or below, "with most being in the 9.0 percent to 9.5 percent range in 2010 –  
 20 2013." (*Id.* at 4.) Mr. Parcell indicated that authorized ROEs for electric and gas utilities have also  
 21 seen a declining trend in recent years, with a national average in 2013 of 9.90 percent for electric  
 22 companies and 9.50 percent for gas utilities. (*Id.* at 7-8.)

23 RUCO witness Ralph Smith testified that if the SIB remains in place, the authorized ROE  
 24 should be reduced to 10.0 percent to remove "the excess ROE that addresses AWC's infrastructure  
 25 replacement." (Rehrg. RUCO Ex. 3, at 6.) He stated that:

26 RUCO has concluded that the combination of an enhanced ROE of  
 27 10.55 percent that was originally boosted by approximately 55 basis  
 28 points to address infrastructure replacement, coupled with the later  
 authorization of a new SIB surcharge that also addresses infrastructure

1 replacement, is unbalanced and unreasonable....The 10.0 percent ROEs  
2 used by AWC's Northern Group and Western Group from recent  
3 settlements, also provide a reasonableness check on what the ROE  
4 should be for AWC's Eastern Group.

5 (Id. at 7.)

6 We find that the additional testimony and evidence presented by RUCO during the Rehearing  
7 Phase of this proceeding are persuasive, and support a finding that AWC's ROE should be set at no  
8 higher than 10.0 percent, consistent with recent ROE findings nationally and in Arizona. Indeed,  
9 based on the updated analysis conducted by Mr. Parcell, we believe an even lower ROE could be  
10 justified at this time given his calculation that AWC's current cost of equity is in the range of 8.5  
11 percent to 10.0 percent. However, in accord with the recent findings for AWC's Northern and  
12 Western Groups, we conclude that a 10.0 percent ROE is appropriate in this case.

13 In addition to the updated ROE evidence presented by RUCO, our determination also  
14 recognizes that AWC was explicitly granted a higher ROE in Phase 1 to recognize and address the  
15 infrastructure replacement needs expressed by the Company. Decision No. 73736 stated:

16 Additionally, although our decision in the 2012 Western Group Rate  
17 Case adopted a COE of 10.0 percent for the Western Group, we  
18 conclude that the Eastern Group, due to the age of some of its systems  
19 and the resulting increased need for infrastructure replacement and  
20 improvement, necessitates a somewhat higher COE.

21 (Decision No. 73736, at 61.) Thus, in adopting a higher ROE for AWC in Phase 1 than would  
22 otherwise have been authorized, we believe the Company's infrastructure replacement needs were  
23 recognized, at least in part. Our approval of the proposed SIB mechanism in the Phase 2 proceeding  
24 was also intended to enable AWC to pursue its infrastructure replacement and improvement needs in  
25 a more timely manner and, therefore, at least partially achieve the same goal that was contemplated in  
26 awarding the Company a higher ROE in Phase 1.

27 AWC argues in the Rehearing Phase that the Commission may not compare the Eastern  
28 Group ROE to the 10.0 percent ROEs approved for the Northern and Western Groups because those  
ROEs were the result of settlement agreements. AWC cites Rule 408 of the *Arizona Rules of*

1 *Evidence*, which states, in relevant part, that “conduct or a statement made during compromise  
2 negotiations about the claim...[are] not admissible - on behalf of any party - either to prove or  
3 disprove the validity or amount of a disputed claim or to impeach by a prior inconsistent statement or  
4 contradiction....”

5 AWC’s assertion ignores the fact that the Commission’s own rules do not require a strict  
6 application of the Rules of Evidence in Commission proceedings. Specifically, A.A.C. R14-3-  
7 109(K), provides as follows:

8  
9 Rules of Evidence. In conducting any investigation, inquiry or hearing  
10 neither the Commission nor any officer or employee thereof shall be  
11 bound by the technical rules of evidence...Rules of evidence before the  
12 Superior Court of the state of Arizona will be generally followed but  
13 *may be relaxed in the discretion of the Commission or presiding officer*  
14 *when deviation from the technical rules of evidence will aid in*  
15 *ascertaining the facts.*

16 (emphasis added.)

17 However, even if Rule 408 were to be strictly applied, AWC’s argument lacks merit because  
18 the ROE comparison being made is to prior Commission Decisions in which the Commission  
19 determined that the terms of the settlement agreements, which were filed publically in the dockets of  
20 the prior cases, were reasonable and in the public interest. No disclosure of confidential discussions  
21 or offers of compromise are being made by such a comparison, which is what Rule 408 is intended to  
22 preclude; rather, the comparison in this case is being made to the final Decisions rendered by the  
23 Commission in those cases based upon the Commission’s review of the agreements and the entirety  
24 of the records in those cases.

