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BEFORE THE ARIZONA CORPORATION COMMISSION RECEIVED

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Docket No. W-01445A-11-0310

Arizona Corporation Commission
DOCKETED

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7 IN THE MATTER OF THE APPLICATION OF
8 ARIZONA WATER COMPANY FOR A
9 DETERMINATION OF THE FAIR VALUE OF
10 ITS UTILITY PLANT AND PROPERTY, AND
11 FOR ADJUSTMENTS TO ITS RATES AND
12 CHARGES FOR UTILITY SERVICE
13 FURNISHED BY ITS EASTERN GROUP
14 AND FOR CERTAIN RELATED
15 APPROVALS.

RUCO'S APPLICION FOR REHEARING

The Residential Utility Consumer Office ("RUCO") hereby files its Application for Rehearing of Decision No. 74590. RUCO, for the same reasons it has enumerated in this docket, requests that the Commission reconsider the implementation of a SIB in the Cochise Division.

RUCO's opposition is for numerous reasons, however to summarize a few¹.

1. THE SIB DOES NOT QUALIFY AS AN AJUSTOR MECHANISM

Permissible adjustor mechanisms allow rates to adjust for the variation in particular *operating expenses*. Further, adjustor mechanisms are appropriate for expenses that routinely

¹ Given the number of arguments in this case where the Commission ultimately rejected RUCO's position, RUCO will not make this Application for Rehearing lengthy when it can just as easily reference its arguments in its Closing and Reply Briefs. RUCO sets forth its arguments in great detail on every issue that the Commission ultimately

1 fluctuate widely. (Decision No. 56450 at 6 (“the principal justification for a fuel adjustor is
2 volatility in fuel prices”); Decision No. 68487 at 14- 15 (costs of pipeline integrity management
3 program recovered through an adjustor due to annual fluctuations in the costs). Here, the costs
4 to be recovered through the SIB mechanism are neither operating expenses, nor are they
5 expected to be volatile. Moreover, the SIB mechanism only permits rates to adjust up, not
6 down. Rather than recovering the costs of infrastructure replacements through an adjustor
7 mechanism, the costs to be recovered through the SIB should be recovered through the
8 standard rate adjustment process of a rate case. *Scates*, at 535, 578 P.2d at 616. Additionally,
9 the implementation of rate mechanisms by which rates are increased without full rate case
10 submissions requires exceptional situations. *Scates*, at 537, 578 P.2d at 618. No such
11 exceptional circumstances exist here. In the hearing in Phase 1, Staff testified that AWC was
12 not facing extraordinary circumstances due to its infrastructure replacement needs, even
13 assuming a \$67 million cost estimate. Nothing has changed about the Company’s expenditures
14 to suddenly create an extraordinary circumstance. Rather, the only difference which Staff cited
15 at the Phase 2 hearing as an extraordinary circumstance was that the Commission had directed
16 the parties to further discuss the DSIC. Essentially, Staff asserted that the Commission’s
17 direction to discuss a DSIC created an “extraordinary circumstance” sufficient to justify the use
18 of a rate adjustment mechanism. The courts have previously rejected such an “*ipse dixit*
19 approach” by the Commission to finding extraordinary circumstances to circumvent the
20 constitutional mandate that rates be established in the context of a full rate case. *See, Rio*
21 *Verde* at 593,pp. 21, 20 P.3d at 1174.

22
23
24 rejected in its hearing briefs including the SIB which RUCO incorporates by reference here. All references in this Application are to the underlying Phase II docket unless indicated otherwise.

1 **2. THE SIB SHIFTS RISK FROM THE COMPANY TO THE RATEPAYER**
2 **WITHOUT ADEQUATE FINANCIAL CONSIDERATION TO THE RATEPAYER**

3 The SIB mechanism reduces regulatory lag in the favor of AWC because the Company
4 will not have to wait until new rates go into effect to recover a return on SIB eligible plant or the
5 depreciation expense associated with it. However, any actual cost savings, such as lower
6 operating and maintenance expenses, attributable to the new plant are not captured by the
7 mechanism and are not flowed through to ratepayers. The reason for the mismatch is the SIB
8 filings will consider eligible plant placed in service after the time period considered in the rate
9 case. Hence, the operating expenses associated with the SIB plant as well as all of the other
10 rate case elements normally considered in a rate case will not be considered. Id. This mismatch
11 works against the ratepayer's interests and assures that ratepayers will not pay their actual cost
12 of service and will more than likely pay more over time.

13 **3. THE SIB WILL INCREASE THE COMPANY'S FAIR VALUE RATE BASE**
14 **WITHOUT ANY DETERMINATION OF FAIR VALUE**

15 Having established that the SIB does not meet any of the criteria required by Arizona's
16 Courts to side-step the Constitution's fair value requirement, the question then becomes
17 whether or not the SIB complies with the Constitution's fair value requirement. First, it is
18 important to recognize what the SIB is – it is a mechanism, not an adjustor mechanism, which
19 will allow for the recovery of, and a return on routine plant in between rate cases, needed to
20 address the Company's plant and improvement needs².

21 Next, as Staff noted, there is a question of whether exceptional circumstances exist for
22 the extraordinary ratemaking being contemplated. The Commission has also determined that
23 cost recovery mechanisms designed to side-step the fair value requirement should only be

24 ² Again, its purpose is the same as the higher ROE that the Commission awarded in the underlying case.

