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**BEFORE THE ARIZONA CORPORATION COMMISSION**

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Arizona Corporation Commission

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APR 04 2014

DOCKETED BY 

**WATER UTILITY ASSOCIATION OF ARIZONA  
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**GREG PATTERSON, DIRECTOR**

**ORIGINAL**

**IN THE MATTER OF THE APPLICATION  
OF CHAPARRAL CITY WATER  
COMPANY FOR A DETERMINATION OF  
THE CURRENT FAIR VALUE OF ITS  
UTILITY PLANT AND PROPERTY AND  
FOR INCREASE IN ITS RATES AND  
CHARGES BASED THEREON.**

**DOCKET NUMBER W-02113A-13-0118**

**CLOSING BRIEF**

“First do no harm.” The ancient advice from Hippocrates applies to utility regulation as much as it does to medicine. For over twenty years the Arizona Corporation Commission has been looking for ways to ensure the viability of private water companies. To its credit, the ACC is considering, for example, SIBs, Acquisition Adjustments, rate consolidation and various other proposals in order to provide much-needed support to private water companies.

In the Chaparral City Water case however, the ACC Staff and RUCO propose that the ACC take a giant step backwards by introducing two policy changes that would make it much harder for utilities to earn their authorized rate of return—policy changes that have not been the subject of workshops, white papers, public hearings or any other form of public process. In

1 addition to bypassing the policy-making process, these two proposed policy changes would add a  
2 great deal of complexity to the ratemaking process, deprive the utility of the opportunity to earn  
3 its authorized return and introduce a level of capriciousness that would mock the very idea of a  
4 reliable regulatory framework. The WUAA urges the ACC to reject the “Hypothetical Capital  
5 Structure” and “Modified Vintage Group Depreciation Method” policy changes that have been  
6 advocated by Staff and eventually adopted by RUCO in this case.

7 **The Company has not earned its authorized rate of return.**

8 In the years leading up to the rate case, CCWC earned a return on year end capital for  
9 2010, 2011, and 2012 of 4.19%, 4.89%, and 5.33%, respectively. During that same period, the  
10 company’s authorized rate of return was over 10%. (Schedule A 2). On the day that EPCOR  
11 purchased Chaparral City Water Company, (CCWC) the company had a capital structure that was  
12 comprised of 84.5% equity and 15.5% debt. (Transcript Vol. 2 at 395 line 11[Cassidy  
13 Testimony]). The ACC approved this capital structure in CCWC’s previous rate case and  
14 EPCOR has made no capital infusions—and has indeed worked to reduce equity by paying  
15 dividends of \$1.5M in both 2011 and 2012. (Transcript Vol. 2 at 209 [Hearn Testimony]).  
16 (Dividend payments are on Schedule E-4).

17 Now however, staff is suggesting that instead of using CCWC’s actual capital structure,  
18 the Commission should create a “Hypothetical” Capital structure comprised of 60% equity and  
19 40% debt. This policy proposal is mathematically equivalent to granting the company a 7.71%  
20 cost of equity and will deny the company an opportunity to earn even the low 9.6% cost of equity  
21 that Staff has recommended. (Transcript Vol. 2 at 202 line 8 [Hearn Testimony]).

22 **Staff’s hypothetical capital structure proposal is a policy change in the guise of an**  
23 **adjustment.**

24 In his Direct Testimony, (page 8 line 18) Mr. Cassidy implies that the staff proposal is  
25 actually an equity adjustment; however, after admitting that he made no actual calculations, Mr.  
26 Cassidy went on to admit during cross examination that creating a hypothetical capital structure

1 wasn't even his idea. He was simply told to make the adjustment based on a policy decision by  
2 someone higher up with staff. There was literally no evidence to support the hypothetical capital  
3 structure at the time that staff proposed it. (Transcript Vol. 2 at 387 to 389 plus 398 Line 24  
4 [Cassidy Testimony]).

