BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

BOB STUMP, CHAIRMAN
GARY PIERCE
BRENDA BURNS
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SUSAN BITTER SMITH

IN THE MATTER OF THE APPLICATION OF LAGO DEL ORO WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS WATER RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO. W-01944A-13-0215 **STAFF'S OPENING BRIEF**

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby submits its Opening Brief in this matter as directed by the Administrative Law Judge ("ALJ") on April 3, 2014,[1] and as amended pursuant to a telephonic conference between counsel for the parties and the ALJ on April 30, 2014.

I. INTRODUCTION.

Lago Del Oro Water Company ("LDO" or "Company") is a Class "B" public service corporation with its business office located in Sun Lakes, Arizona.[2] LDO is engaged in providing water utility service to portions of Pima and Pinal counties pursuant to a certificate of convenience and necessity granted by the Commission.[3] On June 27, 2013, LDO filed its application for a permanent rate increase based on a test year ending December 31, 2012.[4] During the test year, LDO served approximately 6,400 water service connections.[5] LDO's current rates and charges were authorized in Decision No. 56464 issued April 26, 1989, and went into effect on or about May 1, 1989.[6]

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[1] Tr. at 205:24.
[2] Application at1:23-24; 3:6; Cassidy Direct, Ex. S-1C at 2:5-6.
[3] Application at 1:21; Cassidy Direct, Ex. S-1C at 2:6-7.
[4] Application at 3:6-8; Bourassa Direct (Rate Base), Ex. A-5 at 3:10.
[5] Application at 1:22.
[6] Application at 2:15-18.

In its application, LDO requested an increase in gross revenues of $1,193,033 (a 63.38% increase), over adjusted test year revenues of $1,882,238.[7] The Company asserted that this increase, when the proposed rates and charges are fully implemented, would result in a rate of return on its $8,287,733 Fair Value Rate Base ("FVRB") of 8.65% from its water operations.[8] In its rebuttal testimony, LDO adopted a number of rate base and revenue/expense adjustments recommended by Staff as well of some of its own.[9] Included among these were Staff's 4.6% cost of debt and capital structure of 29% debt and 71% equity.[10] Based on these adjustments, the Company then proposed a revenue increase of $1,148,253, or 61%, over its adjusted test year revenues of $1,882,238 for a total revenue requirement of $3,030,491.[11] This would result in an operating income of $647,208 and an 8.79% rate of return[12] on a proposed FVRB[13] of $7,363,846.[14] Though LDO initially proposed a 10.5% return on equity ("ROE")[15], the Company now adopts Staff's recommended 9.7% ROE and, consequently, 8.2% overall rate of return ("ROR").[16]

Staff recommends a revenue increase of $1,029,215 (a 54.68% increase), over test year revenue of $1,882,238 for a total revenue requirement of $2,911,453.[17] This results in an operating income of $604,049 and an 8.2% rate of return on an original cost rate base ("OCRB") of $7,366,456.[18] Staff's recommended 8.2% ROR is an increase from the 7.9% originally recommended

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[7] Application at 3:12-13, 21-22; Bourassa Direct (Rate Base), Ex. A-5 at 3:18-21.
[8] Application at 3:21-24; Bourassa Direct (Rate Base), Ex. A-5 at 3:11; 18.
[9] Bourassa Rebuttal (Rate Base), Ex. A-7 at 2:7-8.
[10] Bourassa Rebuttal (Cost of Capital), Ex. A-8 at 1:25 to 2:9.
[11] Bourassa Rebuttal (Rate Base), Ex. A-7 at 1:23-25, 3:8; Bourassa Rejoinder (Rate Base), Ex. A-9 at 1:22-24, 2:11.
[12] Bourassa Rebuttal (Rate Base), Ex. A-7 at 2:19-21; Bourassa Rebuttal (Cost of Capital), Ex. A-8 at 2:2-9; Bourassa Rejoinder (Cost of Capital), Ex. A-9 at 1:25 to 2:14.
[13] Though the parties recommend different amounts for operating income, they agree that LDO's OCRB is also the Company's FVRB.
[14] Bourassa Rebuttal (Rate Base), Ex. A-7 at 2:12, 3:17; Bourassa Rejoinder (Rate Base), Ex. A-9 at 2:19; Rimback Surrebuttal, Ex. S-3A at 2:20-24.
[15] Bourassa Direct (Rate Base), Ex. A-5 at 2:21-22; Bourassa Direct (Cost of Capital), Ex. A- 6 at 2:1-2.
[16] On April 29, 2014, counsel for LDO telephonically advised Staff counsel that the Company was adopting Staff's recommended 9.7% ROE which will be reflected in the revised schedules attached to LDO's opening brief.
[17] Rimback Surrebuttal, Ex. S-3A at 3:2-3.
[18] *Id.* at 3:3-4.

