



0000152282

BEFORE THE ARIZONA CORPORATION COMMISSION

RECEIVED
AZ CORP COMMISSION
DOCKET CONTROL
2014 APR 4 PM 3 12

- 1
- 2 BOB STUMP
CHAIRMAN
- 3 GARY PIERCE
COMMISSIONER
- 4 BRENDA BURNS
COMMISSIONER
- 5 BOB BURNS
COMMISSIONER
- 6 SUSAN BITTER SMITH
COMMISSIONER
- 7

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 No. W-02113A-13-0118

Arizona Corporation Commission
DOCKETED
APR 04 2014

DOCKETED BY 

RUCO'S CLOSING BRIEF

The Residential Utility Consumer Office ("RUCO") hereby files its Closing Brief in the matter of Chaparral City ("Chaparral," "Chaparral City," or "Company") application for a revenue increase totaling \$2,727,121 for its Water Division. Company Final Schedules – Schedule C-1.¹

1) INTRODUCTION

Chaparral City Water is a relatively small water Company that is making a large request of its customers in this case. Chaparral's revenue increase is approximately 30.25 percent over test year revenues. Company Final Schedule. Chaparral is also requesting post-test year plant totaling \$4,470,237 as well as a SIB mechanism which is estimated to recover approximately \$8.9 million over the next 5 years. Id. All told, Chaparral's request, if approved, would result in a 20.30 percent increase in plant over the test year plant amounts.

¹ For ease of reference, all exhibits will be identified by exhibit number and all transcript references will be identified by page number in the transcript. Company Final Schedule A-1.

1 The Company's request seems excessive and unwarranted since Chaparral has invested
 2 over \$15 million in water infrastructure since its last rate case which was approved in late 2009.
 3 A-1 at 2. Moreover, Chaparral has been experiencing declining water sales (as will be discussed
 4 below) which further draws into question the need for such an excessive infrastructure request.
 5 In addition, the Company's engineer admitted under oath that the plant recovery associated with
 6 the SIB infrastructure could wait until the next rate case. Transcript at 498-499.

7 There are many disputed issues in this case - perhaps because so many of the
 8 Company's requests involve non-traditional ratemaking as well as the application of new ways
 9 to treat the issues. The Commission should stick with the proven and traditional ways of
 10 ratemaking.

11 In summary, RUCO is proposing the following rate base and operating income
 12 adjustments:

13 Rate Base Adjustment No. / Description

14 1 – Post-Test Year Plant and Accumulated Depreciation	(\$1,241,654) ²
15 2 – Retirement of Transportation Vehicles	-- 0 --
16 3 – Asset Retirement Obligation	(889)
17 4 – Customer Meter Deposits	-- 0 --
18 5 – Removal of CAP Deferral	(78,206)
19 6 – Removal of 24 months of AFUDC and Depreciation Expense	(607,898)
20 7 – Cash Working Capital Allowance	<u>(\$897,499)³</u>

21 ² This adjustment also includes the following: Based on Staff's amended surrebuttal filing which was docketed on
 22 February 26, 2014, RUCO has removed \$490,363 in accumulated depreciation from plant account 311 pumping
 23 equipment & other pumping plant, and plant account 341 transportation equipment to correct for plant that was over
 depreciated. For more information on this subject, see the Depreciation Expense, Accumulated Depreciation and
 Plant in Service section of this brief.

24 ³ RUCO has removed \$780,673 in working capital associated with the compensating bank balance that is no longer
 required under the terms of a new debt refinancing approved by the Commission in Decision No. 74388, dated
 March 19, 2014. For more information on this subject, see the subsequent events section of this brief.

1	RUCO Total Recommended Rate Base Adjustments	<u>(\$2,826,143)</u>
2	<u>Operating Income Adjustment No / Description</u>	
3	1 – Declining Usage Adjustment	\$43,787
4	2 – Excess Water Loss Adjustment and External Audit Costs	95,541 ⁴
5	3 – Incentive Pay	14,090
6	4 – Purchased Water Expense	(87,678)
7	5 – Corporate Allocation Expense	141,257
8	6 – Remove Conservation Expense	7,079
9	7 – Tank Maintenance Expense	202,184
10	8 – Depreciation Expense	347,202 ⁵
11	9 – Property Expense	17,144
12	10 – Income Tax Expense	<u>(177,399)</u>
13	RUCO Total Recommended Operating Income adjustments	<u>\$603,207</u>

RUCO's Final Schedules JMM-4 and JMM-13

2) RATE BASE

A) POST-TEST YEAR PLANT

The Company seeks to recover post-test year plant through December 2013. The test year is calendar year 2012. A-1 at 6. RUCO included the first six months' worth of post-test year plant. RUCO did not include the second half of 2013. The Company did not update its

⁴ RUCO has removed \$49,813 in annual audit fees that is no longer required under the terms of a new debt refinancing approved by the Commission in Decision No. 74388, dated March 19, 2014. For more information on this subject, see the subsequent events section of this brief.

⁵ Based on Staff's amended surrebuttal filing which was docketed on February 26, 2014, RUCO has removed \$1,539,667 in plant account 311 pumping equipment and other pumping plant, and \$400,253 in plant account 341 transportation equipment, in its calculation of depreciation expense. For more information on this subject, see the Depreciation Expense, Accumulated Depreciation and Plant in Service section of this brief.

1 schedules to indicate that any additional plant had been completed until January 2014. R-13 at
2 8.

3 RUCO for the most part relied on Staff's engineer for a determination of whether the plant
4 is used and useful. Transcript at 689. RUCO does not typically hire an engineer for such a
5 determination unless there are unusual circumstances or an unusual amount of plant. Staff's
6 position on post-test year plant changed in its surrebuttal case to include the additional five-
7 months of plant. Transcript at 570-572. Staff made its determination based on prepared
8 testimony and Company responses. Id. at 573. Staff, however, never went back to the Company
9 after August 2013 to verify that the additional plant was in use and was useful. Id. When asked
10 why Staff did not go back to verify that the additional plant was used and useful, Staff's engineer,
11 Katrina Stukov, testified:

12 Considering that most of this plant was underground and you can't
13 verify it, such as services and meter and part of distribution system,
 it would be irrelevant for me to go and inspect.

14 Transcript at 573.

15 Upon further questioning, Ms. Stukov admitted that not all the additional post test year
16 plant that Staff recommended be recovered was actually underground. Id. at 574. RUCO is at
17 a loss as to why it would be irrelevant to look at all of the things that Staff is recommending be
18 included for recovery that the Company listed as not being in service or used and useful as of
19 7/31/13. R-13, Attachment A. While it may be that Staff does not subscribe anymore to the old
20 admonishment "trust but verify," it seems like the more likely reason is Staff does not have the
21 time to verify ("Considering time that they have, I couldn't go and inspect this plant." Transcript
22 at 578).

23 At a minimum, a used and useful analysis should include verification that the plant in
24 question is actually being used and is useful. The Company's schedules indicate that post-test

1 year plant that both the Company and Staff are requesting be included were not used and useful
2 as of July 31, 2013. R-15, Attachment A. There is no independent verification that the plant in
3 question was used and useful in 2013 and therefore should be excluded from rates.

4 **B) ASSET RETIREMENT OBLIGATION**

5 The Company failed to remove a portion of a well which it received in a settlement from
6 the Fountain Hills Sanitary District. R-15 at 4. It is appropriate to remove the cost since the
7 Company paid for it and ratepayers should not have to pay again for it.

8 **C) REMOVAL OF DEFERRED CENTRAL ARIZONA PROJECT MAINTENANCE AND
9 INDUSTRIAL COSTS ("CAP M&I")**

10 In the Company's last rate case, Decision No. 71308, the Commission approved the
11 Company's request to rate base the full amount of the additional allocation of 1,931 acre feet of
12 CAP water that the Company had acquired even though the additional CAP allocation was not
13 used and useful at the time. R-13 at 12.

14 The Commission also approved the Company and Staff's agreement to defer 50 percent
15 of the CAP M&I charges. Decision No. 71308 at 25. Staff wanted the deferral period to be 36
16 months in that case so that Staff would be able to evaluate whether the Company was properly
17 accounting for the deferral, and also to determine if all or a portion of the deferred charges are
18 used and useful and therefore eligible to be placed in rates. Id. In the current case the Company
19 is asking to modify the deferral period to 60 months.