5 **The Concept of "Double Leverage" is a red herring.**

6 After Staff used its Direct Testimony to advocate its unwritten policy that the company be  
7 forced to adopt a hypothetical capital structure, Staff invented a *post hoc* justification for the  
8 policy in its surrebuttal testimony. Staff calls this concept "Double Leverage." To its credit, staff  
9 makes it very clear that the "Double Leverage" concept had nothing to do with its original  
10 recommendation because staff admits that it received the information on which its "Double  
11 Leverage" theory is based after it filed its Direct Testimony. (Transcript Vol. 2 at 396 line 6 and  
12 again at line 19 [Cassidy Testimony]).

13 Not only is it clear that "Double Leverage" had nothing to do with the creation of Staff's  
14 policy proposal, it is also clear that "Double Leverage" has nothing to do with this case. "Double  
15 Leverage" allegedly occurs when a company borrows money and then invests it into a regulated  
16 entity. However, EPCOR made no such capital infusion. (Transcript Vol. 2 at 208 line 23 [Hearn  
17 Testimony]). In addition to not being a factor in this case, the concept of "Double Leverage" is  
18 foreign to utility regulation generally. (Transcript Vol. 2 at 208 line 16 [Hearn Testimony]).

19 We are not aware of the ACC requiring the companies it regulates to provide the financial  
20 information of its shareholders in order to determine whether double leverage exists. The concept  
21 of "Double Leverage" is foreign to utility regulation, doesn't fit the facts of this case and was  
22 based on information received after Staff made its policy recommendation. The ACC should  
23 reject this post hoc rationalization for its policy change.

24 **Staff's new policy is impossible to achieve.**

25 Staff asserts that it proposed its new policy of creating hypothetical capital structure in  
26 order to "encourage CCWC to move towards a more balanced capital structure going forward."

1 (Cassidy Direct Testimony page 9 line 20). Let's leave aside the fact that the company had no  
2 notice that it was supposed to change its capital structure, and that it was maintaining the same  
3 capital structure that Staff recommended and the commission approved in the CCWC's previous  
4 rate case. Let's focus on the fact that the company would have violated ACC policies that are  
5 actually written in order to comply with Staff's "encouragement".

6 There are only two ways in which an owner can reduce the equity to debt ratio of its  
7 regulated company. The owner can increase dividends in order to remove equity, or it can infuse  
8 debt into the company. EPCOR proposed to hold its current debt constant to alleviate future  
9 borrowing needs and lessen the increase in equity. This proposal was rejected by staff. Although  
10 staff wants less equity in the capital structure, its position in the capital financing application  
11 suggests the opposite. (See W-02113A-13-004)

12 EPCOR had no notice that it needed to change its capital structure and would have had no  
13 ability to comply had it known of Staff's policy in advance of the hearing. Staff's new  
14 Hypothetical Capital Structure policy is an example of the worst type of regulation. The policy  
15 change was not vetted through a public process or approved by commissioners. The policy  
16 change was disguised as financial adjustment and was justified post hoc using information that  
17 wasn't available when staff recommended the new policy. The company had no notice of the  
18 new policy and no opportunity to comply with the policy. Furthermore, staff made no calculations  
19 to determine how much of a financial penalty the company would be forced to bear in order to  
20 comply with Staff's "encouragement." Finally, other companies regulated by the ACC have no  
21 idea if they are now required to comply with Staff's policy. The ACC needs to reject staff's new  
22 policy and give the company an opportunity to earn a fair return on its actual investment.

### 23 **Modified Vintage Group Depreciation**

24 "Regulatory lag works both ways." That's one of the most common expressions in utility  
25 regulation. When a company complains that it makes investments between rate cases and has to  
26 wait until the next rate case in order to earn a return on those investments, or that it takes too long

1 for a Commission to process a rate case, utility regulators have traditionally said that “Regulatory  
2 lag works both ways.” In this context, the statement means that companies can also have assets  
3 that remain in rate base for longer than their depreciable life. In theory, the “extra’ depreciation  
4 can offset some of the lost revenue from the delay. (Transcript Vol. 5 at 914 line 14 [Becker  
5 Testimony]).

