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**BEFORE THE ARIZONA CORPORATION COMMISSION**

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8 IN THE MATTER OF THE APPLICATION OF  
 9 CHAPARRAL CITY WATER COMPANY FOR  
 10 A DETERMINATION OF THE CURRENT  
 11 FAIR VALUE OF ITS UTILITY PLANT AND  
 12 PROPERTY AND FOR INCREASE IN ITS  
 13 RATES AND CHARGES BASED THEREON.

Docket No. W-02113A-13-0118

Arizona Corporation Commission  
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**RUCO'S REPLY BRIEF**

14 The Residential Utility Consumer Office ("RUCO") hereby files its Reply Brief in this  
 15 matter. RUCO's Closing Brief was long and covered the disputed issues in question at length.  
 16 It is neither the intent nor the desire of RUCO to restate its case in this Reply. Rather, RUCO  
 17 will only reply to arguments not addressed in its Closing Brief or to supplement any points made  
 18 already- so to the extent RUCO does not respond in this Reply Brief to any argument made,  
 19 RUCO refers the Commission to its Closing Brief on the subject which in essence is also RUCO's  
 20 reply to the arguments raised by the Company and the other intervenors.

**COST OF CAPITAL AND INCOME TAX EXPENSE**

21 The Company's primary complaint seems directed at Staff and its "new" practice of  
 22 shifting to a hypothetical capital structure. Staff's "new approach", according to the Company  
 23 would lower its effective ROE, and was done without any analysis of the impact using the  
 24 Company's actual capital structure. Company Brief at 4. Such an abrupt change, suggests the

1 Company, would be unfair (as contrary to Staff's approach in other recent cases) and would be  
2 inconsistent if approved. Company Brief at 4. The irony in the Company's argument is many of  
3 its proposed adjustments in this case would deviate from tradition with significant unfavorable  
4 consequences to the ratepayers. (i.e. deferral of 24 months of AFUDC and depreciation  
5 expense, Incentive pay, Sustainable Water Surcharge, Tank Maintenance Expense estimated  
6 over 18 years, etc., etc.). RUCO agrees with the Company in one regard – it is good for the  
7 Commission to be consistent in its application. Both the Company and the ratepayer benefit  
8 from a consistent application of regulation by the Commission. However, the argument cannot  
9 act as both a sword and a shield.

10 The Commission needs to evaluate each request and determine whether or not it's  
11 warranted. For instance, on the issue of incentive pay – the Commission has typically split it  
12 between the ratepayer and the shareholder. See RUCO Closing Brief at 10-11. There is nothing  
13 new on this issue - no change of circumstances, no new arguments, no past promises to the  
14 Company. It is the same issue it always has been. To change the Commission's approach on  
15 this issue here with nothing more would be flip - it would result in regulatory inconsistency and  
16 hence create the same uncertainty that the Company argues against.

17 The hypothetical capital structure recommendation is different. RUCO recognized this  
18 after reviewing Staff's direct testimony in this case and changed its position in its surrebuttal  
19 case to support Staff's hypothetical capital structure. The Company's claim that RUCO's  
20 position is "unsupported, and an after-the-fact attempt to reduce the Company's revenue  
21 requirement" has no merit. It follows the Company's overall mantra that both Staff and RUCO's  
22 positions are "results" driven. Is one supposed to believe that the Company's requests are not  
23 results driven– is it a coincidence that the Company's ROE request is 10.50 percent which is 90  
24 basis points higher than Staff's (9.60%) and 115 basis points higher than RUCO's (9.35%)?

1 Rhetoric aside, the Company has an actual capital structure of 83.4 percent equity. R-8  
2 at 17. Clearly, the Company's capital structure is not balanced and out of line with most other  
3 Arizona utilities, water industry averages and the Company's parent and sister companies. It is  
4 extremely high in equity which explains why Staff recommended a 40 percent debt and 60  
5 percent equity capital structure. S-3, Executive Summary. The situation is different here than  
6 the normal case of the utility with a balanced or near balanced capital structure. The  
7 Commission has reason to consider and change its "normal" approach regarding capital  
8 structure.

9 It is also well known that equity costs more than debt and that the ratepayers will pay  
10 more in rates as a result of the equity rich capital structure. Debt is cheaper - debt includes  
11 interest which offsets income tax expense. The ratepayer benefits from more debt in the capital  
12 structure. Ratepayers should not have to pay higher rates because the Company chooses an  
13 unbalanced capital structure.