20 Ratepayers have paid and continue to pay a return on the CAP allocation that at the time
21 was not 100 percent used and useful. R-13 at 12. The evidence in this case has shown that
22 the additional CAP allocation is not even 50 percent used and useful.

23 The Company has provided the allocated vs. actual usage and the Company has not
24 even broken into the additional 1,931 acre feet since 2007. R-15 at 6. In 2008, 2009, 2010,
2011, 2012, and 2013, the Company had not used any of the additional allocation. Id. In fact,

1 from 2012 to 2013, the Company's actual usage dropped from 6,776 acre feet to 5,343 acre
2 feet. Id. The Company's original allocation was 6,978 acre feet. Id.

3 On cross examination, the Company's witness admitted that since 2007 the actual use in
4 any given year has not exceeded the original per year allocation of 6,978 acre-feet. Transcript
5 at 522-523. In fact, the amount actually used declined in 2013 to 5,343 acre feet from 6,776 acre
6 feet in 2012. S-17 at 6. Transcript at 523. The evidence in this case leads to only one conclusion
7 – that the additional allocation is not used and useful and that it should continue to be deferred
8 until it is used and useful.

9 Nonetheless, the Company is asking to rate base the remainder of the deferral charges
10 in its application. R-13 at 15. The Company has asked to include an extra year beyond the 48
11 months of CAP M&I charges approved in Decision No. 71308 for a total of 60 months. R-13 at
12 15. The Company claims it is using all of the additional CAP allocation despite the evidence to
13 the contrary. Id. Staff is also recommending that the deferred CAP M&I charges be included in
14 rates. R-15 at 7. Staff has not explained why it believes that the additional CAP allocation is
15 now used and useful, nor is the answer to be found in any of Staff's pre-filed testimony.

16 The Company is properly deferring these CAP M&I costs. R-13 at 7. The Company,
17 however, has not recently been using its full original allocation, let alone its additional allocation.
18 Ratepayers should not have to pay CAP M&I charges for that portion of the Company's allocation
19 that is not used or useful. The rate basing of the CAP acquisition costs in the last rate case has
20 already resulted in generational inequalities since current ratepayers are paying for future
21 ratepayers through growth that comes onto the system. R-13 at 12. The Company should be
22 allowed to defer the costs but ratepayers should not have to pay carrying costs associated with
23 the deferrals. R-13 at 18.

24

1 **D) REMOVAL OF 24 MONTH DEFERRAL OF ALLOWANCE FOR FUNDS USED**
2 **DURING CONSTRUCTION (“AFUDC”) AND DEPRECIATION EXPENSE**

3 The issue is whether the Commission should approve the Company's request to change
4 course and now start deferring AFUDC and Depreciation Expense. The Commission has not
5 historically allowed the Company to include, as a regulatory asset, an additional return on
6 AFUDC on its plant that is in service but has not yet been rate based in a rate case, along with
7 the associated depreciation expense. R-13 at 19. Quite simply, if the Commission approves
8 the deferred costs down the line, which it is likely to do since it allowed the deferral in the first
9 place; the result will be higher rates for ratepayers.

10 It is noteworthy that the Company wants to reduce the regulatory lag in the front end in
11 this instance, but will not agree to reduce the regulatory lag on the back end in other instances.
12 For example, under the currently used group method of depreciation, as will be shown below, it
13 is not uncommon for the plant in question to be over depreciated – likewise, companies
14 frequently do not retire plant timely, resulting in the intended consequence of ratepayers over
15 paying through depreciation expense. Regulatory lag works both ways, and adjustments should
16 be symmetrical –not one-sided as the Company proposes. R-15 at page 7.

17 **E) CASH WORKING CAPITAL**

18 The dispute with cash working capital concerns several of the inputs used in the cash
19 working capital calculation. RUCO believes that two of the inputs, bad debt expense and rate
20 case expense should not be a part of the cash working capital calculation. R-13 at 25-26. Cash
21 Working Capital is calculated as part of a lead-lag study. Id. The Lead-lag study measures the
22 average length of time between the provision of services and the payment of services to the
23 customer (lead) and the average length of time between when a company incurs an expense
24

1 and when the Company makes the cash payment (lag). Id. The whole point of the lead-lag is
2 to measure the Company's cash needs and cash flow.

3 It is not necessary to include bad debt expense in the calculation. There is no payment
4 of cash associated with bad debt expense nor is there an actual payment of bad debt expense.
5 R-13 at 26. Hence, bad debt expense, a non-cash expense, does not affect the Company's
6 cash requirements and should not be included in the cash working capital calculation.

7 Nor should the calculation include rate case expense. R-13 at 26. Rate case expense
8 can be further distinguished in that it is a one-time, non-reoccurring expense normally amortized
9 over 3 or 5 years. Transcript at 676. When calculating cash working capital, the calculation
10 includes re-occurring cash expenses, not one time expenses because reoccurring cash
11 expenses regularly affect the Company's cash outlays. The Commission should not include bad
12 debt expense or rate case expense in the determination of cash working capital.

13 **3) OPERATING EXPENSES**

14 **A) DECLINING USE ADJUSTMENT**

15 The Commission should deny the Company's request for a declining-use adjustment.
16 The Commission should not approve a Company's request for a declining use adjustment unless
17 there is a pattern or trend of declining use. Declining use adjustments guarantee the Company
18 a certain amount of revenue when usage declines. The declining use adjustment is
19 asymmetrical, in that it only addresses the Company's concern if usage declines from year to
20 year. If usage increases, the ratepayer is not refunded and hence the Company over-collects.

21 Webster's dictionary defines "decline" as: "to become lower in amount or less in number."
22 See <http://www.merriam-webster.com/dictionary/decline>. The Company's yearly residential
23 average use, as provided by the Company is as follows:

24 2010 109,556

1 2011 107,056
2 2012 109,628
3 2013 108,166⁶

4 R-13 at 28.

5 Clearly, residential usage has not been declining. These numbers hardly establish a
6 trend of declining use and should not be treated as such. At hearing the Company's witness
7 tried to question these numbers, claiming they may have been manipulated. Transcript at 105.
8 However, when shown the basis for the numbers as being a response to a data request prepared
9 by the same Company witness, the witness testified: "They may not be wrong. They may not
10 have the -- they may not reflect the proper year." Transcript at 161, R-2. The Company never
11 offered any testimony to suggest the numbers are from another year. The Company has clearly
12 failed to meet its burden to show a declining trend to support its request for a declining usage
13 adjustment.

14 RUCO further recommends that the Commission look at all the classes and not just the
15 residential when considering a declining usage adjustment. R-15 at 10. The Commission should
16 ascertain whether the declining usage, if any, is specific to only the residential class or to other
17 classes. Id. at 10-11. The design of any adjustment could then be applied to the appropriate
18 class through the rate design. Id.

19 Should the Commission consider approving the Company's request, RUCO recommends
20 that the Company file an annual report by January 31st of each year in the docket showing the
21 increase/decrease in water usage for each customer class starting with the 2013 information.
22 R-13 at 30.

23

24

⁶ RUCO extrapolated this number from the Spread Sheet dated 2/19/14 provided by the Company during the hearing showing Customer Count and usage.

1 **B) INCENTIVE PAY**

2 RUCO recommends that the Commission share the incentive pay 50/50 between
3 ratepayers and shareholders. There is little question that incentive pay/bonus pay/achievement
4 pay benefits both the shareholders and the ratepayers. R-13 at 30. There is a long history of
5 the Commission sharing incentive pay between the ratepayers and the shareholders. For
6 example, in the UNS Gas rate case, the Commission determined that a 50 percent sharing in a
7 similar program (the Company's Performance Enhancement Program) provides a rebalancing
8 of the interests between ratepayers and shareholders by requiring each group to bear half the
9 costs of the incentive program. Decision No. 70011 at 27. In UNS Electric, the Commission
10 made the exact same award and applied the exact same reasoning (citing the last UNS Gas rate
11 case) regarding the incentive program. Decision No. 70360 at 21. In UNS Electric, the
12 Commission further noted "Given that the arguments raised in the UNS Gas case are virtually
13 identical to those presented in this case; we see no reason to deviate from that recent Decision."
14 Id.