6 Here, Staff has proposed changing the regular Group Deprecation Method to a  
7 modified Vintage Group Depreciation method that appears to be intended to eliminate any chance  
8 that an asset could be “over depreciated.” This is a unilateral policy change that doesn’t  
9 recognize that companies make substantial investment in between rate cases and that it takes  
10 several years of regulatory process for investments to be put into rate base. Even accounting for a  
11 SIB mechanism, EPCOR will make more investment between rate cases than any potential for  
12 over-depreciation. Indeed, EPCOR’s capital plan calls for the company to invest over \$2.5  
13 million in each of years 2014 and 2015. (Transcript Vol. 5 at 909 [Hubbard Testimony]). This  
14 amount of investment is much larger than the plant associated with the assets that Staff is  
15 concerned are being “over depreciated.” (Transcript Vol. 5 at 907 line 8 [Becker Testimony]).

16 **Staff’s proposed method is fundamentally flawed**

17 In addition to tilting the fundamental regulatory balance--by accelerating the removal of  
18 items that are potentially over depreciated while not increasing the pace at which investments are  
19 added to rate base--the “Modified Vintage Group Depreciation Method” is fundamentally flawed  
20 in other ways.

21 **Some items wear out faster than their useful lives.**

22 Staff has analyzed a pool of assets and determined that some have lasted longer than they  
23 were supposed to. Fair enough, but in any group there are also assets that are removed from  
24 service before they have reached their book life. The Group Depreciation Method accounts for  
25 variation in asset lives by depreciating similar assets as a group. Assets that happen to last longer  
26 than anticipated are offset by assets that wear out faster than anticipated. The Group Method is

1 widely accepted and provides a simple and effective way of ensuring that the natural variation in  
2 assets lives is accounted for properly. (Transcript Vol. I at 74 line 18 [Hubbard Testimony]).  
3 Here, Staff has only looked at assets that lasted longer than anticipated and concludes that they  
4 have been “over depreciated” however, Staff did not conduct any analysis of assets that had  
5 shorter lives than the rest of the group and were therefore “under depreciated.” One advantage of  
6 Group Accounting is that it accounts for this natural variation in asset lives--some assets last  
7 longer than expected and some wear out faster than expected--and rather than try to keep track of  
8 all of them by individual “vintage” as staff suggests, the Group Depreciation method  
9 automatically offsets the longer lived assets with the shorter lived assets by combining them in a  
10 single group. Staff’s Vintage Group Depreciation Method introduces a great deal of complexity  
11 in order to solve a problem that the group method solves automatically.

12 **Depreciation expense is not really “over collected.”**

13 Staff’s justification for its new depreciation method appears to be based on a concern that  
14 Depreciation expense will be “over collected”. On the surface, this seems reasonable; if an item  
15 like say, rate case expense, is collected for a longer period of time than its original amortization  
16 period then a company could ultimately collect more money in rates than it originally spent on the  
17 preceding rate case. However, this analysis does not hold true with depreciation expense because  
18 each year’s depreciation expense increases the accumulated depreciation account and the  
19 accumulated depreciation account is then used to decrease the balance of the future asset  
20 purchases. That means that if an asset is in service longer than its book life, the “extra”  
21 depreciation amount will be used to decrease the value of the asset that eventually replaces it.  
22 Take for example the case of a piece of equipment that is supposed to last five years, but instead  
23 it lasts for 10 years. The asset would have been fully depreciated in the first five years and  
24 then—according to staff’s reasoning—the company would “over collect” depreciation expense  
25 for the extra five years that the equipment was in service. On the surface, this analysis seems  
26 correct, however, when the asset is retired after 10 years, the accumulated depreciation account

1 associated with that asset will have a negative balance equal to all of the “over collected”  
2 depreciation expense. Then when the replacement asset is placed in service, its book value will  
3 be the purchase price of the new asset **less the accumulated depreciation associated with the**  
4 **previous asset.** Indeed, if the replacement asset costs the same amount as the original asset then  
5 the book value of the new asset on the day it is placed in service will be zero. Staff has created a  
6 complex and novel depreciation method in order to solve a problem that the current group  
7 accounting method has already solved. (Based on example at Transcript Vol. I at 77-80 [Hubbard  
8 Testimony]).