14 Perhaps even less persuasive is the Company's suggestion that it was somehow waylaid  
15 by Staff's (and RUCO's) hypothetical capital structure recommendation. The Company claims  
16 that it purchased CCWC in 2011 and made no changes to CCWC's capital structure. Company  
17 Brief at 5. The Company either wants sympathy or wants to attribute guilt to the fact that Staff  
18 never indicated a move towards a new capital structure in the Company's application to acquire  
19 CCWC. Company Brief at 5. This argument has an air of desperation – the Company knew  
20 when it purchased CCWC that the capital structure was equity heavy. The Company chose to  
21 maintain an equity-rich capital structure. Staff did not need to tell the Company that it was  
22 concerned with the capital structure at the time of purchase - but the Company could have  
23 always asked Staff at the time if it was a concern. There is no evidence in the record that the  
24 Company asked, and that the Staff indicated otherwise. In fact, the evidence in the record is that

1 Staff in CCWC's last rate case talked about a possible hypothetical capital structure given the  
2 then high equity ratio (75% equity). RUCO-9, Transcript at 83. Had the Company at the time of  
3 its acquisition bothered to review the last rate case, it would have known that the subject had  
4 come up before. Either way, there is no validity to the argument that the Company had no clue,  
5 or should have had no clue that a hypothetical capital structure was outside the realm of  
6 possibilities given the Company's high equity ratio.

7 Another argument raised by the Company in its Brief of little substance is that Staff did  
8 no analysis of the cost of capital using the actual capital structure which made Staff ignorant of  
9 its impact on the Company's cost of capital. Company Brief at 4. Whether a hypothetical capital  
10 structure is appropriate has nothing to do with what an appropriate cost of capital would be based  
11 on the Company's actual capital structure. That is the point – it is not appropriate to use an  
12 actual capital structure in the determination of cost of capital in this case where the equity ratio  
13 is so high and the Company has been on notice since at least its last rate case. Nonetheless,  
14 RUCO in its Direct case did do a cost of capital analysis based on the Company's actual capital  
15 structure – so the Commission does have a traditional analysis based on the actual capital  
16 structure to consider the impact of. R-7 at 16. The Commission has ample evidence to support  
17 a hypothetical capital structure in this case.

18 With regard to the Company's arguments on Cost of Equity, RUCO's 9.35 percent Cost  
19 of Equity is reasonable for all the reasons stated in the testimony and RUCO's Closing Brief.  
20 RUCO Closing Brief at 23 -24.

21 **DEPRECIATION EXPENSE**

22 RUCO agrees with the Company that the Depreciation Expense adjustment is the other  
23 big ticket item in this case. However, RUCO does not agree that Staff and RUCO's proposal to  
24 change the methodology is a momentous change that is unsupported by the evidence in this

1 case. It is an overdue change that would prevent the Company from over-collecting depreciation  
2 expense on plant that has been fully depreciated. What is so interesting about this whole debate  
3 is that this proposal is not one that even tips the balance in favor of the ratepayer unlike so many  
4 of the mechanisms that the Company is requesting and if approved would tip the balance in the  
5 favor of the shareholders.

6 RUCO applauds and supports Staff for making a recommendation that will assure that  
7 ratepayers will not continue to pay for plant that is fully depreciated. The "normal" group method  
8 allows plant assets to remain in plant accounts even after they are fully depreciated – until they  
9 are taken out in the next rate case. R-15 at 41. True, the additional depreciation expense is  
10 negated to some degree by the accumulated depreciation, but it is not a -one to one offset as  
11 RUCO explained in its Closing Brief. RUCO's Closing Brief at 19. This fact negates any  
12 argument that the Company and other proponents make that ratepayers are not harmed by the  
13 over depreciation that results under the traditional group method. Transcript at 614 – 615, 711.

14 In truth, Staff has been recommending the vintage method in several recent cases. As  
15 Mr. Michlik explains:

16 A. This is vintage method by group account.

17 Q. Okay. And is this method common?

18 A. Yes. Well, it has become common as of late. I explain in my surrebuttal  
19 testimony Staff has been pushing that for some time. So in the Bella Vista  
20 case, they pushed it. I believe it was unsuccessful. Then in the Rio Rico  
21 case it was partially successful. And then the New River case it was  
22 accepted by the Commission.