15 In an earlier Southwest Gas case, Decision No. 68487, the Commission stated the
16 following:

17
18 *"We believe that Staff's recommendation for an equal sharing of the*
19 *costs associated with MIP compensation provides an appropriate*
20 *balance between the benefits attained by both shareholders and*
21 *ratepayers. Although achievement of the performance goals in the*
22 *MIP, and the benefits attendant thereto, cannot be precisely*
quantified there is little doubt that both shareholders and ratepayers
derive some benefit from incentive goals. Therefore, the costs of the
program should be borne by both groups and we find Staffs equal
sharing recommendations to be a reasonable resolution."

23 Decision No. 68487 at 18. The same should hold true here.
24

1 Even the Company's witness, under questioning, begrudgingly admitted that the
2 shareholders derive some benefit from incentive pay. Transcript at 116. The Company's view
3 is much less than an equal sharing, but it still is an admission that the shareholder derives some
4 benefit from the expense. There is no reason to deviate from the Commission's past reasoning
5 on this issue – the Commission should share the expense equally.

6 **C) PURCHASED WATER EXPENSE**

7 The Company is requesting both a Sustainable Water Surcharge ("SWS") and a pro-
8 forma adjustment for its purchased water. R-13 at 32. Both mechanisms are not necessary to
9 collect what amounts to the same thing. RUCO is not opposed to projecting future CAP costs
10 into the Company's purchased water rates, as the Company is already doing. Id. RUCO
11 recommends adjusting the Company purchased water expense upward by \$87,678 for CAP M&I
12 charges and Capital charges by utilizing a five year average of charges from the CAP 2013
13 through 2018 rate schedule based (which was updated on June 6, 2013) on the Company's
14 original CAP allocation of 6,978 a.f. *plus one-half of the additional CAP allocation of 1,931 a.f.,*
15 *or 7,943.5 a.f. as shown in Schedule JMM-15. Id. at 33.*

16 **D) SUSTAINABLE WATER SURCHARGE**

17 RUCO also recommends denial of the Company's proposed SWS. In lieu of a SWS,
18 RUCO recommends projecting the CAP M&I charges and capital costs (not related to the
19 additional CAP allocation of 50 percent), and deferring any under or over-collection until the next
20 rate case.

21 If the Commission is inclined to adopt a SWS, RUCO recommends that the SWS also
22 include a component for revenue generated from customer growth (i.e. revenue collected from
23 new customer billings) to help offset the CAP M&I expenses. This is not to be confused with
24 spreading the CAP M&I expenses to new customers coming onto the system. R-15 at page 33.

1 Furthermore, the Commission should also consider a further reduction of the ROE. The SWS
2 mechanism proposed by the Company will cut the regulatory lag between rate cases, lowering
3 the Company's financial risk, since costs will be trued up every year instead of at the next rate
4 case. And as stated above, the Company's pro-forma adjustment should be eliminated, as the
5 SWS expense will flow through the adjustor mechanism and be trued-up every year.

6 **E) CORPORATE ALLOCATION EXPENSE**

7 RUCO and the Company have agreed on most of the corporate allocations. However,
8 RUCO believes that the At-Risk cost pool should be removed from corporate allocations. The
9 At-Risk Cost Pool involves incentive programs at the corporate level that are allocated to
10 EPCOR's utilities. R-13 at 33. The At-Risk Cost Pool has nothing to do with the Company's day
11 to day operations. R-15 at 17. The At-Risk Cost Pool has more to do with the Company's profits
12 and therefore should be removed. R-15 at 17.

13 **F) TANK MAINTENANCE EXPENSE**

14 The tank maintenance expense is one of the larger outstanding disputes. Here again,
15 the Company is proposing something different than what the Commission has allowed in the
16 past. The Company's proposal will allow for the recovery of cost estimates, as opposed to
17 "known and measurable" costs which is the traditional way the Commission has handled tank
18 maintenance expense. This is another proposal, which if approved, would shift the risk to the
19 ratepayer. In other words, should the Company incur less costs than approved, the ratepayer
20 will not be credited nor refunded the overage and the Company will over collect.

21 The Company's proposal will cover the costs associated with the stripping, treating and
22 coating of the tanks over an 18 year period. R-13 at 37. The cost of the maintenance over the
23 next 18 years is estimated - it is not known whether the actual tank maintenance will follow the
24 Company's estimated schedule. Id. Since the amounts are estimates only, they are not known

1 or measurable. Id. Adding to the problem, the farther one moves from the historical test year,
2 which in this case is far, the greater the mismatch between rate base, revenues and expenses.
3 Id. at 37.

4 Moreover, as with the incentive pay and other Company proposals, the Commission has
5 not supported the concept the Company is proposing in the past – in fact the Commission has
6 rejected it. In the 2010 Arizona Water Company’s multi-district case the Commission concluded:

7 *“Despite the Company’s claims, we do not believe there is any valid*
8 *reason for treating tank maintenance expenses differently from other*
9 *properly incurred costs. Although we recognize that these costs tend*
10 *to be cyclical in nature, that fact alone does not justify requiring*
11 *ratepayers to support the Company’s accrual account methodology*
12 *that would allow recovery in this case based solely on estimates*
13 *adjusted by an inflation factor.”*

14 Decision No. 71845 at 26. The Commission made a similar finding in Decision No. 71410, (dated
15 December 8, 2009), in the Arizona American Water Company rate case (now EPCOR Water of
16 Arizona Inc.). In that case, Arizona American proposed a reserve for tank maintenance expense
17 wherein the funds would be recorded in a deferred liability account. Decision No. 71410 at 36.
18 Arizona American’s deferral proposal at least provided ratepayers safeguards whereas the
19 current proposal which is an estimate over an abnormally long term provides no safeguards to
20 the ratepayer. The Commission in the Arizona American case still denied the Arizona
21 American’s request, concluding:

22 *“We are not opposed to the Company instituting a 14-year interior*
23 *coating and exterior painting program for its water tanks. However,*
24 *we do not believe that it is necessary or reasonable to adopt the*
Company’s proposal for advance funding of a Reserve for Tank
Maintenance at this time. Because the tank maintenance expense
reserve account balance proposed by the Company is not based on
known and measurable Company expenditures, we find the
normalization maintenance expenses proposed by Staff, which is
based on a three year average of expenses for each district to be the
more reasonable alternative. Staffs normalization adjustment will
therefore be adopted for each of the six water districts.”

1 Decision No. 71410 at 37.

2 Surprisingly, Staff has abandoned its prior position on this issue of requiring known and
3 measurable costs and is supporting the Company's recommendation. Staff's position is
4 puzzling, given Staff's prior positions and its position in the recent New River case. The Decision
5 in the New River case was docketed January 29, 2014 – Decision No. 74294. New River had
6 proposed \$470,000 in normalized tank painting costs to be amortized over a 15 year period.
7 Decision No. 74294 at 28. There was testimony in the case that a contract had been made
8 between the Company and a vendor concerning \$130,000 of the \$470,000 total request. Id.
9 Staff recommended denial of the proposed expense because it was not a historical cost and the
10 amount was not known and measurable. Id. Staff further recommended that the \$130,000 be
11 rejected because it “would be tantamount to single-item ratemaking where the expense is not
12 properly matched to the expense of the same period,” because only the tank painting expense
13 would be considered, not any reductions in other expenses or any change in revenues in 2013.
14 (Id. at 294.) R-15. Staff's witness in that case, Crystal Brown, testified that the “mismatch would
15 not necessarily be fair to ratepayers.” Id. at 28-29. New River argued that it was relying on the
16 Arizona-American Aqua Fria Case in Decision No. 73145 where tank coating expense was
17 based on cost projections. The Commission, nevertheless, did not find New River's “argument
18 compelling, considering that Decision No. 73145 involved Commission approval of a Settlement
19 Agreement and did not include any findings of fact regarding normalized tank recoating
20 expense.” Id. at 29.

