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BEFORE THE ARIZONA CORPORATION

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Arizona Corporation Commission
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BOB STUMP, CHAIRMAN
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BRENDA BURNS
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IN THE MATTER OF THE APPLICATION OF FARMERS WATER COMPANY FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE.

DOCKET NO. W-01654A-13-0267

STAFF'S CLOSING BRIEF

ORIGINAL

I. INTRODUCTION.

Farmers Water Company ("Farmers" or "Company") is an Arizona public service company certificated to provide water utility service in parts of Pima County, Arizona. Currently, the Company serves approximately 2,725 customers distributed among four different water systems: the Sahuarita, Continental, Santa Rita Spring, and Sahuarita Highlands systems. The Company's current rates were approved by Decision No. 71510 (March 17, 2010).

On August 2, 2013, Farmers filed an application for a permanent rate case. The application was found sufficient on August 30, 2013. In its application, the Company proposed a $186,158 increase in revenue (a 22.68 percent increase) from test year revenue of $820,815 to $1,006,697. Due to the Company's negative rate base, the Company proposes the use of an operating margin of 10.0 percent as the basis for operating income.

In response, Staff made various recommendations regarding operating revenue, income and expenses, operating margin, rate design, and engineering which were largely accepted by the Company. In addition, Staff made several recommendations regarding two additional issues, improving the amount of equity in the Company's capital structure and the Company's financial relationship with its parent, Farmers Investment Company ("FICO"). The majority of the disputes between Staff's and the Company's positions regard the treatment of these two issues.

II. DISCUSSION.

A. Rate Case Issues.

1. Rate Base.

Staff and the Company agree that Farmers has an Original Cost Rate Base ("OCRB") of negative $15,143. The Company did not provide a Fair Value Rate Base ("FVRB") and requested use of its OCRB as its FVRB for purposes of this rate case.

Due to the negative rate base, use of a rate of return methodology to produce operating income would be inappropriate in this case. Consequently, as discussed below, Staff recommends that rates be established on a cash flow basis.

2. Revenue Requirement.

a. Operating Revenue.

Staff and Farmers largely agree on the subject of operating revenue. Because both parties recommend setting rates on the basis of an operating margin or cash flow basis, the difference in operating revenues and operating income largely stems from the differences between Staff's and the Company's positions on operating expenses.

b. Operating Expenses.

The Company largely accepted all of Staff's adjustments to test year operating expenses. The only areas of dispute are with regard to the matter of employee bonuses and web-based banking fees.

i. Salaries and Wages.

The Company proposes to include $6,566 in annual employee bonuses as part of Salaries and Wages expense. The Company asserts that bonuses are necessary to acquire and retain qualified personnel.[1] The bonuses that the Company provides are based on a 1/24 fraction of the employee's annual pay.[2] The Company acknowledges that it has the discretion not to pay bonuses at any given time.[3] Further, the Company explains that employees have grown accustomed to receiving the bonuses which are typically received at the end of the year.[4]

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[1] Tr. at 6-7.
[2] *Id.* at 29.
[3] *Id.* at 30, 58.
[4] *Id.* at 29-30.

Staff disagrees that bonuses are necessary to the provision of water utility service. Staff contends that while the employees' base salaries and wages are a required cost of the utility, and thus appropriately recovered from ratepayers as a cost of doing business, bonuses are an optional cost.[5] As such, Staff believes the more appropriate recommendation is to disallow bonuses from salaries and wages expense.

ii. Web-Based Banking Fees.

The Company also proposes the inclusion of web-based banking fees in the amount of $5,111.[6] Staff agrees with the inclusion of web-based banking fees but recommends only approving $3,586. The nature of the dispute is that the Company did not incur any web-based banking fees during the test year and that to the extent that Staff is recommending the inclusion of post-test year expenses, Staff recommends allowing the expense only out to one year after the test-year.[7] Conversely, the Company proposes to recognize the actual full year of expense even though doing so requires stepping outside of the test year by more than a full year.

Staff's recommendation is appropriate and is consistent with Commission practice. "The Commission generally limits post-test year expenses to one year after the test year unless the expense is significant and/or has the potential of creating a financial hardship for the Company."[8] The monetary difference between the Staff position and the Company's position is $1,525 which Staff contends is not going to cause Farmers financial hardship.