23 Transcript at 615. Decision No. 74294 at 19-20.

24 Furthermore, the Commission recognized in the New River case that Staff's  
implementation of the vintage year model for depreciation of all of its plant accounts going  
forward was consistent with the straight-line method required by the NARUC USOA and would

1 result in a rational and systematic depreciation methodology consistent with its own rules.  
2 Decision No. 74294 at 19-20. The Company's suggestion that Staff's vintage methodology  
3 somehow does not measure up to NARUC's guidelines is misguided. The Company does not  
4 argue that Staff's vintage proposal offends the Commission's rules in any way.

5 Equally unpersuasive are the Company's arguments regarding the costs of implementing  
6 a new depreciation methodology. The burdensome cost of implementing a new system to  
7 compute depreciation is a real weak argument, and like so many of the Company's arguments,  
8 asymmetrical to its other positions. RUCO does not doubt there is a cost, but there are costs in  
9 implementing all the adjustor mechanisms and other mechanisms that the Company has been  
10 awarded and are being considered in this case that benefit the Company. Yet the costs to  
11 implement those measures has never been raised by the Company. If cost were an issue, the  
12 cost of implementing a SIB would seem to be one of the more considerable costs, yet the  
13 Company is silent. The cost aside, the Company should be keeping records anyway which  
14 show when an assets useful life is over for purposes of depreciation. Transcript at 714. The  
15 Commission should not be persuaded by the Company's arguments.

16 It is noteworthy that the vintage depreciation methodology does not deprive the  
17 shareholder of any authorized revenues. On the contrary, in a sense it deprives the shareholders  
18 of recovering on plant assets twice. Once an asset has reached the end of its useful life  
19 ratepayers should not have to pay for it anymore. Nobody wants to or should pay for something  
20 twice. What the vintage methodology would do is eliminate the over depreciation that accrues  
21 as a result of regulatory lag. Ratepayers are not getting anything additional – they are simply  
22 not paying anymore for an asset that they have already paid for – the way it should be. The  
23 Commission should approve Staff and RUCO's recommendation to use the vintage depreciation  
24 methodology.

1           **RUCO'S RESPONSE TO THE WATER UTILITY ASSOCIATION OF ARIZONA**  
2           **("WUAA") – COST OF CAPITAL AND MODIFIED VINTAGE YEAR DEPRECIATION**

3           The WUAA refers to RUCO's and Staff's proposal for a "Hypothetical Capital Structure"  
4           and "Modified Vintage Group Depreciation as Commission policy changes. Neither RUCO's nor  
5           Staff's position on these two very important issues are by-passing the policy making process, as  
6           the WUAA claims in its Closing Brief. WUAA Brief at 2. There are no specific Commission  
7           policies that addresses either of these two issues.

8           Moreover, contrary to the WUAA's suggestion, the Commission has on several occasions  
9           approved a hypothetical capital structure when the circumstances of the case warranted such  
10          adjustment, as is warranted in this rate filing.

11          In Decision No. 70662, Gold Canyon Sewer Company, the hypothetical capital structure  
12          of 40 percent debt and 60 percent equity was ultimately approved by the Commission as was  
13          recommended by RUCO.

14          In the recent Rio Rico case, Decision No. 73996, a hypothetical capital structure was  
15          approved by the Commission for both Rio Rico Utilities water and wastewater systems. The  
16          Company had proposed the structure based on the hypothetical structure that had been  
17          approved in the previous 2011 Rio Rico decision - Decision No. 72059.

18          In 2008, the Commission approved the hypothetical capital structure, with very minor  
19          changes, that had been proposed by Tucson Electric Power ("TEP") - Decision No. 70628.

20          As is evident in the decisions just referenced the Commission recognizes that when  
21          capital structures are out of line, a revision to the capital structure is necessary. Both Staff and  
22          RUCO believe that to be fair to both the Company and to ratepayers that the Commission should  
23          approve a capital structure comprised of 40 percent debt and 60 percent equity. Regarding  
24          depreciation methodology, the WUAA also claims that both RUCO and Staff are proposing a  
            "unilateral policy change" by recommending a change to a "Modified Vintage Group Depreciation

1 Method.” WUAA Brief at 5. Once again, there is no policy, that RUCO is aware of, that  
2 specifically addresses what depreciation method to use.