21 The Commission ultimately allowed the \$130,000 normalized over 15 years reasoning
22 that the Commission's rules allow for pro forma adjustments, noting however that such
23 adjustments for future expenses are allowed when there is evidence establishing that the future
24

1 expenses are known and measurable. Id. at 30. The Commission rejected the balance of the
2 total cost. Id.

3 What has changed in two months since the New River case that would explain why Staff
4 would change its position? In response to that question, Staff's witness Gerald Becker testified
5 that he thought the projections were reasonable after talking with Ms. Stukov. Transcript at 898.
6 While the estimates may appear reasonable, that is not the same as being known and
7 measurable. That is the point – estimated costs are not the same as known as known and
8 measurable costs – and should not be treated as such. The difference between to two is the
9 risk that the ratepayer becomes burdened with. There is no reason why the Commission should
10 change its policy at this time.

11 **G) PROPERTY TAX EXPENSE**

12 RUCO originally recommended that a property tax ratio of 19 percent based on the
13 passage of House Bill 2001 which was signed into law on February 17, 2011. R-13 at 40. The
14 Company in its application uses 20 percent. R-15 at 26. Thereafter, RUCO agreed with Staff
15 that a three year average of the property tax assessment ratio is appropriate. R-15 at 26.
16 Accordingly, RUCO reduced its property tax assessment ratio from 19 percent to 18.5 percent
17 which RUCO recommends the Commission approve. Id.

18 **H) INCOME TAX EXPENSE**

19 RUCO has reduced the state corporate income tax rate it used in its gross revenue
20 conversion factor from 6.968 to 6.5 percent to comply with House Bill 2001. R-13 at 40. The
21 six percent rate was changed by the Bill to six percent for taxable years beginning December
22 31, 2014 through December 31, 2015. Id. at 41. It is appropriate to use the lower rate which
23 has the effect of increasing the test year income tax expense. Id.

24

1 On another related matter, RUCO would also agree in this case with the approach Staff
2 took on the issue of Excess Deferred Income Tax ("EDIT") in the recent Litchfield Park Case.
3 Litchfield Park Service Company - Docket Nos. SW-01428A-13-0042 and W-01428A-13-0043.
4 Staff's approach to EDIT in that case was to require the Company to first determine the amount
5 of excess deferred income tax related to the change in state income tax, and present a plan,
6 within 60 days of a Commission decision in that matter on how to refund any excess state income
7 tax recoveries to rate payers. R-15 at 27. Staff is not recommending this procedure in this case
8 – when asked why not Staff's witness Gerald Becker replied "It did not come up". Transcript at
9 893. Although amusing, it really would not be good policy, should the Commission adopt Staff's
10 approach in LPSCO, for the Commission to treat Companies differently on how they are required
11 to handle EDIT. RUCO sees the need for consistency and would not object to this treatment
12 here should the Commission deem it appropriate in the LPSCO case.

13 **I) RATE DESIGN**

14 RUCO's rate design is summarized in Mr. Michlik's Final Schedule JMM-24. RUCO did
15 not change its rate design structure but revised its rate design to conform to the changes in the
16 revenue requirement. RUCO recommends a monthly minimum charge for a 3/4-inch residential
17 customer of \$17.78. Id. No gallons are included in the monthly minimum charge. RUCO
18 recommends the residential water commodity rate for the 3/4-inch residential customer of
19 \$2.4900 per thousand gallons for 1 to 3,000 gallons, \$3.2000 per thousand gallons for 3,001 to
20 9,000 gallons, and \$3.9200 per thousand gallons for any consumption over 9,000 gallons. Id.

21 **4) OTHER ISSUES**

22 **A) SUBSEQUENT EVENT**

23 The Company at the time it filed its application had also filed in another docket a financing
24 application with the Commission. Company witness Mr. Thomas M. Broderick, in this case,

1 stated the following about other favorable outcomes if the Company's refinancing application is
2 approved:

3 "Other favorable impacts of the refinancing include eliminating
4 approximately \$46,000 annual expense in the cost of service for an
5 external audit not required by the replacement financing and
6 elimination of the required bank balance of \$780,673 associated with
7 the debt to be refinances and included in the working capital
8 allowance in this rate application."

9 A-3 at 20.

10 When questioned about this subject, the Company Witness who adopted Mr. Broderick's
11 testimony, Sheryl Hubbard, agreed that the compensating balance should be removed from
12 working capital and the external audit expense should also be eliminated⁷. Transcript at 810.

13 The Commission subsequently approved the financing application in Decision No. 74388,
14 dated March 19, 2014. As a result RUCO in its final schedules removed \$780,673 in working
15 capital associated with the compensating bank balance (RUCO Final Schedule JMM-11), and
16 \$49,813 in annual audit fees that are no longer required under the terms of the new debt
17 refinancing (RUCO Final Schedule JMM-15). RUCO requests that the aforementioned
18 adjustments be made.

19 **B) DEPRECIATION EXPENSE, ACCUMULATED DEPRECIATION AND PLANT IN**
20 **SERVICE.**

21 In the surrebuttal phase of this case, RUCO noticed that Staff's accumulated depreciation
22 adjustment was higher and its depreciation expense was lower than the Company's depreciation
23 expense⁸. R-15 at 40. The reason was because Staff had reclassified some plant and removed
24

22 ⁷ The Company's witness actually testified that she agreed that those items should be removed. See Transcript
23 at 810. RUCO understands that the Company has no objection to the removal of these items.

24 ⁸ On February 26, 2014, Staff filed amended surrebuttal testimony, which recalculated plant since the
Company's last rate case and eliminated over depreciated plant. Based on Staff's amended surrebuttal filing which
was docketed on February 26, 2014, RUCO in its Final schedules has removed \$490,363 in accumulated
depreciation from plant account 311 pumping equipment & other pumping plant, and plant account 341
transportation equipment to correct for plant that was over depreciated. Likewise RUCO has removed \$1,539,667

1 fully depreciated plant assets from its depreciable plant balance since the last rate case. Id.
2 Staff's calculations were the result of using the group asset per account by vintage year method
3 ("vintage method") of depreciation rather than the group method used by the Company. Id. Staff
4 has made the same recommendation in the Bella Vista Water case (Docket No. W-02465A-09-
5 0411) and the Rio Rico case (Docket No. WS-02676A-12-0196). The Commission actually
6 approved the vintage method in the New River case two months ago. Docket No. W-O1737A-
7 12-0478 – docketed January 29, 2014. In New River, the Commission concluded:

8
9 The Commission has the authority, under A.R.S. § 40-222 as well as
10 its exclusive and plenary constitutional ratemaking authority, to
11 prescribe depreciation methodology. Staff's recommendations - to
12 retain the 12.5-percent depreciation rate for the pumping equipment
13 account, not to restate the accumulated depreciation balance for the
14 pumping equipment account using a depreciation rate other than the
15 12.5 - percent depreciation rate authorized in Decision No. 65134,
16 and to require New River to implement the vintage year model for
17 depreciation of all of its plant accounts going forward - are consistent
18 with the straight-line method required by the NARUC USOA and will
19 result in a rational and systemic depreciation methodology consistent
20 with the Commission's rules. The consistency of Staff's
21 recommended methodology should minimize the confusion and
22 potential problems that could occur with the unique and singular plan
23 advocated by New River to use the vintage year model only for the
24 pumping equipment account. We will adopt Staff's recommendations
for adjustments to accumulated depreciation, for depreciation rates,
and for the depreciation model to be used by New River going
forward.

19 See Decision No 74294 at 19 -20.

20 Nonetheless a change in the allowed depreciation methodology in this case would make
21 a significant difference in the amount of depreciation expense and accumulated depreciation. In

23 in plant account 311 pumping equipment and other pumping plant, and \$400,253 in plant account 341 transportation
24 equipment, in its calculation of depreciation expense. RUCO Final Schedules JMM-5, and JMM-21.

1 truth, the use of the vintage depreciation methodology is better for ratepayers than the group
2 method for the reason that under vintage method of depreciation, plant assets which are fully
3 depreciated (although they still may remain in service) and are removed from the plant accounts
4 when calculating depreciation expense. R-15 at 41.

