EXCEPTION

OPEN MEETING AGENDA ITEM

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BEFORE THE ARIZONA CORPORATION COMMISSION

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ORIGINAL

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

DOCKET NUMBER W-02113A-13-0118

EXCEPTIONS

Let's literally start with the bottom line. The parties agree that in the years leading up to the rate case, Chaparral City Water Company earned a return on year end capital for 2010, 2011, and 2012 of 4.19%, 4.89%, and 5.33%, respectively. During that same period, the company's authorized rate of return was over 10%. Unfortunately, this story is the same for many of Arizona's private water companies. To its credit, the Arizona Corporation Commission is working with stakeholders in order to develop policies that can make it more likely that companies will get closer to their authorized rate of return. Unfortunately, in a classic case of the right hand not knowing what the left hand is doing Staff and RUCO have suggested policy changes in this case that serve to make it harder for the company to earn its authorized rate of

return. Perhaps worse is that these policy changes have been introduced in the guise of adjustments and proposed as part of a closed process in which other stakeholders are unable to participate.

Staff's Proposed Policy on Hypothetical Capital Structures

On the day that EPCOR purchased Chaparral City Water Company, (CCWC) the company had a capital structure that was comprised of 84.5% equity and 15.5% debt. The ACC approved this capital structure in CCWC's previous rate case and EPCOR has made no capital infusions—and has indeed worked to reduce equity by paying dividends of $1.5M in both 2011 and 2012. Now however, staff is suggesting that instead of using CCWC's actual capital structure, the Commission should create a "Hypothetical" Capital structure comprised of 60% equity and 40% debt.

Staff's hypothetical capital structure proposal is a policy change in the guise of an adjustment.

In his Direct Testimony, Mr. Cassidy implies that the staff proposal is actually an equity adjustment; however, after admitting that he made no actual calculations, Mr. Cassidy went on to admit during cross examination that creating a hypothetical capital structure wasn't even his idea. He was simply told to make the adjustment based on a policy decision by someone higher up with staff. There was literally no evidence to support the hypothetical capital structure at the time that staff proposed it.

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

After Staff used its Direct Testimony to advocate its unwritten policy that the company be forced to adopt a hypothetical capital structure, Staff invented a *post hoc* justification for the policy in its surrebuttal testimony. Staff calls this concept "Double Leverage." To its credit, staff makes it very clear that the "Double Leverage" concept had nothing to do with its original recommendation because staff admits that it received the information on which its "Double Leverage" theory is based after it filed its Direct Testimony.

Not only is it clear that "Double Leverage" had nothing to do with the creation of Staff's policy proposal, it is also clear that "Double Leverage" has nothing to do with this case. "Double Leverage" allegedly occurs when a company borrows money and then invests it into a regulated entity. However, EPCOR made no such capital infusion. In addition to not being a factor in this case, the concept of "Double Leverage" is foreign to utility regulation generally. We are not aware of the ACC requiring the companies it regulates to provide the financial information of its shareholders in order to determine whether double leverage exists. The concept of "Double Leverage" is foreign to utility regulation, doesn't fit the facts of this case and was based on information received after Staff made its policy recommendation. The ACC should reject this post hoc rationalization for its policy change.

Staff's new policy is impossible to achieve.

Staff asserts that it proposed its new policy of creating hypothetical capital structure in order to "encourage CCWC to move towards a more balanced capital structure going forward." Let's leave aside the fact that the company had no notice that it was supposed to change its capital structure, and that it was maintaining the same capital structure that Staff recommended and the commission approved in the CCWC's previous rate case. Let's focus on the fact that the company would have violated ACC policies that are actually written in order to comply with Staff's "encouragement".

There are only two ways in which an owner can reduce the equity to debt ratio of its regulated company. The owner can increase dividends in order to remove equity, or it can infuse debt into the company. EPCOR proposed to hold its current debt constant to alleviate future borrowing needs and lessen the increase in equity. This proposal was rejected by staff. Although staff wants less equity in the capital structure, its position in the capital financing application suggests the opposite.