Further, Staff believes that its recommendation more accurately describes the conditions Farmers will be experiencing when new rates go into effect.[9] Staff notes that while the Company proposes to step farther than ordinary outside of the test year for purposes of recognizing expenses, it is not equally willing to consider increased revenues that it has also experienced since the test year.[10] To the extent the Company may argue that increased revenues is not likely, Staff's unrebutted engineering testimony suggests that the Company is on course to observe steady growth for several

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[5] Ex. S-3, Surrebuttal Testimony of Crystal Brown at 3-4.
[6] Ex. A-7 Rejoinder Testimony of Thomas Bourassa, Schedule C-2 page 8.
[7] Ex. S-3 at 5.
[8] *Id.*
[9] *Id.* at 6.
[10] *Id.*

years into the future.[11] Consequently, Staff recommends following the ordinary Commission practice and disallowing that portion of the expense that was incurred more than a year beyond the test-year because it is more realistic of conditions that the Company will be facing when new rates go into effect.

c. Operating Income.

Staff and the Company both propose operating incomes that produce 10.0 percent operating margins. The difference between Staff's and Farmers' operating incomes is substantially due to the difference between the parties on operating expenses.

3. Rate Design.

During the course of filing Staff's Direct Testimony and the Company's Rebuttal Testimony, Staff and the Company have come to agreement on rate design.[12]

4. Engineering.

Staff made various engineering recommendations, including recommendations regarding water loss and best management practices ("BMPs"). With regard to water loss, Staff recommends that Farmers monitor water loss for its Sahuarita water system and submit the water pumped and sold to determine the non-account water for a full year and docket the results of its monitoring. Staff further recommends that the Company prepare a report detailing how it plans to reduce water loss in its Sahuarita Highlands and Continental water systems to 10 percent or less.[13]

With respect to BMPs, Staff noted that Farmers currently does not have any Commission approved BMP tariffs.[14] Based on a water utility of Farmers' size, Staff recommends that the Company adopt seven BMPs.[15]

Based on the testimony provided by Ms. Triana at hearing, the Company has no objection to the Staff engineering recommendations and is prepared to meet them.[16]

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[11] Ex. S-1, Testimony of Jian Liu, attached Exhibit JWL Engineering Report at 7 showing that current rate of growth projections suggest as many as 256 new customer connections by December 2017.
[12] Tr. at 54-55.
[13] Ex. S-1, attached Engineering Report at 7.
[14] *Id.* at 10.
[15] Tr. at 110.
[16] *Id.* at 17.

B. FICO Recommendations.

In addition to the disputes arising within the traditional range of rate case issues, a significant dispute between Staff and the Company has arisen with respect to the financial relationship between the Company and its parent. Farmers points to the relationship it has with its parent FICO as a benefit in that, among other things, it permits easy access to funds.[17] Staff does not dispute that there is a benefit to having ready access to a funding source. However, Staff is concerned that this ease of access also exposes the Company to certain financial risks that run counter to the effective operation of a regulated utility.

Staff first noted the implications of Farmers' relationship with FICO as part of its regulatory audit when it discovered a $95,023 receivable owed to Farmers by FICO.[18] At the time that Staff developed its prefiled direct testimony in this proceeding, Staff took the position that FICO should be required to repay the $95,023 to Farmers and that the Company cease recording receivables to FICO.[19] The practice of creating receivables arises from making loans between affiliates.[20] As Staff explained, "The Company chose to record the transaction as a notes receivable from FICO. A notes receivable, by definition is a written promise to receive a sum of money from another party (in this case, from FICO) on one or more future dates."[21]

Staff has further observed that the relationship between FICO and Farmers gives rise to commingling of funds. The testimony of Ms. Triana on behalf of the Company explains that it is the system of shared accounts and subaccounts that gives rise to the creation of notes receivable as well as notes payable.[22]

Moreover, the easy flow of cash between FICO and Farmers can give rise to radical swings in the financial posture of the relationship. During the processing of the rate case, Staff was aware that the Company had notes receivable of $95,023 owed to it by FICO. However, during the hearing in

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[17] *See e.g. Id.* at 18, testimony of Heather Triana discussing a circumstance where access to funds through common bank accounts with FICO permitted Farmers to fund operations in September of 2013 without resort to an outside lending institution.
[18] Ex. S-2 Direct Testimony of Crystal Brown at 12.
[19] *Id.*
[20] Ex. S-3 at 7.
[21] *Id.*
[22] Tr. 23-25.

this matter, Staff first learned that the posture had changed and now Farmers has a note payable to FICO. Effectively, Farmers is now in the position of being in debt to FICO. As both Mr. Bourassa and Ms. Triana conceded on behalf of the Company, there is no restriction on when the note payable must be repaid to FICO and it could conceivably be longer than one year.