5 Under the group method of depreciation, plant assets are not considered fully depreciated
6 until they are retired. Stated another way, plant assets may be fully depreciated, but continue to
7 remain in these plant accounts until they are eventually retired. The group method approach
8 may cause plant assets to be over depreciated. Id. The vintage methodology eliminates over
9 depreciation. Once the plant reaches the end of its useful life, the Company no longer recovered
10 depreciation expense. Likewise, the Company no longer accumulates depreciation on the plant.

11 Accumulated depreciation is a deduction to rate base, however, it only accumulates at an
12 amount proportionate to the Company's approved return. Transcript at 710. Depreciation
13 expense, on the other hand, is accounted for dollar for dollar. Id. at 709. Accordingly, the benefit
14 to the ratepayer of the rate base reduction resulting from the accumulated depreciation, is much
15 less than the dollar for dollar cost that the ratepayer continues to pay in depreciation expense.
16 Id. at 710 – 711. Perhaps more importantly, and strictly from a fairness standpoint, under the
17 vintage method the ratepayer no longer has to pay for plant that is fully depreciated. Under the
18 group method, there is no circumstance where it is fair or right for a ratepayer to have to pay for
19 depreciation expense on plant that is fully depreciated because of regulatory lag (i.e. having to
20 wait until the Company's next rate case to make the adjustment).

21 There are so many requests in this case where the Company is asking to shift the risk to
22 the ratepayer to reduce the effects of regulatory lag when they work against the Company (i.e.
23 the SIB, the SWS, etc.) It is only fair that the ratepayer should get the benefit of the few
24 accounting mechanisms that reduce or eliminate regulatory lag to the benefit of the ratepayer.

1 **C) RATECASE EXPENSE RECOVER SURCHARGE**

2 RUCO is requesting a rate case expense recovery surcharge. R-13 at 50, Transcript at
3 710. The rate case recovery surcharge would prevent the Company from over collecting rate
4 case expense which it is virtually guaranteed should the Commission approve the rate case
5 expense without it. The Company is requesting \$275,000 in rate case expense to be amortized
6 over three years. Transcript at 813. That amounts to approximately \$91,000 a year. Id. There
7 is no stay out issue in this case, however, under the terms of the SIB, the Company must file its
8 next rate case no later than June 30, 2018. S-6, SIB POA at 5.

9 So barring a rate case filing before then, the Company will over collect rate case expense.
10 Transcript at 814. RUCO is not suggesting that another rate case filing cannot be filed before
11 2018 but the likelihood is remote. More than likely, the Company's request for a SIB will be
12 approved which will allow recovery of approximately \$1.8 million of plant a year. The Company
13 will have recovered significant post-test year plant in this case and there is no evidence or
14 suggestion that the Company will incur significant cash outlays in the near future – the Company
15 also projects its usage to decline (although RUCO questions that based on the evidence in this
16 case). The Commission will likely approve other accounting mechanisms described throughout
17 this Brief which will reduce regulatory lag. In other words, the Company will continue to recover
18 rate case expenses through most of 2018, well after it has fully collected its authorized rate case
19 expense.

20 The Commission's concern of reducing regulatory lag needs to go both ways. RUCO's
21 request here is to assure that the ratepayers only pay for the amount of rate case expense
22 approved – no more and no less. There is no reasonable reason why the Commission should
23 allow the Company to over collect rate case expense. Moreover, the Commission has already
24 approved the same rate case expense surcharge in Decision No. 73573. R-13 at 51.

1 RUCO, consistent with the language in Decision No. 73573, recommends that the
2 Commission implement a surcharge of \$0.55⁹ per customer with the surcharge remaining in
3 place for either (1) a period of 36 months, or (2) until EPCOR has collected \$275,000 in rate
4 case expense recovery, whichever comes first.

5 **D) COST OF CAPITAL**

6 Like the Gold Canyon case before, and any case where a utility proposes an imprudent
7 capital structure, the cost of capital issue comes down to the best method to adjust for the
8 Company's financial risk. The Company has an actual capital structure of 83.4 percent equity.
9 R-8 at 17. The Company's actual capital structure is out of line with the industry average and
10 deprives ratepayers of the benefits associated with debt and is therefore imprudent. Id. It is
11 also significantly out of line with the capital structures of its affiliated and parent companies. Id.
12 at 18. RUCO believes that a hypothetical capital structure is more appropriate here because it
13 best balances the interests of the ratepayers and the shareholders.

14 RUCO came to this conclusion upon review of the Company's affiliated and parent
15 company capital structures. Id. at 18-19. RUCO also considered Staff's filing which recommend
16 a capital structure of 60 percent debt and 40 percent equity. S-3 at Executive Summary.

17 Staff argued, and RUCO agrees that there are several reasons that the hypothetical
18 capital structure is appropriate in this case. The hypothetical capital structure gives recognition
19 to the Company's reduced exposure to financial risk relative to both Staff and RUCO's group of
20 proxies. Id. at 3. It encourages the Company to move towards a more balanced capital structure
21 going forward. Id. Finally, both Staff and RUCO consider a balanced capital structure to be in
22 the range of 60 percent equity and 40 percent debt. Id.

23
24

⁹ \$275,000 rate case expense / 13,730 customers / 36 months.

1 Staff is also concerned that the Company is double leveraged, which if true, would add
2 further support to the use of a hypothetical capital structure. Id. at 4. Double leverage occurs
3 when a parent issues debt and allocates it down to the regulated subsidiary while characterizing
4 it as equity capital. Id. If the regulator then allows such costs in the revenue requirement,
5 ratepayers would be required to pay higher equity costs. Id. Double leveraging is a difficult thing
6 to prove which even Staff admits, but the circumstances here does raise a question. Id. The
7 argument, as Staff admits comes down to the fungibility of money which is always difficult to
8 trace. S-3 at 4. However, given that the Company's 84.5 percent equity component is much
9 higher than the parents 53.1 percent equity component and 38.8 percent higher than its
10 immediate parent, EPCOR Water Arizona's equity component, it is a fair presumption that
11 double leveraging exists. Id. Whether the Company is double leveraged is further reason why
12 the use of a hypothetical capital structure, which makes it a moot point, is the appropriate solution
13 in this case.

14 Nor is the argument persuasive that the Company was not warned that its capital structure
15 would be called into question. In the Company's previous rate case, Docket No. W-02113A-07-
16 0551, Mr. Parcell's testified on behalf of Staff on the issue of cost of capital. RUCO-9. The issue
17 of the Company's growing equity ratio was addressed by Mr. Parcell. Id. Mr. Parcell testified
18 that a case could be made that a hypothetical capital structure could have been used at the time
19 because of the high, 75 percent equity. Id. Given the 86 percent equity now, Mr. Parcell notes
20 that the case for a hypothetical capital structure is even stronger. Transcript at 283.

21 The use of a hypothetical capital structure will also produce a more appropriate level of
22 income tax expense for ratemaking purposes. Since the Company has little debt, there is not
23 an adequate interest deduction to offset the Company's income tax expense. Hence, ratepayers
24 are being asked by the Company to pay more income tax expense than they should because of

1 the Company's choice to use an imprudent capital structure. The level of income tax that results
2 from the hypothetical capital structure is the appropriate level of income tax. The Company
3 completely ignores this aspect, and believes that ratepayers should pay its inflated income tax
4 expense. The Commission should adopt the hypothetical capital structure.

5 RUCO is recommending a Cost of Common Equity of 9.35 percent and a Cost of Debt of
6 5.92 percent. R-7 at 19. RUCO is recommending a weighted average cost of capital of 7.98
7 percent. Id. RUCO's Cost of Equity recommendation is derived from the application of three
8 cost of equity models. The Discounted Cash Flow ("DCF") Model – midpoint – 8.7 percent, the
9 Capital Asset Pricing Model ("CAPM") – mid-point 7.25 percent, and the Comparable Earnings
10 Model – midpoint – 9.25 percent. R-7 at 26. The 9.35 percent represents the average of the
11 mid-point values and is fair and reasonable in this case. Id. at 27.