EPCOR had no notice that it needed to change its capital structure and would have had no ability to comply had it known of Staff's policy in advance of the hearing. Staff's new

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

The Proposed Order

To her credit, the Judge rejects the notion of imposing a hypothetical capital structure on the company. However, in a move that would dismay Alice during her trip to Wonderland, the Judge then imposes the COST of a hypothetical capital structure, without actually adopting a hypothetical capital structure. What do we call this new structure? Perhaps it's a "Virtual-Hypothetical Capital Structure."

The Judge correctly points out that the Company proposes a cost of equity of 10.50 percent; RUCO recommends 9.35 percent, and staff recommends 9.60 percent. The Judge then refers to the arguments used in favor of establishing a hypothetical capital structure and comes up with this incredible sentence. "After considering all the testimony and evidence presented by the parties, we find that a cost of equity of 8.65 percent should be approved." (ROO Page 40). Really? What evidence would that be? Staff witness Cassidy admitted that he made no calculations to determine the effect that the hypothetical capital structure would have on the cost of equity. How could the Judge reject Staff and RUCO's recommended capital structure and then adjust the cost of equity to reflect a hypothetical capital structure—which is a calculation that staff never made—and get a result that is 70 basis point BELOW the lowest cost of equity number suggested by any party?

Modified Vintage Group Depreciation

"Regulatory lag works both ways." That's one of the most common expressions in utility regulation. When a company complains that it makes investments between rate cases and has to wait until the next rate case in order to earn a return on those investments, or that it takes too long for a Commission to process a rate case, utility regulators have traditionally said that "Regulatory lag works both ways." In this context, the statement means that companies can also have assets that remain in rate base for longer than their depreciable life. In theory, the "extra' depreciation can offset some of the lost revenue from the delay.

Here, Staff has proposed changing the regular Group Deprecation Method to a modified Vintage Group Depreciation method that appears to be intended to eliminate any chance that an asset could be "over depreciated." This is a unilateral policy change that doesn't recognize that companies make substantial investment in between rate cases and that it takes several years of regulatory process for investments to be put into rate base. Even accounting for a SIB mechanism, EPCOR will make more investment between rate cases than any potential for over-depreciation. Indeed, EPCOR's capital plan calls for the company to invest over $2.5 million in each of years 2014 and 2015. This amount of investment is much larger than the plant associated with the assets that Staff is concerned are being "over depreciated."

Staff's proposed method is fundamentally flawed

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

Some items wear out faster than their useful lives.

Staff has analyzed a pool of assets and determined that some have lasted longer than they were supposed to. Fair enough, but in any group there are also assets that are removed from service before they have reached their book life. The Group Depreciation Method accounts for

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

Depreciation expense is not really "over collected."

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

for the extra five years that the equipment was in service. On the surface, this analysis seems correct, however, when the asset is retired after 10 years, the accumulated depreciation account associated with that asset will have a negative balance equal to all of the "over collected" depreciation expense. Then when the replacement asset is placed in service, its net book value will be the purchase price of the new asset **less the accumulated depreciation associated with the previous asset**. Indeed, if the replacement asset costs the same amount as the original asset then the net book value of the new asset on the day it is placed in service will be zero. Staff has created a complex and novel depreciation method in order to solve a problem that the current group accounting method has already solved.

Staff's new method is much too complex.

Staff's new depreciation method would grandfather in the existing Group Depreciation Method and create a system going forward in which each new asset would be grouped with similar assets purchased in the same year. These annual sub groups would comprise "Vintages" and would be depreciated individually. Thus for an asset with a 20 year life, in the year 2034, the company will still have the original pre 2014 Group account followed by 20 individual "Vintages" that reflect annual purchases—at which time the 2015 Vintage will be retired. Thus 2034 will be the first year in which the ACC will be ensuring that there is no "over depreciation" of these assets. Staff admits that it invented this methodology based on one day's work on an Excel spreadsheet.