The difficulty with notes receivable (and notes payable) in conjunction with the commingling of funds is that they are not in the public interest. The harm to the public interest is the risk that arises because cash Farmers receives as payment for the services it renders is deposited in a common bank account with FICO's funds. The common account is exposed to the creditors of and successful litigants against FICO or any of its other subsidiaries making use of the common account.[23] Regardless that Farmers may have legal remedies to undo the attachment of its portion of funds within the common account, the litigation risks and the time necessary to resolve them undermine any ease of access benefits that come from the financial relationship between the Company and FICO.

These financial risks do not benefit the ratepayer and concerns for these types of practices between affiliates contributed to the enactment of the Public Utility Holding Company Act which inspired the Commission's adoption of the Public Utility Holding Companies and Affiliated Interest ("Affiliated Interest") rules.[24] While Staff acknowledges that the Affiliated Interest rules would not apply to a utility of Farmers' size,[25] the spirit of the rules seek to protect are applicable in this instance.

Therefore, Staff recommends that the Commission order the Company to cease commingling funds with FICO. Specifically, Staff recommends that Farmers be ordered to cease incurring payables and receivables with FICO and that the Company keep its funds in an entirely separate account held in its name.

An additional issue arose at hearing specifically regarding the payable currently owed to FICO. To the extent that the potential exists for Farmers to enter into accounts payable owed to

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[23] Ex. S-3 at 7.

[24] Tr. at 147-48.

[25] Arizona Administrative Code Rule R14-2-802 limits the applicability of the Affiliated Interest Rules to Class A utilities. Farmers is a Class B utility.

FICO and that such debts may potentially take more than a year to repay further complicates the analysis of the financial relationship between FICO and Farmers. Staff learned of the practice for Farmers to record payables during the hearing in this matter when it was stated that the Company now owes FICO approximately $187,000 pursuant to a note payable that was recorded sometime prior to March of 2014.[26] Adding to the unusual circumstances surrounding this advance from FICO is that Farmers recorded it as a negative accounts receivable rather than as an accounts payable.[27] Consequently, Staff does not have sufficient information regarding the conditions that give rise to incurring accounts payable by the Company to evaluate whether the payable is long term debt that requires Commission approval.

Staff contends that any debt carried for longer than one year is long term debt. Staff would further observe that it is unclear why a utility of Farmers' size with the same cash flow would incur $187,000 in debt to cover operating expenses in a single year only months after showing a $95,000 receivable. Ordinarily, in circumstances of an unauthorized long term debt, Staff recommends, and the Commission typically approves, treating the unauthorized loan as paid-in-capital.[28] In this circumstance, requiring any unapproved long term debt to be treated as paid-in-capital at this time would be consistent with the ordinary Commission approach and would provide the additional benefit of infusing more equity into the Company's equity balance. At such time as the payable can be confirmed as debt with a repayment period greater than one year, Staff's recommendation will be that it be treated as paid-in-capital. However, Staff is without sufficient information to confirm the payable is in fact a debt of the Company at this time.

C. Equity Improvement Recommendations.

The remaining area of significant dispute between the parties is with respect to Farmers' current equity capitalization. In the Company's last rate case, the Commission identified the Company's lack of equity as a basis for why rate of return methodology could not be used to set rates.

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[26] Tr. at 27.

[27] *See e.g.* Ex. A-7 attached Farmers' Annual Report for year ending 9-30-2013 at 5 (line 146) and 7 (line 234).

[28] Tr. 146-47.

> Because the Company has a negative rate base, the Commission is unable to set rates based on fair value. In order to reach a more balanced capital structure, we direct the Company to develop and file with the Commission an equity improvement plan.[29]

Farmers filed a plan in the prior rate case docket on March 4, 2011. In that filing, the Company expressed the view that various accounting adjustments adopted by Decision No. 71510, including adjustments to plant in service, accumulated depreciation, and contributions in aid of construction ("CIAC") have contributed to an improvement in the Company's equity.[30] To that end, the Company's filing asserted that Farmers' equity balance improved by $438,871 from what it was at the end of the test year used in that rate case.[31]

In this proceeding, Farmers contends that it has followed its equity improvement plan and that it is working. In the direct testimony of Mr. Bourassa, the Company asserts that it has made over $1.9 million worth of investments in its plant in service net of new plant funded by CIAC and advances in aid of construction ("AIAC").[32]