25 Based on the entirety of the record, we find that the 10.55 percent ROE approved in Decision  
26 No. 73736, and affirmed in Decision No. 73938, no longer reflects a reasonable or appropriate cost of  
27 equity for AWC’s Eastern Group systems and should therefore be reduced to 10.0 percent. Applying  
28 the Company’s 6.82 percent cost of debt and 10.0 percent cost of equity to the capital structure of  
49.03 percent debt and 50.97 percent equity produces an overall WACC for AWC of 8.44 percent,  
which we find to be reasonable under the overall facts and circumstances of this case. AWC should

1 therefore file, by no later than April 30, 2014, revised schedules of rates, using the same rate design  
 2 parameters approved in Decision No. 73736. AWC should consult with Staff and RUCO prior to  
 3 filing the revised rate schedules to ensure that the parties are in agreement with respect to the revised  
 4 rates to be included in those schedules.

5 \* \* \* \* \*

6 Having considered the entire record herein and being fully advised in the premises, the  
 7 Commission finds, concludes, and orders that:

8 **FINDINGS OF FACT**

9 1. On August 5, 2011, AWC filed with the Commission an application requesting  
 10 adjustments to its rates and charges for utility service provided by its Eastern Group water systems,  
 11 including its Superstition (Apache Junction, Superior, and Miami); Cochise (Bisbee and Sierra  
 12 Vista); San Manuel; Oracle; SaddleBrooke Ranch; and Winkelman water systems. AWC also  
 13 requested several other authorizations in the application.

14 2. On February 20, 2013, the Commission issued Decision No. 73736 in Phase 1 of this  
 15 matter, granting AWC a rate increase for its Eastern Group systems and, among other things, keeping  
 16 the docket open for purposes of further consideration of AWC's proposed Distribution System  
 17 Improvement Charge.

18 3. Additional hearings were conducted and, on June 27, 2013, the Commission issued  
 19 Decision No. 73938 in Phase 2 which approved a System Improvement Benefits mechanism for  
 20 AWC.

21 4. On July 17, 2013, RUCO filed an Application for Rehearing of Decision No. 73938,  
 22 pursuant to A.R.S. § 40-253. RUCO requested rehearing on two issues: that the Commission should  
 23 have reduced AWC's cost of equity when the SIB mechanism was approved; and that the SIB  
 24 mechanism does not qualify as an adjustor mechanism and is therefore illegal under Arizona law.

25 5. On August 1, 2013, AWC filed a Response in Opposition to RUCO's Application for  
 26 Rehearing.

27 6. On August 5, 2013, the Commission voted in a Staff Open Meeting to grant RUCO's  
 28 Application for Rehearing "for the sole purpose of extending the time for the Commission to further

1 consider the application....”

2 7. On August 15, 2013, the Commission passed the following motion made by  
3 Commissioner Bitter Smith during a Staff Open Meeting: “[to] grant RUCO’s Application for  
4 Rehearing of Decision No. 73938, and also [re]open Decision No. 73736, under A.R.S. § 40-252, for  
5 consideration of modifying the Decision [73736] concerning the determination made related to the  
6 return on equity, and that these matters shall be consolidated. Further, as part of my motion, the  
7 Hearing Division is directed to hold proceedings on these consolidated matters and prepare a  
8 Recommended Order for the Commission’s consideration.”

9 8. On August 26, 2013, a Procedural Order was issued scheduling a procedural  
10 conference for September 4, 2013, to discuss scheduling and procedural issues regarding the  
11 Rehearing Phase.

12 9. On August 30, 2013, AIC filed a Notice of Waiver of Appearance stating that it would  
13 not be participating in the Rehearing Phase of the proceeding.

14 10. A procedural conference was held on September 4, 2013, as scheduled, during which  
15 the parties tentatively agreed to a hearing on November 25 and 26, 2013; filing of direct testimony by  
16 October 4, 2013; and filing of rebuttal testimony by October 31, 2013.

17 11. On September 11, 2013, AWC filed a Notice of Acceptability of Hearing Dates,  
18 confirming that the Company agreed with the tentative schedule established at the August 26, 2013,  
19 procedural conference.

20 12. On September 16, 2013, a Procedural Order was issued scheduling a hearing to  
21 commence on November 25, 2013, and establishing other testimony filing deadlines.

22 13. On September 18, 2013, RUCO filed transcripts of the February 12, 2013 and June 12,  
23 2013 Open Meeting discussions regarding Phase 1 and Phase 2 of this proceeding.