3 WUAA discusses the accounting treatment as it relates to the calculation of depreciation  
4 expense – it claims that “Depreciation expense is not really over collected” by allowing a plant  
5 item to be depreciated more than the depreciable life of the asset. WUAA Brief at 5-7. WUAA is  
6 simply wrong. This can easily be shown through a simple example - assume that an asset is  
7 purchased for \$100 and has a useful life of ten years, and depreciation expense is recorded at  
8 \$10 per year. In reality, if the asset is not replaced until year twenty, depreciation has been  
9 recorded for the entire twenty year period, and total depreciation recorded in the Company’s  
10 accounting records for ratemaking purposes is \$200. This simple example shows how clearly  
11 depreciation expense has been over collected – it is no more complicated than this. By adopting  
12 a Modified Vintage Year methodology, negative depreciation balances will be eliminated and the  
13 ratepayer will be charged the correct amount. The Modified Vintage Depreciation Method has  
14 been approved by the Commission in previous rate decisions and is not a deviation from a non-  
15 existent policy.

16 **TANK MAINTENANCE EXPENSE**

17 The Company raises two Commission Decisions – 71410 (Arizona American Water  
18 Company – multiple districts) and 72047 (Arizona American Water Company – Sun City Water  
19 District) in support of its recommendation. Company Brief at 23-24. The Company claims that  
20 these cases provide support for its present request, when, in fact, they provide support against  
21 what the Company is asking for here. The Company’s proposal in this case is a maintenance  
22 plan of eighteen years of estimated costs. Id. At 23, RUCO Brief at 12. RUCO, as the Company  
23 notes is recommending a deferral. RUCO distinguished Decision No. 71410 in its Closing Brief.  
24 RUCO Closing Brief at 13-14. There the Commission approved Staff’s three year normalization

1 adjustment because the Company's 14 year program was not based on known and measurable  
2 changes. Decision No. 71410 at 37. Decision No. 71410 does not support the Company's  
3 current request.

4 Decision No. 72047 does not support the Company's current request either. Like the  
5 other Decision, Decision No. 72047 supports RUCO's request in this case – not the Company's.  
6 In Decision No. 70247:

7 The Company also requests authority to establish a deferral account to allow  
8 it to defer tank maintenance expenses for the Anthem Water district until the  
9 next rate case for the district, at which time the Company may seek recovery  
10 of the deferred amounts. RUCO does not oppose the establishment of such  
11 a deferral account, as the Company already has such an account in place for  
12 the Sun City Water.

13 Decision No. 70247 at 58. The Commission agreed with the Company's request in that case  
14 which is, as the Company notes in this case, the same request that RUCO makes in this case.  
15 Company Brief at 24.

16 In the Sun City Water District case (Decision No. 70247) the Company proposed a tank  
17 maintenance reserve account. Decision No. 70247 at 57. Staff proposed the following which  
18 the Company later agreed to and the Commission approved:

19 Staff recommends that instead of establishment of a tank maintenance  
20 reserve account, the Company be authorized to include the known and  
21 measurable costs associated with tank maintenance as a normalized  
22 expense, in the amount of \$362,000

23 Decision No. 70247 at 57. Again, the reasons for not approving the tank maintenance proposal  
24 by the Company in these other cases is that the costs were not known and measurable. That is  
the same situation in this case, in addition to the eighteen-year period being exceedingly long.  
Nothing new with the Company's argument – just the hope that if the Company continues to  
make it in each new rate case, eventually the Commission will approve it, which, with Staff

1 abandoning its prior position in this case is a good bet. Nonetheless, the Commission should  
2 defer the tank maintenance. After the Company makes the repairs and the cost of the repairs  
3 known, ratepayers can then pay for the actual amount of the costs.

4 **DECLINING USAGE**

5 What declining usage??

6 **POST TEST YEAR PLANT**

7 While the Company may not agree with RUCO's recommendation to exclude post-test  
8 year projects not completed until the second half of 2013, it was hardly an "arbitrary"  
9 recommendation. On the contrary it was well thought out. Should the Commission decide to  
10 include post-test year plant, as an adjustment to rate base - that it's Staff did not take the time  
11 to independently verify was in the ground and used and useful, then the Commission's choice,  
12 in RUCO's view would be arbitrary.

13 **REMOVAL OF THE DEFERRED CAP M&I**

14 There are two different concepts at play here. The Company is trying to confuse them by  
15 making it appear like there is only one concept at play – the concept that the additional CAP  
16 allocation was already included in rates and now RUCO is reviving an old issue. But RUCO is  
17 not doing that – RUCO is raising the issue of used and useful as it pertains to the deferred CAP  
18 M&I charges only and not the acquisition costs that have already been rate based in the last rate  
19 case. Decision No. 71308.