9 **Staff’s new method is much too complex.**

10 Staff’s new depreciation method would grandfather in the existing Group Depreciation  
11 Method and create a system going forward in which each new asset would be grouped with  
12 similar assets purchased in the same year. These annual sub groups would comprise “Vintages”  
13 and would be depreciated individually. Thus for an asset with a 20 year life, in the year 2034, the  
14 company will still have the original pre 2014 Group account followed by 20 individual  
15 “Vintages” that reflect annual purchases—at which time the 2015 Vintage will be retired. Thus  
16 2034 will be the first year in which the ACC will be ensuring that there is no “over depreciation”  
17 of these assets. Staff admits that it invented this methodology based on one day’s work on an  
18 Excel spreadsheet. (Transcript Vol. 5 at 903 line 10 [Becker Testimony]).

19 The company, of course, has a much more complex system of accounts than an Excel  
20 spreadsheet and estimates that the programming costs alone of switching to Staff’s new method  
21 would exceed \$500,000. (Transcript Vol. 5 at 791 [Hubbard Testimony]). However, the real  
22 cost associated with the new Vintage Method will be the ongoing costs of trying to identify and  
23 track assets by Group and Vintage instead of simply by Group. (*id*) One can envision a scenario  
24 in which a tank is built in one year and the company makes life-extending improvements in  
25 another year. Under the group method, all of those assets would simply be in a category called  
26 “tanks.” Under the vintage method, the company would have to maintain an original tank

1 account and would then have to track each life-extending improvement by vintage. Thus under  
2 Staff's method, a single asset may have multiple "vintages." (See for example, Transcript Vol. 5  
3 at 896 line 14 [Becker Testimony]).

4 **Vintage Depreciation information is not readily available.**

5 While companies do indeed keep track of the purchase dates of various assets, they do not  
6 track, say, capitalized labor costs or major repairs in separate vintages. How does a company  
7 account for major repairs on a section of pipe that it installed five years ago? The costs of major  
8 repairs are added to the cost of the asset, but which vintage? When the company replaces large  
9 sections of pipe, it would have to determine when pieces of that pipe were installed, adjust the  
10 cost to reflect previous repairs and recalculate the historic vintages accordingly. Additionally,  
11 companies would face the additional complication of keeping track of different lives for different  
12 vintages as products improve, or become obsolete at different rates. It's quite possible that pumps  
13 and equipment built in, say, 2016 could have shorter lives than improved pumps and equipment  
14 placed in service in, say, 2024. Meanwhile, both of these Vintages could have longer lives than  
15 the original "grandfathered" pre 2014 rate case Vintage. This would lead to the absurd result of  
16 an asset class having 20 different Vintages and those individual vintages having different  
17 depreciation rates. (Transcript Vol. 1 at 70 to 73 [Hubbard Testimony]).

18 **Vintage Depreciation is quite different from IRS Depreciation**

19 Companies have to record the purchase price and date of assets for tax purposes, but that's  
20 where the similarity in IRS accounting and Financial Accounting ends. For example, IRS  
21 accounting reduces—and in many cases eliminates—the need for annual vintages through a large  
22 annual deduction called a "Section 179" deduction. The IRS uses an accelerated depreciation  
23 method called MACRES that has different lives than Financial Accounting. This means that  
24 many assets remain on the books for financial accounting purposes even though they have long  
25 been removed for tax purposes. The two systems are quite different and IRS accounting would  
26 provide little if any information that would help a company establish or maintain a vintage

1 accounting system. (Transcript Vol. 4 at 726 [Michlik Testimony]).

