OPEN MEETING AGENDA ITEM

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EXCEPTION

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

BOB STUMP, Chairman
GARY PIERCE
BRENDA BURNS
BOB BURNS
SUSAN BITTER SMITH

ORIGINAL

IN THE MATTER OF THE APPLICATION OF FARMERS WATER CO., AN ARIZONA CORPORATION, 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

Arizona Corporation Commission
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JUL 17 2014
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EXCEPTIONS OF FARMERS WATER CO.

July 17, 2014

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Pursuant to A.A.C. R14-3-110(B) and the July 8, 2014 Memorandum from the Commission's Executive Director transmitting Administrative Law Jane L. Rodda's Recommended Opinion and Order ("ROO") in the above-captioned and above-docketed proceeding ("Instant Proceeding"), Farmers Water Co. ("Farmers Water" or the "Company") hereby submits its Exceptions to the ROO.

I. INTRODUCTION

Farmers Water and Commission's Staff are the only parties to the Instant Proceeding. As a result of pre-hearing exchanges of pre-filed prepared testimony and discovery exchanges, Farmers Water and the Commission's Staff were able to reach agreement in a number of areas with respect to Farmers Water's request for an increase in its rates and charges for water service. In its Rate Application, Farmers Water proposed an increase in revenues, based upon a 10 percent operating margin, of $186,158; or an increase of 22.68 percent over the adjusted and annualized test year revenues. (*See* ROO at page 5, lines 5-7). Staff recommended an increase in revenues, to provide a 10 percent operating margin, of $150,829, an increase of approximately 18.26 percent for a total revenue requirement of $976,757. (*See* ROO at page 5, lines 12-14). By hearing, Farmers Water was requesting an increase in revenues, based upon a 10 percent operating margin, of $160,062, or an increase of 19.38 percent for a total revenue requirement of $985,991. (*See* ROO at page 5, lines 16-18). Given the Company's negative rate base[1], both the Company and Staff agreed that a 10 percent operation margin was appropriate in this case and was not disputed.

At hearing, only two issues affecting operating expenses were in dispute: Staff's adjustments concerning salaries and wages and web-based banking fees. (*See* ROO at page 5, lines 19-20). More contentious were Staff's recommendation to segregate the

[1] The Company's fair value rate base in the Test Year was negative $15,143. (*See* ROO at page 5, line 5).

Farmers Water bank account from that of its parent Farmers Investment Co. ("FICO"), and Staff's recommendations to modify the Company's Equity Improvement Plan. (*See* ROO at page 5, lines 20-21).

II. OPERATING REVENUE AND EXPENSES; REVENUE REQUIREMENT

a) Salaries and Wages

The ROO supports the Company's position related to recovery of annual bonuses as part of salaries and wages as follows:

> *In this case, the year-end bonus is not tied to performance goals. The evidence in this case supports a finding that the annual bonuses paid to employees are more like a part of their total compensation package than they are like optional performance bonuses. The total salaries and wages amount including the year-end bonus is reasonable. As such, they are appropriately included in the salaries and wages expenses.*

(*See* ROO at page 6, lines 18 1/2-22 1/2).

b) Miscellaneous Expenses -web-based banking fees

The ROO supports the Company's position related to recovery of web-based banking fees as follows:

> *The on-line banking fees were implemented at customers' request and provide a benefit to rate payers. We find that the annual costs of the web banking fees are a permissible and reasonable pro forma adjustment to test year expenses. Although they began to be incurred three months after the end of the test year, these fees are known and measureable and will be an on-going expense. To allow only nine months of the actual costs that the Company will face during the period the new rates are in effect, would understate the expense. Consequently, we will allow the entire annual cost of $5,111.*

(*See* ROO at page 7, lines 18 -22, page 8, lines 1-2).

c) Revenue Requirement (Operating Margin)

As set forth above, the ROO determined that Farmers Water is entitled to annual bonuses and web-based banking fees, the two issues associated with operating expense that were in dispute. As such, and considering that both the Company and Staff agreed that a 10 percent operation margin was appropriate in this case and was not disputed, the Company anticipated the ROO would award its requested increase in revenues of \$160,062, or an increase of 19.38 percent for a total revenue requirement of \$985,991. (*See* ROO at page 5, lines 16-18). Instead, the ROO reduced the operating margin by approximately 50 percent thereby authorizing an increase in revenues of \$101,595, or an increase of 12.3 percent for a total revenue requirement of \$927,524. (*See* ROO at page 10, lines 3-10). This reduced operating margin will not provide the company with enough earnings cushion on a going forward basis thereby requiring the Company to come back to the Commission prematurely to seek an additional rate increase.

Upon cross examination by the Administrative Law Judge ("ALJ") , the Company provided unrefuted evidence by accounting witness Tom Bourassa as to why a minimum of 10.00 percent operating margin is necessary in this case:

> *But a minimum of ten percent is considered necessary because we want the company between, between the time it gets its new rates and the next rate cycle, next time it needs to come in, let's say three to five years, we don't want them to run operating deficits. Why? Because, again, it degrades the company's financial health.*

(Tr. at page 83, lines 9-15 [Bourassa]). Specifically, Mr. Bourassa testified that in the last rate case, even though a 10 percent operating margin was authorized by the Commission, the Company still recorded negative earnings within a three year period:

> *So in 2007, the company was running a deficit. For two years thereafter, it ran further deficits. And so it wasn't until the decision in 2010 -- which was*

> *like March, so I think rates went in effect in April. The company didn't then see positive earnings until fiscal year 2010. Then in fiscal year 2011 it saw positive earnings. Then in fiscal year 2012, it ran a deficit again. So the ten percent that was granted didn't even last . . . a full three-year cycle. Right? We conceivably wanted to go three to five years.*

(Tr. at page 83, lines 23-25 through page 84, lines1-9 [Bourassa]).