by Staff in its direct testimony[19] and is based on a 9.1% average cost of equity produced by its DCF ("DCF") models and a 60 basis point upward economic assessment adjustment.[20] By adopting Staff's recommended 9.7% ROE, 4.6% return on debt and capital structure of 29% debt and 71% equity, the Company, by necessity, adopts Staff's recommended 8.2% ROR.

As a result of constructive discussions between the parties prior to commencing the hearing, many of the contested issues had been resolved. However, at the hearing, four rate base adjustments (Audit Fees, Depreciated Plant (including Depreciation Method)), amortized contributions in aid of construction ("CIAC") and accumulated deferred income taxes ("ADIT")) and one income statement adjustment, depreciation expense, remained in dispute and resulted in unresolved amounts of OCRB/FVRB and Total Test Year Expenses. The parties also disputed the COE, Overall ROR, Best Management Practices ("BMPs") and Arizona Department of Water Resources ("ADWR") compliance. However, as will be discussed below, in light of events which have transpired since the hearing, Audit Fees, COE, ROR, and ADWR compliance have been resolved.

II. UNRESOLVED ISSUES.

A. Rate Base Adjustments.

Three rate base adjustments remain in dispute between Staff and LGO. First, the parties contest the amount of accumulated depreciation to be applied to plant in service and the method to be used to determine such depreciation. Second, there is disagreement regarding the amount of accumulated ADIT. Third, Staff and LDO differ on the amount of amortized CIAC.

1. Depreciation.

a. Original Cost of Purchased Plant in Service.

The Commission set LDO's current rates in Decision No. 56464 which became effective on or about May 1, 1989.[21] At that time, the Company served approximately 700 connections.[22] During the course of the ensuing years, LDO added major plant to accommodate its now 6,400 plus

[19] *Id.* at 3:11-12; Cassidy Surrebuttal, Ex. S3-B at 5:21-23.
[20] Cassidy Surrebuttal, Ex. S-3B at 6:18-22.
[21] Application at 2:15-18; Jones Direct, Ex. A-1 at 614-15; Rimback Direct, Ex. S-1A at 4:1.
[22] Rimback Direct, Ex. S-1A at 4:3-4.

connections.[23] Such plant was constructed and initially funded by LDO's affiliated company, Saddlebrooke Development Company ("SDC"), at various times during the 1997–2009 period.[24]

In 2012, LDO purchased a significant portion of this plant from SDC at a cost of $3,887,998.[25] Initially, Staff removed $1,136,587 from the original cost of these facilities (and $28,415 from accumulated depreciation relating to the half year of depreciation in test year 2012) to ensure that the value attributable to this purchased plant reflected only the Company's net investment therein.[26] In other words, Staff adjusted the original plant values to reflect the level of accumulated depreciation that would have been booked since the plant was placed in service assuming a depreciation rate of 5% had applied to these assets.[27] The 5% annual depreciation rate aligns with the rate in effect since the last rate case.[28] Staff proposed this $1,136,587 downward adjustment to the original cost of the added plant in service because no consideration was given to the level of accumulated depreciation that would have been recorded between the time the plant was placed in service and the time it was actually purchased by LDO.[29] As a result, Staff originally valued these assets at $2,751,411 for purposes of ratemaking.[30]

The Company disputed Staff's adjustment to the original cost of the added plant in service and, citing the National Association of Regulatory Commissioners Uniform System of Accounts ("NARUC USOA") Accounting Instruction No. 21 subsection B (1), asserted that purchased plant should be recorded at its original cost and, under subsection B (2), accumulated depreciation associated therewith be recorded for utility plant, purchased or sold.[31] In essence, LDO argued that such assets should be recorded in a manner that makes clear both the original cost and accumulated depreciation from the point the assets were first devoted to utility service, i.e., by recording the