12 The Company argues for the most part that its inputs in the various cost of capital
13 methodologies should be substituted for RUCO's. There are arguments both ways but RUCO's
14 arguments are compelling and many of the Companies are wrong. R-15. Ms. Ahern's criticism
15 that the DCF model has a tendency to miss-specify investors required rate of returns is
16 misplaced. A-11 at 36-37. Informed investors are aware that most utilities have their rates set
17 based on the book value of their assets. R-8 at 2. If investors believe that markets are efficient,
18 there is no reason to modify either the stock prices or market models that stock prices are based
19 on. Id. The Company also claims that the DCF model produces understated results. Id., A-11
20 at 20 – 22. The Company also claims that the DCF model is predicated on the Efficient Market
21 Hypothesis. A-11 at 15. Both cannot apply – if the market is in fact efficient, the DCF models
22 are reflective of the market conditions. R-8 at 2.

23 The Company's arguments related to the Capital Asset Pricing Model ("CAPM") model
24 are equally unpersuasive. The Company claims that it is improper to consider geometric mean

1 returns in the determination of the risk premium. A-11 at 41-45. Investors, however, have
2 access to both geometric and arithmetic returns so it is proper to use geometric returns in the
3 analysis. R-8 at 7. Moreover, mutual fund investors regularly receive reports on their own funds
4 as well as prospective funds which show only geometric means. Id. RUCO believes it
5 appropriate to consider both geometric and arithmetic returns in its CAPM model. Id. at 8.

6 Ms. Ahern attempts to show a trend of increasing risk premiums – she claims that risk
7 premiums have increased from 2009 to present. Id. Her claim, however, is based on the selective
8 use of the beginning point which distorts the real trend that has taken place. The ending of 2009
9 was in the midst of the Country's financial crises. Id. at 9. In fact, risk premiums have declined
10 since the period prior to the recession. Id.

11 Finally, on the Comparable Earning Method ("CE"), the Company believes that the proxy
12 group used in the CE analysis should exclude utilities to avoid circularity since the achieved
13 returns on book common equity of utilities are substantially influenced by regulatory awards. A-
14 11 at 58-59. But in truth, this is the very reason that the utility returns should be considered in a
15 CE analysis. R-8 at 10-11. The use of the utility returns is necessary to conform to the relative
16 risk dictates of the Bluefield and Hope decisions. Id. at 11. It is appropriate to consider
17 regulatory rewards since by comparison, other regulatory rewards are based on similar types of
18 analysis as are being considered in the current case. Id.

19 By comparison to the Company's 10.50 percent ROE recommendation, RUCO's 9.35
20 percent recommendation is closer to Staff's 9.60 percent ROE recommendation. Staff's 9.6
21 percent recommendation includes a 60 basis point "economic assessment" adjustment. S-3,
22 Executive Summary. The Company does not raise its own equity capital. R-7 at 31. Neither
23 the Company's business risk adjustment nor Staff's economic assessment is warranted.
24 RUCO's 9.35 percent ROE is fair and reasonable and should be approved by the Commission.

1 **E) THE COMMISSION SHOULD REJECT THE SIB.**

2 **1) THIS COMPANY SHOULD NOT BE AWARDED A SIB UNDER THE**
3 **FACTS AND CIRCUMSTANCES OF THIS CASE.**

4 This Company should not be awarded a SIB. Unfortunately, the eligibility criteria
5 identified in the Plan of Administration ("POA") is broad and does not take into consideration
6 many circumstances unique to the case. S-6, POA § (V) (D). For example, where a utility has
7 not maintained its infrastructure up to industry standards and it results in more and higher costs
8 to make the repairs, should the Commission award a SIB? For the most part, from what RUCO
9 can see, all a Company has to do is request a SIB and it is approved by Staff. That is not to say
10 that Staff will approve the annual filings as easily – that has yet to be seen. What is apparent is
11 the mechanism itself appears to be a rubber stamp which RUCO can only hope was never the
12 intention of the Commission.

13 RUCO went through the origins of the SIB in this case. The SIB which is a DISC has its
14 origins in the Arizona Water Company ("AWC") system wide rate case – Docket No. W-01445A-
15 08-0440. Decision No. 71845 – R-1. Staff did an analysis of AWC's systems and among other
16 things found that eight of AWC's systems had water losses over 10 percent. R-1 at 71. Staff
17 recommended that AWC should be required to evaluate the systems and prepare a report for
18 corrective measures on how it plans to reduce the water losses to less than ten percent. Id.
19 AWC insisted that if it was required to comply with Staff's water loss recommendations, then it
20 should be awarded a DSIC. Decision No. 71845 at 72. R-1. The Commission declined to adopt
21 the DSIC but believed it appropriate for the Company to further develop the issue. The
22 Commission stated that AWC "... should prepare a study on a DSIC mechanism designed to
23 implement leak detection devices and make conservation based repairs to infrastructure."
24 Decision No. 71845 at 76. Decision No. 71845 was docketed on August 10 2010. Id. at 1. Fast

1 forward to the present and what we have is a DSIC-type mechanism that has broad criteria for
2 approval and allows for a wide latitude of eligible plant. See POA at 8. S-6 – Attachment C.

3 Procedurally, it was Staff and not even the Company that filed the POA in this case. S-
4 6. In most rate cases, the Company and not Staff, has the burden of supporting its request. By
5 necessity, it should be the Company that files a POA with its application. While the POA in this
6 case is a template, the Company is going to file its POA after the hearing – too little too late.
7 Transcript at 564. Moreover, the schedules of the POA in this case are for the most part
8 undetermined with the exception of the SIB schedule I. S-6. Transcript at 719. In the Eastern
9 Group case the accompanying schedules of the SIB Settlement were filled also out. See
10 Decision 73938. While it is true that the SIB Schedules in the Settlement were estimates, it at
11 least provided the Commission with relevant information in support of the SIB in that case. In
12 particular, the additional schedules provided the Commission with the expected rate increases
13 as it relates to residential ratepayers

14 In the subject case, the Company admits that the previous owner

15 "...did not maintain assets in the CCWC system at levels
16 commensurate with industry standard; the assets were replace on a reactive
17 basis only after they failed. Water utility infrastructure, or any infrastructure
18 for that matter, requires a continuous infrastructure replacement program as
the assets age. Without a proper annual asset replacement program, the
water system becomes inefficient, begins to fail, and replacement costs are
only pushed down the road at ever increasing costs."

19 A-17 at 13. The Company acquired the utility from its previous owner in 2011 and there is no
20 evidence in the record to support a conclusion that the Company did not know the condition of
21 the utility that it acquired. Even if there was evidence to the contrary, it would indicate the
22 Company did not do its due diligence or was negligent in its review, neither of which RUCO is
23 suggesting.
24

1 RUCO is suggesting, however, that the costs associated with improvements to a utility
2 that falls into a state of disrepair because of the failure of the previous owner to maintain the
3 assets at an acceptable industry standard should not become the burden of the ratepayer. The
4 fact that the repairs and improvements are now needed to address the negligence of the
5 previous owner should not become the entire burden of the ratepayer. The Company knew the
6 condition of the utility when it bought it and acted on its own peril.

7 Of course, the repairs still need to be made regardless of the prior condition of the assets.
8 But does the Commission need to award a SIB or can the Commission address the
9 improvements through traditional ratemaking? After all, the SIB is a mechanism designed to
10 ameliorate regulatory lag through a streamlined process that cuts short the safeguards inherent
11 in a rate case and should only be considered when it is necessary to do so. Its benefits to the
12 shareholders far outweigh the benefits to the ratepayers and the ratepayers would prefer that
13 the improvements be addressed in the traditional way. It should not be a given that every
14 Company is entitled to it, and it surely should not be an award for Companies who are negligent
15 in maintaining their infrastructure.