24 14. On October 4, 2013, AWC filed the Rehearing Direct Testimony of Joel Reiker;  
25 Liberty Utilities and Global Water filed the Rehearing Direct Testimony of Paul Walker; RUCO filed  
26 the Rehearing Direct Testimony of Robert Mease, David Parcell, and Ralph Smith; and Staff filed the  
27 Rehearing Direct Testimony of Steven Olea.

28 15. On October 31, 2013, AWC filed the Rehearing Rebuttal Testimony of Joel Reiker

1 and Pauline Ahearn; Liberty Utilities and Global Water filed the Rehearing Rebuttal Testimony of  
2 Paul Walker and Greg Sorenson; RUCO filed the Rehearing Rebuttal Testimony of David Parcell and  
3 Ralph Smith; and Staff indicated that it would not be filing Rehearing Rebuttal Testimony.

4 16. On December 20, 2013, RUCO filed its Opening Rehearing Brief.

5 17. On January 17, 2014, AWC, Staff, EPCOR, and Liberty Utilities/Global Water filed  
6 Rehearing Responsive Briefs.

7 18. On January 24, 2014, RUCO filed its Reply Rehearing Brief.

8 19. The 10.55 percent ROE authorized in Phase 1, and affirmed in Phase 2, should be  
9 adjusted downward to 10.0 percent based on more recent cost of capital determinations; to reflect  
10 consistency with ROEs approved in recent cases for the Company's Northern and Western Groups;  
11 and due to the duplicative purpose of the increased ROE in Decision No. 73736 to recognize the age  
12 of some of its systems and the resulting increased need for infrastructure replacement and  
13 improvements. We believe that a 10.0 percent ROE is just and reasonable, and in the public interest,  
14 under the circumstances of this case.

15 **CONCLUSIONS OF LAW**

16 1. AWC is a public service corporation within the meaning of Article XV of the Arizona  
17 Constitution and A.R.S. §§ 40-250, 40-251, 40-252, 40-253, and 40-367.

18 2. The Commission has jurisdiction over AWC and the subject matter of the application.

19 3. Notice of the proceeding was provided in accordance with the law.

20 4. The SIB mechanism approved in Decision No. 73938 is compliant with the  
21 Commission's constitutional requirements, as well as the case law interpreting the Commission's  
22 authority and discretion in setting rates.

23 5. A 10.0 percent ROE is just and reasonable under the circumstances of this case, based  
24 on the entirety of the record. Applying the Company's 6.82 percent cost of debt and 10.0 percent cost  
25 of equity to the capital structure of 49.03 percent debt and 50.97 percent equity produces an overall  
26 WACC for AWC of 8.44 percent, which is reasonable under the overall facts and circumstances of  
27 this case.

28

**ORDER**

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IT IS THEREFORE ORDERED that the 10.55 percent ROE authorized in Decision No. 73736, and affirmed in Decision No. 73938, should be adjusted downward to 10.0 percent using the same rate design parameters approved in Decision No. 73736.

IT IS FURTHER ORDERED that Arizona Water Company shall file, by no later than April 30, 2014, revised schedules of rates, using the same rate design parameters approved in Decision No. 73736. AWC should consult with Staff and RUCO prior to filing the revised rate schedules to ensure that the parties are in agreement with respect to the revised rates to be included in those schedules.

IT IS FURTHER ORDERED that the revised rates and charges adopted herein, pursuant to the adjusted 10.0 percent return on equity adopted herein, shall be effective for all service rendered on or after May 1, 2014.

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1 IT IS FURTHER ORDERED that Arizona Water Company shall notify its affected customers  
2 of the revised schedule of rates and charges, pursuant to the adjusted 10.0 percent return on equity  
3 adopted herein, by means of an insert in its next regularly scheduled billing, and by posting a notice  
4 on its website, in a form and manner acceptable to the Commission's Utilities Division Staff.

5 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

6 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

7  
8

9 CHAIRMAN \_\_\_\_\_ COMMISSIONER

10  
11 COMMISSIONER \_\_\_\_\_ COMMISSIONER \_\_\_\_\_ COMMISSIONER

12

13 IN WITNESS WHEREOF, I, JODI JERICH, Executive  
14 Director of the Arizona Corporation Commission, have  
15 hereunto set my hand and caused the official seal of the  
16 Commission to be affixed at the Capitol, in the City of Phoenix,  
17 this \_\_\_\_\_ day of \_\_\_\_\_ 2014.

16

17 JODI JERICH  
18 EXECUTIVE DIRECTOR

19 DISSENT \_\_\_\_\_

20

21 DISSENT \_\_\_\_\_

22 DN:dp

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1 SERVICE LIST FOR: ARIZONA WATER COMPANY

2 DOCKET NO.: W-01445A-11-0310

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