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[23] Application, Ex. A-1 at 1:22; Cassidy Direct, Ex. S-1C at 2:8-9.
[24] Rimback Direct, Ex. S-1A at 4:5-6; 8:17-18; 9:2-14; Rimback Surrebuttal, Ex. S-3A at 4:3-4; Thompson Direct, Ex. S-1B, Engineering Report Section J.
[25] Rimback Direct, Ex. S-1A at 4:6-7.
[26] *Id.* at 6:1-6.
[27] *Id.* at 10:4-6.
[28] *Id.* at 10:6-7.
[29] *Id.* at 9:17-22.
[30] Rimback Surrebuttal, Ex. S3-A at 4:17-18.
[31] *Id.* at 3:20-24.

original $3,887,998 value and recognizing an accumulated depreciation reserve of $1,233,787 thereon.[32]

Taking into account the Company's argument that it is important to acknowledge that such assets have been providing utility service for a number of years, Staff now concurs with LDO and recommends recognition of the $3,887,998 original cost of the assets purchased from SDC for ratemaking purposes.[33] However, Staff maintains that an additional accumulated depreciation adjustment of $1,136.587 must be added to the $97,200 accumulated depreciation reserve adjustment LDO included in its application. Given this, Staff proposes that the net value of the assets purchased from SDC is $2,654,211.[34]

b. Accumulated Depreciation Adjustment.

The parties dispute the amount of accumulated depreciation that should be attributable to plant in service. The Company contends that all fully depreciated plant has been properly included in its application. Staff disagrees. Based on documentation provided by LDO and, specifically, work papers from Mr. Bourassa,[35] Staff performed an audit analysis of the plant and accumulated depreciation balances since the last rate case in 1988. In doing so, Staff, citing both NARUC USoA definition No. 12 and A.A.C. R14-2-102(A)(7), relied on the concept that plant is "retired" when [plant] is removed from service, not when the recordkeeping reflects that it is fully depreciated.[36] Staff analyzed the Company's year-by-year transactions and recalculated each year's depreciation expense by NARUC account taking into consideration additions and retirements set forth in information provided by the Company. In doing so, Staff followed the dictates of A.A.C. R14-2-102 (3) which provides "'Depreciation' means an accounting process which will permit the recovery of the original cost of an asset less its net salvage over the service life." During such exercise, Staff determined that, once the original cost of certain plant was fully expensed for depreciation, some of

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[32] Rimback Surrebuttal, Ex. S-3A at 3-7.
[33] *Id.* at 5:7-9.
[34] *Id.* at 12-23.
[35] Tr. 178:3-4; 179:9-10; 180:3-4; 182:18-22; 184:5-6; 187:8-23; 190:15 to 191:6
[36] Rimback Surrebuttal, Ex. S-3A at 6:11-21.

that plant continued to be depreciated.[37] Staff further submits that recovery of depreciation beyond the original cost of the plaint in service does not comply with A.A.C. R14-2-103(3) [sic].[38] Moreover, this removes fully depreciated plant from the going forward calculation of depreciation expense.[39] As a result, Staff submits that the Company's accumulated depreciation is over-stated by $371,263 and should be reduced by that amount.[40]

c. Depreciation Methodology.

In calculating accumulated depreciation, Staff utilized the vintage year group method of depreciation ("vintage year method"). LDO utilized the group method of depreciation ("group method"). In this matter, application of the two methods resulted in a $371,000 discrepancy in accumulated depreciation.[41] Staff submits that there are significant concerns and problems associated with the use of the group method of depreciation and that, based on the resulting inequities, adjustments under the vintage group method are appropriate.

The most notable problem with the group method is that it allows plant to be depreciated beyond its original cost. Staff witness, Mary Rimback, testified that, based on her review of Company provided records, where LDO did not retire plant, it continued to depreciate it. Because such action does not comport with A.A.C. R14-2-102(3), Staff adjusted the amount of accumulated depreciation to reflect the original cost of that plant.[42] In sum, Staff contends that use of the vintage year method is more appropriate because it allows the Company to recover the original cost of an asset, no more and no less. Conversely, the group method allows for the over recovery of an asset's cost by allowing plant to be depreciated beyond its original cost, i.e., over depreciation.