The company, of course, has a much more complex system of accounts than an Excel spreadsheet and estimates that the programming costs alone of switching to Staff's new method would exceed $500,000. However, the real cost associated with the new Vintage Method will be the ongoing costs of trying to identify and track assets by Group and Vintage instead of simply by Group. One can envision a scenario in which a tank is built in one year and the company makes life-extending improvements in another year. Under the group method, all of those assets would simply be in a category called "tanks." Under the vintage method, the company would have to

maintain an original tank account and would then have to track each life-extending improvement by vintage. Thus under Staff's method, a single asset may have multiple "vintages.

Vintage Depreciation information is not readily available.

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

Staff's complex new method ignores simple solutions.

For the sake of argument, let's say that the ACC concludes that some items are indeed "over" depreciated and that this is a problem. Staff's proposed solution ignores traditional and well established accounting remedies that are readily available. The most obvious solution is to simply increase the depreciable life of the group. If an asset class, say pumps, is being depreciated over 15 years and they are being used for an average of say 18 years, then just change the depreciable life of the pump class to 18 years. There's no reason to establish a "vintage" class for annual pump purchases and then try to determine how to account for capitalized repair expenses, or the cost of installation or disposal by vintage. If the pumps actually last 18 years, then depreciate them over 18 years

Conclusion

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

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

Staff's proposed policy changes are complex, controversial, have broad implications and can affect a wide variety of companies. The WUAA believes that it is inappropriate for these policy changes to be introduced by Staff in a company-specific rate case. By the time the WUAA learned of these proposals and understood their implications, the date for intervention had passed. Fortunately, the ALJ saw fit to grant the WUAA a limited intervention over RUCO's objection. However, other companies that will be affected by these policy changes are not in the case. Indeed, even with proper notice and broad based intervention, a rate case is a poor forum to discuss substantial policy changes. The Commission usually employs its much more open and flexible workshop process in which Staff (or preferably Commissioners) can propose policy changes and stakeholders can discuss the implications of those changes. The Commission can then adopt or reject those changes and companies have time to implement them. Here, EPCOR had no idea that it was going to be penalized for maintaining a capital structure that the ACC had approved in its last rate case. The company also had no idea that the Staff would reject the depreciation method that the ACC and NARUC have used for years. Furthermore, if the ACC does approve these policy changes as part of this case will other companies be bound by them? Should other companies switch to the Modified Vintage Group Depreciation Method that Staff believes should be required of EPCOR? Should the WUAA and other companies intervene in each rate case in order to be properly positioned in case Staff proposes—and RUCO then

adopts—a broad based policy change? Are other water companies now on notice that staff no longer accepts the well established Group Depreciation Method? How about Tucson Electric Power, Southwest Gas and Arizona Public Service? What method of depreciation should they use in their next rate case? Does the ACC now use a different depreciation methodology for different industries? Are Southwest Gas's pipes going to be depreciated using the Group Method while Chaparral City's water pipes are depreciated under the Modified Group Vintage method? How about Arizona Water Company? Which method should it use?

As argued above, WUAA believes that the evidence in this case shows that the Hypothetical Capital Structure and Modified Group Vintage Depreciation methods are ill advised and should be rejected. The Judge's rejection of the Staff's proposed hypothetical capital structure...followed by her imposition of the effects of that capital structure...leading to a cost of equity number that is well below the range of options set by the parties should be rejected.

We also believe that there is a need for comprehensive policy changes that would allow water companies an opportunity to earn their authorized rate of return, incentivize infrastructure investment and encourage consolidation. Those potential changes should be discussed in an open forum in which stakeholders have adequate notice and an opportunity to discuss the issues that will affect them. The Chaparral City rate case is not that forum. The WUAA urges the ACC to reject the concepts of Hypothetical Capital Structure and Modified Vintage Group Depreciation and to also reject the process that allowed those concepts to be introduced in this case.

RESPECTFULLY SUBMITTED this 6th Day of June, 2014

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