2 **Staff's complex new method ignores simple solutions.**

3 For the sake of argument, let's say that the ACC concludes that some items are indeed  
4 "over" depreciated and that this is a problem. Staff's proposed solution ignores traditional and  
5 well established accounting remedies that are readily available. The most obvious solution is to  
6 simply increase the depreciable life of the group. If an asset class, say pumps, is being  
7 depreciated over 15 years and they are being used for an average of say 18 years, then just  
8 change the depreciable life of the pump class to 18 years. There's no reason to establish a  
9 "vintage" class for annual pump purchases and then try to determine how to account for  
10 capitalized repair expenses, or the cost of installation or disposal by vintage. If the pumps  
11 actually last 18 years, then depreciate them over 18 years. (Transcript Vol. 5 at 766 line 21  
12 [Hubbard Testimony]).

13 **Conclusion**

14 Staff's proposed Modified Group Vintage Depreciation method is complex, unwieldy,  
15 expensive to design and maintain and yet it provides little if any additional accuracy and doesn't  
16 solve the "problem" of over depreciation any better than the widely used and much simpler group  
17 depreciation method. Staff witness Becker admitted that he designed this new depreciation  
18 method in a single day using an Excel Spreadsheet. Frankly, Staff's proposal looks like it was  
19 designed in a single day using an Excel Spreadsheet.

20 **This rate case is an inappropriate forum in which to introduce these proposals.**

21 Staff's proposed policy changes are complex, controversial, have broad implications and  
22 can affect a wide variety of companies. The WUAA believes that it is inappropriate for these  
23 policy changes to be introduced by Staff in a company-specific rate case. By the time the WUAA  
24 learned of these proposals and understood their implications, the date for intervention had passed.  
25 Fortunately, the ALJ saw fit to grant the WUAA a limited intervention over RUCO's objection.  
26 However, other companies that will be affected by these policy changes are not in the case.

1 Indeed, even with proper notice and broad based intervention, a rate case is a poor forum to  
2 discuss substantial policy changes. The Commission usually employs its much more open and  
3 flexible workshop process in which Staff (or preferably Commissioners) can propose policy  
4 changes and stakeholders can discuss the implications of those changes. The Commission can  
5 then adopt or reject those changes and companies have time to implement them. Here, EPCOR  
6 had no idea that it was going to be penalized for maintaining a capital structure that the ACC had  
7 approved in its last rate case. The company also had no idea that the Staff would reject the  
8 depreciation method that the ACC and NARUC have used for years. Furthermore, if the ACC  
9 does approve these policy changes as part of this case will other companies be bound by them?  
10 Should other companies switch to the Modified Vintage Group Depreciation Method that Staff  
11 believes should be required of EPCOR? Should the WUAA and other companies intervene in  
12 each rate case in order to be properly positioned in case Staff proposes—and RUCO then  
13 adopts—a broad based policy change? Are other water companies now on notice that staff no  
14 longer accepts the well established Group Depreciation Method? How about Tucson Electric  
15 Power, Southwest Gas and Arizona Public Service? What method of depreciation should they  
16 use in their next rate case? Does the ACC now use a different depreciation methodology for  
17 different industries? Are Southwest Gas's pipes going to be depreciated using the Group Method  
18 while Chaparral City's water pipes are depreciated under the Modified Group Vintage method?  
19 How about Arizona Water Company? Which method should it use?

20 As argued above, WUAA believes that the evidence in this case shows that the  
21 Hypothetical Capital Structure and Modified Group Vintage Depreciation methods are ill advised  
22 and should be rejected. We also believe that there is a need for comprehensive policy changes  
23 that would allow water companies an opportunity to earn their authorized rate of return,  
24 incentivize infrastructure investment and encourage consolidation. Those potential changes  
25 should be discussed in an open forum in which stakeholders have adequate notice and an  
26 opportunity discuss the issues that will affect them. The Chaparral City rate case is not that

1 forum. The WUAA urges the ACC to reject the concepts of Hypothetical Capital Structure and  
2 Modified Vintage Group Depreciation and to also reject the process that allowed those concepts  
3 to be introduced in this case.

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6  
7 RESPECTFULLY SUBMITTED this 4<sup>th</sup> Day of April, 2014

8  
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