16 In 2011, the amount of relevant spending on the infrastructure that would qualify for the
17 SIB if spent now was \$774,194. A-17 at 12. In 2012, the cost of the relevant improvements that
18 would qualify for the SIB mechanism was \$589,285, Id. By comparison, the Company forecasts
19 the following annual SIB requests through 2018:

20	2014	\$1,812,258
21	2015	\$1,807,903
22	2016	\$1,769,953
23	2017	\$1,803,838
24	2018	\$1,789,353

1 A-17 at 13. The amount spent verses the amount forecasted is simply out of whack. If the
2 Company bought a utility that was in such a state of disrepair, why did the Company spend less
3 than half of its SIB yearly forecast in 2011 and approximately one-third in 2012? Clearly, the
4 situation is not as dire as suggested or this Company, like its predecessor did not adequately
5 address the failing condition of the infrastructure after it acquired it. Another possibility is that
6 the Company just assumed it was going to get a SIB or DSIC like mechanism and did not do
7 the improvements in anticipation of the approval. While RUCO does not know the answer, one
8 thing is for sure, there is a big question regarding the urgency and necessity of the SIB in this
9 case.

10 If this is not enough, then the testimony of the Company's witness should remove all
11 doubt. At the hearing the Company's engineer, Candace Coleman testified to the following:

12 Q. Let me ask you, Ms. Coleman, why can't the company make the
13 repairs and the improvements and then request recovery in the next rate
14 case, which is the traditional way things are done?

15 A. We could.

16 Transcript at 498-499. So why then does the Commission need to award a SIB when the
17 Company admits it could wait until the next rate case when the Commission could handle this
18 by traditional ratemaking? The answer is that is what the Commission should do and would be
19 appropriate under the circumstances of this case. The Commission should deny the Company's
20 request for a SIB in this case.

21 **2) THE SIB SHIFTS RISK FROM THE COMPANY TO THE RATEPAYER
22 WITHOUT ADEQUATE FINANCIAL CONSIDERATION TO THE
23 RATEPAYER**

24 RUCO opposes the SIB mechanism because ratepayers are not adequately
compensated for the additional risk associated with the SIB and because it is illegal. The SIB
mechanism reduces regulatory lag in favor of Chaparral because the Company will not have to

1 wait until new rates go into effect to recover a return on SIB eligible plant or the depreciation
2 expense associated with it. R-14 at 41. However, any actual cost savings, such as lower
3 operating and maintenance expenses, attributable to the new plant are not truly captured by the
4 mechanism and are not adequately flowed through to ratepayers. Id. at 42 The reason for the
5 mismatch is the SIB filings will consider eligible plant placed in service after the time period
6 considered in the rate case. Hence, the operating expenses associated with the SIB plant as
7 well as all of the other rate case elements normally considered in a rate case will not be factored
8 into the calculation. Transcript at 602. This mismatch works against the ratepayer's interests and
9 assures that ratepayers will not pay their actual cost of service and will pay more over time.

10 Ratepayers will be paying for the recovery of and return on routine plant placed into rate
11 base in between rate cases that the ratepayer would not otherwise pay until the next rate case.
12 To the extent the ratepayer receives a benefit through the efficiency credit on the return
13 associated with the SIB related plant that paltry benefit will only accrue until the next rate case
14 filing when the relevant plant is rolled into the rate base and subject to the COE awarded in the
15 next rate case.

16 Another financially related argument advanced in support of the SIB is that the SIB will
17 promote rate gradualism. Transcript at 602-603. While the SIB may promote rate gradualism,
18 it comes at a cost. Ratepayers are very likely to pay higher rates over time because of the failure
19 to consider all of the rate case elements at each SIB filing. Id. Gradualism will also come at
20 the expense of rate stability. Id. Ratepayer's rates will change yearly as the result of each SIB
21 filing. S-6, POA.

22 Each filing will also result in a rate increase. For reasons which will be addressed below,
23 the SIB is not an adjustor. Ratepayers will see no actual cost savings that might otherwise be
24

1 realized without extraordinary ratemaking and will no longer benefit from the rate stability that
2 exists under traditional ratemaking. The Commission should reject the SIB.

3 **3) THE SIB IS NOT AN ADJUSTOR MECHANISM**

4 The Arizona Constitution protects consumers by generally requiring that the Commission
5 only change a utility's rates in conjunction with making a finding of the fair value of the utility's
6 property.¹⁰ However, Arizona's courts recognize that, "in limited circumstances," the
7 Commission may engage in rate making without ascertaining a utility's rate base.¹¹ One of those
8 circumstances exists where the Commission has established an automatic adjustor mechanism.
9 *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616; *Residential Util.*
10 *Consumer Office v. Arizona Corp. Comm'n* ("Rio VeR-13e"), 199 Ariz. 588, 591 ¶ 11, 20 P.3d
11 1169, 1172. An automatic adjustor mechanism permits rates to adjust up or down "in relation to
12 fluctuations in certain, narrowly defined, operating expenses." *Scates* at 535, 578 P.2d 616. An
13 automatic adjustor permits a utility's rate of return to remain relatively constant despite
14 fluctuations in the relevant expense. An automatic adjustor clause can only be implemented as
15 part of a full rate hearing. *Rio Verde* at 592 ¶ 19, 20 P.3d 1173, *citing Scates* at 535, 578 P.2d
16 616.

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

20 The principle justification for a fuel adjustor is volatility in fuel prices.
21 A fuel adjustor allows the Commission to approve changes in rates
22 for a utility in response to volatile changes in fuel or purchased power

23 ¹⁰ Arizona Constitution. Art. XV, § 14; *Simms v. Round Valley Light & Power Company*, 80 Ariz. 145, 151, 294 P.2d
378, 382 (1956); see also *State v. Tucson Gas*, 15 Ariz. 294, 308; 138 P.781, 786 (1914); *Arizona Corporation*
24 *Commission v. State ex rel. Woods*, 171 Ariz. 286, 295, 830 P.2d 807, 816 (1992).

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

1 prices without having to conduct a rate case. (Decision No. 56450,
2 page 6, April 13, 1989).

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

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

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

19 **4) THE COMPANY HAS NOT REQUESTED INTERIM RATES**

20 The only other circumstance where the Commission may engage in rate making without
21 ascertaining a utility’s rate base involves requests for interim rates.¹² The Commission’s
22 authority to establish interim rates is limited to circumstances in which 1) an emergency exists;
23 2) a bond is posted guaranteeing a refund if interim rates are higher than final rates determined
24

¹² *Scates v. Ariz. Corp. Comm’n*, 118 Ariz. 531, 533-35, 578 P.2d 612, 614-16 (App. 1978).

1 by the Commission; and 3) the Commission undertakes to determine final rates after making a
2 finding of fair value.¹³ The Arizona Attorney General has opined that an emergency exists when
3 “sudden change brings hardship to a company, when a company is insolvent, or when the
4 condition of the company is such that its ability to maintain service pending a formal rate
5 determination is in serious doubt.”¹⁴

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

11 **5) THE SIB WOULD NOT QUALIFY UNDER THE ‘THIRD EXCEPTION’**

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

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

(118 Ariz. 531, at 537, 578 P.2d 612, at 618).

¹³ 199 Ariz. at 591, ¶12, citing *Scates*.

¹⁴ 71-17 Opinion Arizona Attorney General at 50. (1971).

1 RUCO believes that an unabridged gap exists between a conclusion that a third exception
2 exists and that the Arizona courts have determined that a third exception exists. *Scates* did
3 define what was needed for interim rates – an emergency which is far more tangible than a mere
4 directive. *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616 (App. 1978).
5 *Scates* also explained that an automatic adjustor is a device that permits rates to adjust as
6 explained above. RUCO is unaware of any case¹⁵ in Arizona that specifically identifies and sets
7 forth the criteria for a third exception. Moreover, the Commission, if anything should be looking
8 to narrow, not expand the exception to Arizona's Constitutional requirement that fair value be
9 found. The provisions of Arizona's Constitution should be liberally construed to carry out the
10 purposes for which they were adopted. *Laos v. Arnold*, 141 Ariz. 46, 685 P.2d 111 (1984).
11 Conversely, exceptions to a constitutional requirement should be narrowly construed. See
12 *Spokane & I.E.R. Co. v. U.S.*, 241 U.S. 344, 350, 36 S.Ct. 668, 671 (1916) (an "elementary rule"
13 that exceptions from a general policy embodied in the law should be strictly construed). The
14 Commission should not use the "emergency" exception or the adjustor mechanism exception
15 liberally or create a "third exception" to set aside the rule of finding fair value when setting rates.

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

23
24

¹⁵ Clearly *Scates* does not define a third exception.