Staff's reliance on the vintage year method mirrors its position successfully asserted in the recent decision in New River Utility Company. (Dec. No. 74294, January 29, 2014) There, as here, Staff posited that the vintage year was the appropriate method to apply when calculating accumulated

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[37] Tr. 178:20-22; 180:15-22; 184:5-22; 185:18-22; 186:1-6.
[38] Rimback Surrebuttal, Ex. S3-A at 7:9-12.
[39] *Id.* at 7:20-21.
[40] *Id.* at 7:16-17.
[41] Tr. 177:24 to 178:22.
[42] Tr. 178:20-22; 180:15-22; 184:5-22; 185:18-22; 186:1-6; 190:15 to 191:13.

depreciation as it precludes over depreciation of plant by tracking individual assets and their applicable useful lives. In essence, under the vintage year method, fully depreciated assets that remain in service are no longer depreciated. Conversely, in that case, New River urged the application of the group year method as it pertained to its pumping equipment account. Testifying for New River, Mr. Jones explained that under the broad group method individual assets lose their identity as individual assets when they are placed in a group and the group is then depreciated as a whole. Though such individual assets are not tracked for purposes of depreciation, when the asset is retired, it is retired as if it were exactly 100 percent fully depreciated, regardless of how long the asset has actually been in service, i.e., whether one day or many years. As Mr. Bourassa has similarly asserted in this matter,[43] Mr. Jones opined that such retirement treatment is a "trade-off" for depreciating by group rather than individual asset as it keeps the group in balance and keeps an individual asset from being depreciated in excess of original cost. Simply put, the Commission rejected New River's argument and recommended application of the vintage year depreciation method for all of its plant accounts.[44]

Based on the foregoing, Staff urges that the vintage year depreciation method and its attendant $371,000 adjustment be adopted here.

2. CIAC and Amortization of CIAC.

LDO proposed no adjustments to CIAC or accumulated amortization ("AA") and maintained its proposed CIAC and AA balances of $852,693 and $469,879, respectively.[45] The Company submits that the $99,158 difference in CIAC balance is due to Staff's application of the vintage group method to CIAC accounting.[46]

Referencing schedules provided by LDO which showed CIAC added and amortization of CIAC since the Company's last rate case, Staff calculated the CIAC balance for the end of the test year.[47] Contrary to the Company's calculations, referring to LDO's Application Schedule B-2 at page

[43] Tr. 203:5-12.
[44] Dec. No. 74294 at 80.
[45] Bourassa Rebuttal (Rate Base), Ex. A-7 at 13:20-22.
[46] *Id.* at 14:1-10.
[47] Rimback Direct, Ex. S-1A at 11:15-21.

5.1,[48] Staff found that LDO continued to amortize CIAC that was completely amortized in 1995.[49] As a result, Staff recommends decreasing gross CIAC by $99,158 and decreasing CIAC amortization by $186,882 with a net increase of $87,524.[50] Notwithstanding Mr. Bourassa's assertion to the contrary, Staff contends that its position with regard to vintage year depreciation does not impact the Company's CIAC balance.[51] While the Company proposed no adjustments to CIAC or AA, it is of import to note that LDO offered no testimony to contradict Staff's CIAC position at the hearing.

3. Accumulated Deferred Income Tax ("ADIT").

Based on its adjustment for plant purchased from SDC, removal of accumulated depreciation on fully depreciated plant, and its CIAC adjustment, Staff increased the amount of ADIT by $68,229 as set forth in Surrebuttal Schedule MJR-W8.[52] The Company's position that the change in book value affected the amount of bonus depreciation claimed by LDO on its 2012 tax returns is irrelevant to this rate case.

No mention of bonus depreciation was included in the Company's original application.[53] Staff contends that, since the plant purchased from the Company's affiliate was placed in service over a period of many years, if applicable, bonus depreciation would have been an issue for the affiliate in the years the assets were placed in service and would not have resulted in bonus depreciation implications only in 2012 as the Company appears to suggest.[54] Staff would presume that the Company contracted with tax experts to file its 2012 tax return. Staff submits that an error of this magnitude, which was beneficial to LDO from a tax vantage point, should not result in a detriment to ratepayers.