20 Ratepayers are currently paying a full return through rates of the Company's purchase of  
21 an additional 1,931 acre feet of CAP water that was rate based in the prior Decision. In addition  
22 current customers are paying half of the CAP M&I charges related to the additional CAP  
23 allocation. R-13 at 13. The Commission in Decision No. 71308, specifically allowed only one half  
24 of the CAP M&I costs associated with the additional CAP allocation. Decision No. 71308 at 25.

1 In that decision the Commission also allowed the Company to defer CAP M&I costs for up to 48  
2 months, and asked Staff (presumably in the next rate case) to make a used and useful  
3 determination on whether the additional cap allocated is used and useful, so that all or a portion  
4 of the deferred Charges would eligible to be placed into rates Id., R-13 at 15. It is clearly uncertain  
5 whether Staff made a used and useful determination on this. When asked, Staff engineer,  
6 Stukov, did not and did not know if anyone else at Staff had done it. Transcript at 580. Staff's  
7 rate analyst, when asked thought that it was the duty of the engineer on the case, Ms. Stukov to  
8 make that determination. Transcript at 899-900. It really appears that no one at Staff did and  
9 that this is truly a bona fide issue that should not be overlooked.

10 **So RUCO is recommending that the additional 50 percent should be deferred and**  
11 **not rate based at this time as the Company is recommending.** The Company recommends  
12 that ratepayers should now pay for the deferred CAP M&I charges plus an extra 12 months or  
13 60 months on the additional CAP allocation when the Company has not broken into the additional  
14 CAP allocation since 2007. R-15 at 6. The Company's actual usage has in fact declined in the  
15 last two years. Id. The Company claims that it is should be the ratepayer burden to pay for the  
16 deferred CAP M&I charges related to the additional allocation because it was "prudent" for the  
17 Company to purchase the extra allotment. Company Brief at 17. The Company's position is not  
18 consistent with the prior decision. Prudency is not synonymous with used and useful. The risk  
19 of the Company's choice to purchase the extra allotment and then not need the allotment should  
20 not fall entirely on the ratepayer as the Company requests. The current ratepayers are already  
21 paying for the additional CAP allocation acquisition costs but not questioning that in this case.  
22 RUCO recommends that one half of the additional CAP M&I charges continue to be deferred  
23 with no carrying costs until at least 50 percent of the additional CAP allocation is used and useful  
24 consistent with decision No. 71308. If necessary, RUCO will hire a water engineer to make a

1 used and useful determination in the Company's next rate case on the additional CAP allocation.  
2 If approved, future ratepayers will be the only ones who benefit from what with hindsight appears  
3 to be an inaccurate decision of the Company.

#### 4 **CASH WORKING CAPITAL**

5 The use of a hypothetical capital structure does in fact include an imputed interest  
6 component. Company Brief at 18. However, for the reasons stated above, the hypothetical  
7 capital structure is appropriate in this case. A more balanced capital structure would include  
8 more interest expense which would reduce the Company's cash working capital needs. RUCO  
9 admits that there is an air of imprecision when calculating the imputed interest. However, it still  
10 is a reasoned calculation unlike many of the estimates used in mechanisms being proposed by  
11 the Company to reduce regulatory lag.

#### 12 **THE SIB**

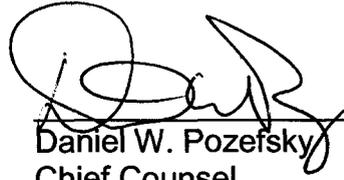
13 The Company's discussion of the SIB in its Closing Brief like its discussion of the SIB in  
14 the rest of this case is sparse. This is not a Company that should be getting a SIB. It has an  
15 equity rich capital structure, cash reserves, and has admitted that it could wait until the next rate  
16 case to request recovery. Transcript at 498-499.

17 RUCO does not believe the Commission's intent was that every Company that applies  
18 for a SIB should get it. If that was the Commission's intent, then RUCO is even more persuaded  
19 that the SIB should be rejected. Nonetheless, Chaparral is not a Company that should be  
20 awarded a SIB and RUCO request the Commission reject the Company's request.

#### 21 **CONCLUSION**

22 For all of the above reasons the Commission should approve RUCO's recommendations.  
23  
24

1 RESPECTFULLY SUBMITTED this 25<sup>th</sup> day of April, 2014.

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3   
4 Daniel W. Pozersky  
5 Chief Counsel

6 AN ORIGINAL AND THIRTEEN COPIES  
7 of the foregoing filed this 25<sup>th</sup> day  
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