Staff's audit of the Company indicates that the Company's equity balance has not improved to the extent suggested by the Company and it has in fact worsened since the prior rate case. According to Staff witness Crystal Brown,

> Generally, equity is increased when a company earns a "profit" or pays in additional capital (i.e. paid in capital). Equity is decreased when a company loses money (i.e. incurs a loss) or pays dividends. Other miscellaneous adjustments such as stock transactions, prior period adjustments, and certain changes in accounting principle can also increase or decrease equity.[33]

As Staff further explained, based on Mr. Bourassa's assertion one would expect to see $1.9 million worth of net income, paid in capital, and various adjustments totaling $1.9 million recorded and accumulated in the Company's equity account from the end of the last test year to the end of the current test year.[34] However, the Company has experienced operating losses each year from 2008 to 2012, indicating that it would not have profits to invest.[35] As the Commission noted in the last rate

[29] Decision No. 71510 at 15.
[30] Farmers Water Co.'s Notice of Filing Equity Improvement Plan Pursuant to Decision 71510 docketed March 4, 2011 ind Docket No. W-01654A-08-0502, attached Equity Improvement Plan at 1.
[31] *Id.*
[32] Ex. A-4 at 3.
[33] Ex. S-2 at 13.
[34] *Id.*
[35] *Id.* at 14.

case, the substantial majority of the Company's plant was constructed using AIAC which helped depress the Company's rate base into a negative value. Staff's review indicates that the Company continues to rely on AIAC and CIAC to fund plant additions and that the net AIAC and CIAC on the Company's books increased $1,886,060 since Farmers' last rate case.[36] Due to the continuing infusion of CIAC and AIAC, Staff's analysis shows that the Company's equity has *decreased* by $288,714 to negative $728,916 since the last rate case.[37]

In order to attain the Commission's goal that the Company transition to a rate base amenable to using traditional rate of return methodology, Staff recommends that the Company be required to achieve specific equity level improvement targets. Staff believes that the Company should be required to increase its equity sufficient to make equity constitute 20 percent of rate base within five years, 30 percent of rate base within seven years and 40 percent of equity within ten years.[38]

Likewise, Staff recommends that the Company be required to include paid-in-capital in addition to internally generated retained earnings as part of its efforts to build equity and fund plant additions. Such equity building efforts should be required to include funding AIAC repayments with paid-in-capital. Further, Farmers' equity improvement plan should be modified to include a plan to improve rate base.

In conjunction with its equity target recommendations, Staff also took the opportunity in testimony to advise the Company that should the relevant targets not be met at the time Farmers files its next general rate case, that it should anticipate that Staff will make recommendations in that future rate case to incent the Company away from using an operating margin methodology to set its operating income. To wit, Staff will recommend that:

> [I]f the Company has a negative or zero rate base in its next rate case, that the Company's revenue requirement should be set to break-even, i.e., zero percent operating margin. If the Company has a small rate base, the revenue requirement should be based on operating margin or rate-of-return, whichever is less. The Company's revenue requirement should be based on rate-of-return if the Company has sufficient rate base.[39]

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[36] *Id.* at 15.
[37] *Id.*
[38] Ex. S-3 at 14.
[39] *Id.*

The Company admits it can accelerate the payment of AIAC refunds as a means to inject equity and increase its rate base.[40] Staff noted that building its rate base up to a positive one million dollars could create a positive rate base sufficient to produce the same operating income using a rate of return methodology as the 10 percent operating margin that is being employed in this case.[41] Accelerating the pace of AIAC refunds also serves to slow the eventual transformation of non-refunded AIAC monies into CIAC and therefore avoids these funds from becoming a permanent deduction to rate base[42].

Staff's recommendation reasonably moves the Company toward the rate base improvement that Decision No. 71510 aimed to achieve through the requirement that the Company submit an equity improvement plan. Staff believes that its equity recommendations are appropriate and should be adopted.

III. CONCLUSION.

For all the above stated reasons, Staff's recommendations are reasonable and should be adopted.

RESPECTFULLY SUBMITTED this 2nd day of June, 2014.

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[40] Tr. at 75.
[41] Ex. S-2 at 21.
[42] Pursuant to the operation of Rule R14-2-406(D), AIAC that is not refunded within 10 years becomes nonrefundable and is entered as CIAC.

Copy of the foregoing mailed this _2nd_ day of _June_, 2014, to:

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