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

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

9 The SIB mechanism itself will be established as part of the pending rate case. Within 12
10 months of the date of the Commission's final decision, Chaparral will be able to file a request to
11 implement the SIB surcharge. S-6, POA at 5. The Company will be able to file for the SIB
12 surcharge no more than five times between rate case decisions. Id. – POA, Exhibit 4. The
13 Commission will ultimately consider and then may approve each surcharge filing. The
14 Commission, however, will not be making a new FVRB finding as part of each surcharge filing.
15 It will be updating the prior fair value finding with the new SIB related plant and associated
16 depreciation expense. It will not consider other expenses and revenues in the calculation. The
17 SIB will do far more than simply pass on increasing costs to the Company - it will allow for
18 increasing rates in between rate cases based on the costs of routine plant effectively increasing
19 the fair value rate base without a meaningful consideration of fair value. The fact that the
20 Company will be subject to an annual earnings test and will have to file balance sheets, income
21 statements and other financial information does not cure the constitutional infirmity.

22 The financial filings are covered in SIB Schedule D which appears to be the answer to
23 the fair value issue from the proponents' perspective. RUCO's perspective is different– the facts
24 are the facts and the fact is that each SIB filing will not result in a meaningful FVRB finding nor
will there be any finding by the Commission of what fair value is:

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

6 Schedule D will show an analysis of the impact of the SIB plant on the fair value rate
7 base, revenue, and the fair value rate of return. S-6, POA at 5. This provision was obviously put
8 in to satisfy *Scates*, but it does not go far enough:

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

21 While the SIB Schedule (D) may show the impact of the SIB plant on the rate base, the
22 revenue and the fair value rate of return, the Commission will not, as required by law, make a
23 meaningful finding of fair value and use that finding as a rate base for the purpose of establishing
24 rates. In the Phase II Eastern Division case, Schedule D shows the rate base (O.C.L.D.) but it

1 only shows the capital costs and the depreciation expense associated with the plant additions.
2 Decision No. 73938, Settlement Agreement, Schedule D. Hence, the SIB filings will only
3 consider one piece – the SIB plant (and depreciation expense). It will not consider the operating
4 expenses associated with that plant, the working capital, etc. in the calculation. The operating
5 expenses that will be included in the rates that the Commission will approve after each SIB filing
6 will be the operating expenses ultimately approved in the Decision in this case - operating
7 expenses from a completely different period than the time period of the SIB plant under
8 consideration. In sum, there is no tie back to fair value and the SIB raises the specter of single
9 issue ratemaking which was a concern of the *Scates* Court. *Scates* at 534, 578 P.2d. 615. The
10 SIB mechanism is single issue ratemaking; it is not fair value ratemaking.

11 Decision No. 73938 added an earnings test calculation. Decision No. 73938 at 51. While
12 an earnings test will provide the Commission with a measure of the Company's earnings at a
13 designated point in time, it will not cure the constitutional fair value infirmity. The earnings test
14 is an after-the-fact indicator of whether the Company's actual rate of return exceeded its
15 authorized rate of return looking back over a designated time period. *Id.* An earnings test is not
16 relevant to an actual finding of fair value. There are other provisions of the Eastern Division
17 Settlement ("Eastern Division Settlement") which will assure Commission oversight and approval
18 of the SIB filings but nothing that requires a meaningful finding of fair value as required by
19 Arizona's Constitution. The SIB is illegal and should be rejected.

20 **7) THE SIB DOES NOT SET ASIDE DEPRECIATION EXPENSE**

21 Under A.R.S. section 40-222 the Commission can order a public service corporation to
22 set aside its depreciation expense. If the premise of water and wastewater companies is their
23 systems/districts are in dire need of repair, and even with a SIB it is not enough, then why not
24 reinvest monies received through depreciation expense? Instead of these monies going back to

1 shareholders or other affiliates/companies these monies should be set aside and be used to pay
2 for improvements and replacement of plant. R-15 at 31.

3 **8) THE SIB IS NOT IN THE PUBLIC INTEREST**

4 There are numerous reasons why RUCO does not believe the SIB is in the public interest.
5 The SIB is illegal in Arizona, and hence not in the public interest. The SIB does not adequately
6 compensate ratepayers for the shift in risk that will result – a five percent efficiency credit is a
7 paltry quid pro quo. Moreover, at the Company admits, it can wait to file for the inclusion of the
8 improvements until its next rate case. Transcript at 498-499.

9 For every argument made in support of the SIB, there are counter- points which weigh
10 more heavily to reject the SIB. There is the argument that the SIB mitigates regulatory lag
11 alluded to above. This is true; however, this benefit to the Company comes at the higher
12 expense of regulatory scrutiny. Elimination of regulatory lag is not in the best interests of
13 ratepayers.

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

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

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

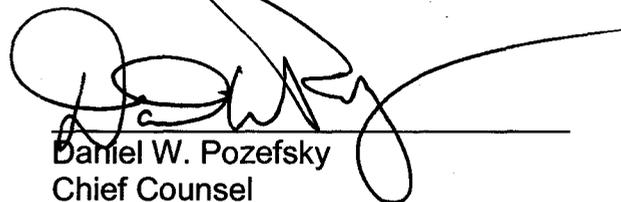
3 Aside from regulatory lag and the various other arguments, quite simply the SIB is poor
4 ratemaking as far as the ratepayer is concerned. The SIB is a mechanism that lets a utility add
5 in-between rate cases gross plant less related depreciation expense to a rate base determined
6 in a prior rate case. The ratepayer is not protected and a small, token efficiency credit is not
7 equal to the hope that the end result will imitate or even be close to the rates the ratepayer would
8 get if all of the rate case elements were scrutinized and applied as would be required in a rate
9 case.

10 Moreover, given the facts in this case, approval of a SIB would pretty much signal that
11 any Company that asks for SIB will get it. Here, the Company admits that the previous recent
12 owner did not keep the repairs and improvements up and that the improvements can wait until
13 the next rate case. The Company after the acquisition and prior to the present did not put the
14 money in the system that it now claims the system needs. Why is it so critical and necessary
15 now to do the improvements and not wait until the next rate case to consider the recovery? The
16 SIB should not be a rubber stamp.

17 **F) CONCLUSION**

18 For all of the above reasons the Commission should approve RUCO's recommendations.
19

20 RESPECTFULLY SUBMITTED this 4th day of April, 2014.

21 
22 Daniel W. Pozefsky
23 Chief Counsel
24

1 AN ORIGINAL AND THIRTEEN COPIES
2 of the foregoing filed this 4th day
3 of April, 2014 with:

3 Docket Control
4 Arizona Corporation Commission
5 1200 West Washington
6 Phoenix, Arizona 85007

6 COPIES of the foregoing hand delivered/
7 mailed this 4th day of April, 2013 to:

7 Lyn Farmer
8 Chief Administrative Law Judge
9 Hearing Division
10 Arizona Corporation Commission
11 1200 West Washington
12 Phoenix, Arizona 85007

11 Janice Alward
12 Legal Division
13 Arizona Corporation Commission
14 1200 West Washington
15 Phoenix, Arizona 85007

14 Steve Olea
15 Utilities Division
16 Arizona Corporation Commission
17 1200 West Washington
18 Phoenix, Arizona 85007

17 Michael Hallam
18 Lewis and Roca LLP
19 40 N. Central Ave.
20 Phoenix, Arizona 85004-4429

19 Leonora Hebenstreit
20 16632 E. Ashbrook Drive, Unit A
21 Fountain Hills, Arizona 85268

21 Leigh Oberfeld-Berger
22 16623 E. Ashbrook Drive, Unit #2
23 Fountain Hills, Arizona 85268

23 Tracey Holland
24 16224 E. Palisades Blvd
Fountain Hills, Arizona 85268

Gale Evans
Patricia Huffman
16218 E. Palisades Blvd
Fountain Hills, Arizona 85268

Lina Bellenir
16301 East Jacklin Drive
Fountain Hills, Arizona 852168

Andrew McGuire
David A. Pennartz
Landon W. Loveland
Gust Rosenfeld PLC
One E. Washington, Suite 1600
Phoenix, Arizona 85004

By Cheryl Fraulob
Cheryl Fraulob