Moreover, even Mr. Bourassa admits that since the plant purchased in 2012 "is not actually newly constructed plant but used plant and, therefore, may not even be entitled to bonus

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[48] Rimback Surrebuttal, Ex. S-3A at 8:4-6.
[49] *Id*; Rimback Direct, Ex. S1-A at 11:23-25; Tr. at 173:9-15.
[50] Rimback Direct, Ex. S1-A at 12:2-3; Tr. at 173: 9-15.
[51] Rimback Surrebuttal, Ex. S-3A at 8:4-6.
[52] Rimback Surrebuttal, Ex. S-2A.
[53] *Id.* at 8:13-14.
[54] *Id.* at 8:14-18.

depreciation."[55] He is uncertain as to whether, in fact, the Company actually took bonus depreciation on the plant in issue.[56]

B. <u>Income Statement Adjustment</u>.

1. Depreciation Expense.

In its application, LDO proposed a depreciation expense of $861,127.[57] Staff initially recommended $784,622 as reflected in Schedule MJR-W12 based on rate base adjustments to purchased plant and accumulated depreciation to arrive at depreciable plant amounts.[58] Staff's recommended $371,263 adjustment to accumulated depreciation, in addition to increasing rate base by that amount, also removes fully depreciated plant from the going forward calculation of depreciation expense.[59]

C. <u>Best Management Practices ("BMPs) Tariff</u>.

Staff initially recommended that LDO file as a compliance item seven BMPs in the form of tariffs that substantially conform to the templates created by Staff for Commission review and approval.[60] Staff acknowledged that LDO was regulated by ADWR and was required to implement a basic public education program plus five BMPs. Staff further acknowledged that, as of August 24, 2009, ADWR had approved LDO's Public Education Program and five BMPs.[61]

The Company contested Staff's recommendation and asserted that such requirement was excessive and duplicative as it took LDO beyond what was required by ADWR's Modified Non-Per Capita Conservation Program ("Modified NPCCP").[62] Staff disagrees. As Mr. Thompson explained, the Modified NPCCP "addresses large municipal water providers (cities, town and private water companies serving more than 250 acre feet per year) and was developed in conjunction with stakeholders from all [Active Management Areas ("AMAs")]." Participation is required for all large

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[55] Tr. at 87:24 to 88:1.
[56] Tr. at 90:16-19.
[57] Application; Rimback Direct, Ex. S-1A at 13:8.
[58] Rimback Direct, Ex. S-1A at 14-15.
[59] Rimback Surrebuttal, Ex. S-2A at 14-21; Tr. at 172:23 to 173:5.
[60] Thompson Direct, Ex. S-1B, Ex. MT-1 at 21.
[61] *Id.*
[62] Jones Direct, Ex. A-1 at 4:9-10; Thompson Surrebuttal, Ex. S-3C at 2:22 to 3:2.

municipal water providers in AMAs that do not have a Designation of Assured Water Supply and that are not regulated as a large untreated water provider or an institutional provider."[63] Taking issue with Mr. Jones' duplication argument, Mr. Thompson explained that BMPs -- the number and tariff form of which are based on Staff policy[64] -- address implementation, notification of water company/customer requirements, and notification of steps for service termination, if needed, which the ADWR filing does not address.[65] Further, ACC approved BMP tariffs give water companies additional tools to prevent water loss at little to no extra cost to the company and assist customers in water use efficiency, thereby preventing excessively high water bills.[66]

III. RESOLVED ISSUES.

A. Return on Equity.

Staff and LDO agree with the adoption of Staff's recommended capital structure of 29% debt and 71% equity.[67] The parties also agree with Staff's recommended 4.6% cost of debt.[68]

LDO initially sought a ROE of 10.5% and an overall rate of return ("ROR") on rate base, or weighted average cost of capital, of 8.65%.[69] The Company then agreed to adopt Staff's recommended capital structure of 29.0% debt and 71% equity and 4.6% cost of debt. Maintaining Mr. Bourassa's recommended 10.5% ROE, LDO's amended overall ROR was 8.79%.[70]

Staff first recommended a ROE of 9.3% and ROR of 7.9%, respectively.[71] Staff thereafter updated its cost of capital analysis and increased its recommended ROE to 9.7% and ROR to 8.2%.[72]

Subsequent to the hearing, counsel for LDO contacted Staff counsel to advise that the Company had agreed to adopt Staff's 9.7% ROE. As a result, the parties also agree on Staff's overall ROR of 8.2%, which Staff urges the Commission to accept.