Mr. Bourassa further testified that a ten percent operating margin in this case may not be sufficient:

> *In fiscal year 2013, the Company ran another deficit of $51,000, as I showed you earlier on the annual report. So this ten percent operating margin resulted in losses for two of the four years the rates were in effect. So one would say, well, maybe ten percent in this case isn't enough.*

(Tr. at page 84, lines 13-19 [Bourassa]).

Even the ALJ, in questioning Mr. Bourassa on the stand, seemed to recognize that when an operating margin is used, the Commission should provide for some type of contingency to account for unexpected expenses:

> *Q.(Rodda) But should operating margin be a fallout? When we can't use rate of return analysis, shouldn't it be here is where our expenses are, here is what we need because we have a capital improvement budget or we've got advances to refund, and we need some contingency because you never know what's going to happen, pump's going to break, and then operating margin should be a fallout, not set ten percent and hope for the best?*
>
> *A. (Bourassa) Correct. In cases where cash flow could be an issue where you have to refund AIAC, you have to pay debt service, you have capital improvements, then that's your next step. You know, you need to look at, well, what do I expect here, and is ten percent enough?*

(Tr. at page 84, lines 22-25 [Rodda]) through page 85, lines 1-9 [Rodda/Bourassa]). In addressing the ALJ's question regarding whether operating margin is a fallout number, Mr. Bourassa explained:

> *And then you look at . . . what are the drivers for increases in the level of operating expenses that might impact the future which, to some extent, affected the running of deficits when we hit 2012. . . . what changed? Well, depreciation went up. Purchased power went up. We had some savings in materials and supplies. But salaries and wages went up. So the mix of things was such that there were greater increases in some of the expense accounts than there were reductions in some of the expense accounts. And then we have to look at our revenues are not at where we expected them to be. Okay? One of the reasons is revenue erosion. Our average use is lower than in the prior case, which means that our average revenue per customer we collect is lower. Those all converged to contribute to an operating deficit. So again, I could make the case, we should get 15 percent or maybe 20. But recognizing we got ten percent in the last case. You know, we're trying to improve the rate base. We think it is working. Maybe ten percent will be all right this time around. But again, I could make the argument it should be more.*

(Tr. at page 85, lines 24-25 through page 86, lines 1-21 [Bourassa]).

Finally, Mr. Bourassa testified that if we assume the Company is to receive the 10 percent operating margin (which would compute to approximately $98,000 in operating income), the Company would only have approximately $20,000 cash left over once you account for depreciation and expenditures:

> *[L]et's say the Company is granted a ten percent, and it actually comes true. We get $98,000 of income. Here we are two years or a year and a half after the test year. So I don't know that the rates we grant today are actually going to give us 98, but let's assume we actually get $98,000 out of it in the first year the rates go into effect, and we add that to the depreciation which is another, let's say, 256. So now we're at $354,000. Right? Of cash flow from the operations, the A-5 top part. And then we have expenditures. Again, we expended 333 in 2013. Let's assume that's on average going to be our thing. We've got a little bit of cash left over, $20,000, right?*

(Tr. at page 99, lines 1-55 [Bourassa]).

As shown at hearing, the operating margin authorized in the ROO not only gives little to no cushion to the Company to account for unexpected expenses; it will actually result in an operating deficit by the end of 2014.

III. INTERCOMPANY TRANSACTIONS

Although it is the Company's position that discontinuing the interconnected banking arrangement between the Company and FICO will: effectively destroy the efficiencies and cost savings for Farmers Water through the use of a common banking relationship; destroy the Company's ability to access funds readily, particularly in cases where the Company experiences a cash shortfalls; prevent the Company from leveraging its overall banking needs to obtain better pricing then if the Company was to have to seek separate banking and loan funding; and incur additional costs; the Company agrees to institute separate banking arrangements by June 30, 2015, and zero out any payables between the Company and its parent, by June 30, 2016, and shall by July 31, 2015, as a compliance item in this Docket, file an acknowledgement signed by a corporate officer confirming the separation has been completed. (*See* ROO at page 25, lines 24-27).

IV. EQUITY IMPROVEMENT PLAN

On March 4, 2011, the Company filed its Equity Improvement Plan pursuant to Decision No. 71510. (*See* ROO at Page 19, lines 14-26 and page 20, lines1-10). The ROO acknowledges that the Company has made progress including: Farmers' rate base has improved from a negative $748,646 in Decision No. 71510 to negative $15,141 in the current test year (*See* ROO at Page 21, lines 7-8) and that at the end of the test year, Farmers' equity was $125,427, despite several years of net losses. (*See* ROO at page 21, lines 10-12). Although the Company is already making progress, the Company agrees to file a revised Equity Improvement Plan that acknowledges the role of additional paid-in-capital in attaining and maintaining a more balanced capital structure (*See* ROO at page 22, lines 17-20).

V. CONCLUSION

Based upon evidence in this case, the Commission should adopt an order increasing Farmers Water's revenues, based upon the undisputed 10 percent operating margin, of $160,062, or an increase of 19.38 percent for a total revenue requirement of $985,991.

RESPECTFULLY SUBMITTED this 17th day of July, 2014.

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