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[63] Thompson Surrebuttal, Ex. S-3C at 3:9-14.
[64] Tr. at 117:7-9; 119:20-24.
[65] Thompson Surrebuttal, Ex. S-3C at 4:23 to 5:2.
[66] *Id.* at 4:2-5.
[67] Tr. at 135:1-6; 136:4-5.
[68] Bourassa Rebuttal (Cost of Capital), Ex. A-8 at 1:25 to 2:9.
[69] Bourassa Direct (Rate Base), Ex. A-5 at 3:11, 19.
[70] Bourassa Rebuttal (Cost of Capital), Ex. A-8 at 2:17-19; Cassidy Surrebuttal, Ex. S-3B at 2:5-9.
[71] Cassidy Direct, Ex. S-1C at 3:2-9.
[72] Cassidy Surrebuttal, Ex. S-3B at 5:21-23.

B. Audit Fees.

Staff initially recommended denial of the Company's proposed $8,000 audit expense adjustment due to inadequate documentation that the bank will be requiring audits of the Company's loan. At hearing, Staff witness, Mary Rimback, related that, if the Company could establish that an audit is actually required by the bank's loan terms, Staff would probably include that expense.[73] Subsequent to the hearing, counsel for the parties discussed this issue and, based on documentation that was not submitted with the Company's application, agreed to a pro forma adjustment of $7,100 for audit expense.

C. Rate Adjustment.

Subsequent to the docketing of pre-filed testimony but prior to the hearing, Ms. Rimback and Mr. Bourassa discussed Staff's Rate Design and the revenues that were to be generated thereby. According to the Company, Staff's rate calculations resulted in an approximate $12,000 shortfall in revenue. Upon review, Staff agreed and filed Revised Surrebuttal Schedules which reflect the revenue disparity.[74]

D. ADWR Compliance.

Staff initially recommended that any increase in the Company's rates approved by the Commission not become effective until ADWR has determined that LDO is in compliance with departmental requirements governing water providers and/or community water systems.[75] Specifically, prior to the docketing of Staff witness, Michael Thompson's, direct testimony, LDO had not submitted its Water System Plan to ADWR for approval, which made the company non-compliant with departmental requirements.[76] Subsequently, LDO submitted its Water System Plan to ADWR and was, therefore, deemed in compliance with respect to such plan.

However, pursuant to a January 14, 2014, ADWR Water Provider Compliance Report, Mr. Thompson determined that the Company was non-compliant with departmental requirements

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[73] Tr. at 192:14-19.
[74] Ex. S-4.
[75] Thompson Direct, Ex. S-1B, Exhibit MT-1 at 2; Thompson Surrebuttal, Ex. S-3C at 1: 25 to 2:3.
[76] Thompson Surrebuttal, Ex. S-3C at 1:22-25.

governing water providers for a different reason, i.e., LDO's well No. 55-573651 (LDO Well No. 19) had not been permitted as a service well by ADWR.[77] As a result of this situation, Staff re-urged its recommendation that conditioned any Commission approved rate increase on the Company's compliance with ADWR requirements regarding the Company's Well No. 19.[78]

Subsequent to the hearing, Staff received documentation that LDO is now in compliance with ADWR requirements regarding Well No. 19. As a result, it is not necessary to condition approval of the rate increase on compliance with ADWR requirements.

IV. CONCLUSION.

Staff respectfully requests that the Commission adopt its recommendations on the disputed issues for the reasons stated above and the testimony provided.

RESPECTFULLY SUBMITTED this 5th day of May, 2014.

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[77] Thompson Surrebuttal, Ex. S-3C at 2:8-12.
[78] *Id.* at 2:15-18.

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