1 allowed in extraordinary circumstances. For example, see Decision No. 70351 at 36. Staff's
2 Director, Steve Olea, provided insight on this important consideration. Staff concluded that the
3 Company had not demonstrated extraordinary circumstances in the underlying case to justify
4 the Company's proposal. When asked in this Phase what has changed, Mr. Olea responded the
5 Commission's request that the parties were all directed to talk about the DSIC. In Staff's view,
6 a Commission directive to look at the DSIC constitutes an extraordinary circumstance. Staff's
7 definition of "extraordinary" is even more murky and inconsistent³ when one considers that the
8 Commission in the last company-wide rate case ordered the Company to do a DSIC study and
9 report on it in this case. While it does not appear that Arizona's case law defines extraordinary
10 or exceptional, it is doubtful that it would include the Commission's directive in this case. For
11 example, *Scates* did define what was needed for interim rates – an emergency which is far
12 more tangible than a mere directive. *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 535, 578
13 P.2d 612, 616 (App. 1978).

14 Finally, comes the question of exactly how the SIB works mechanically and whether it
15 meets the fair value requirement. The mechanism itself will be established as part of the
16 pending rate case. Within 12 months of the date of the Commission's final decision, AWC will
17 be able to file a request to implement the SIB surcharge. The Company will be able to file for
18 the SIB surcharge no more than five times between rate case decisions. The Commission will
19 ultimately consider and then may approve each surcharge filing. The Commission, however,
20 will not be making a new FVRB finding as part of each surcharge filing in such a way as to
21 make fair value meaningful. As Staff noted concerning the DSIC, the SIB will do far more than
22 simply pass on increasing costs to the Company - it will allow "...surcharges based on the cost

23 _____
24 ³ I.e. it was not extraordinary when Staff considered the Company's proposed DSIC but is extraordinary in

1 of the new plant, effectively increasing the fair value rate base without any determination by the
2 Commission of what that fair value is.” The SIB suffers from the same constitutional deficiency
3 effectively making it illegal in Arizona.

4 **4. THE SETTLEMENT DOES NOT CURE THE CONSTITUTIONAL INFIRMITIES**
5 **OF THE SIB**

6 The proponents of the SIB claim that the necessary constitutional safeguards are in
7 place and the SIB passes constitutional scrutiny. RUCO challenges such a conclusion – the
8 facts are the facts and the fact is that each SIB filing will not result in a meaningful FVRB finding
9 nor will there be any finding by the Commission of what fair value is:

10 “It is clear . . . that under our
11 constitution as interpreted by this court, the commission is
12 required to find the fair value of (the utility's) property and use
13 such finding as a rate base for the purpose of calculating what
14 are just and reasonable rates. . . . While our constitution does
15 not establish a formula for arriving at fair value, it does require
16 such value to be found and used as the base in fixing rates.
17 The reasonableness and justness of the rates must be related
18 to this finding of fair value.” Simms v. Round Valley Light &
19 Power Co., 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956).

20 Section 7.17 of the Settlement requires the filing of Schedule D which will show an
21 analysis of the impact of the SIB plant on the fair value rate base, revenue, and the fair value
22 rate of return as set forth in Decision No. 73736. A-1 at 9. This provision was obviously put in to
23 satisfy *Scates*, but it does not go far enough:

24 We do not need to decide in this case whether as a matter of law
there must be a de novo compliance with all provisions of the order in
connection with every increase in rates. The Commission here not only
failed to require any such submissions, but also failed to make any
examination whatsoever of the company's financial condition, and to
make any determination of whether the increase would affect the
utility's rate of return. There may well be exceptional situations in which

consideration of the Settlement's proposed DSIC.

1 the Commission may authorize partial rate increases without requiring
2 entirely new submissions. We do not decide in this case, for example,
3 whether the Commission could have referred to previous submissions
4 with some updating or whether it could have accepted summary
5 financial information. *We do hold that the Commission was without*
6 *authority to increase the rate without any consideration of the overall*
7 *impact of that rate increase upon the return of Mountain States, and*
8 *without, as specifically required by our law, a determination of Mountain*
9 *States' rate base. Simms v. Round Valley Light & Power Co., 80 Ariz.*
10 *145, 294 P.2d 378 (1956); Ariz.Const. art. 15, section 3; A.R.S. section*
11 *40-250.* The Commission not only failed to make any findings to support
12 its conclusion that the increases were just and reasonable, but it
13 received no evidence upon which such findings could be based. *Scates*
14 *at 537, 578 P.2d 618. (Emphasis added).*

15 While the SIB Schedule (D) may show the impact of the SIB plant on the rate base, the
16 revenue and the fair value rate of return, the Commission will not, as required by law, make a
17 meaningful finding of fair value and use that finding as a rate base for the purpose of
18 establishing rates. In order to meet *Scates*, and hence fair value, the SIB filing would have to
19 be on the scale of a rate case or at least a mini-type rate case where all of the rate case
20 elements are considered. Schedule D shows the rate base (O.C.L.D.) but it only shows the
21 capital costs and the depreciation expense associated with the plant additions. Hence, the SIB
22 filings will only consider one piece – the SIB plant. It will not consider the operating expenses
23 associated with that plant, the working capital, etc. The operating expenses that will be
24 included in the rates that the Commission will approve after each SIB filing will be the operating
expenses approved in Decision No. 73736 - operating expenses from a completely different
period than the SIB plant under consideration. In sum, there is no tie back to fair value and the
SIB raises the specter of single issue ratemaking which was a concern of the *Scates* Court, the

1 Commission's judges but apparently is no longer a concern of Staff⁴. *Scates* at 534, 578 P.2d.
2 615, RUCO 5 at 5. **The SIB mechanism is single issue ratemaking, it is not fair value**
3 **ratemaking - Schedule D renders fair value meaningless.**

4 There are other provisions of the Agreement which will assure Commission oversight
5 and approval of the SIB filings but nothing that requires a meaningful finding of fair value as
6 required by Arizona's Constitution. The SIB is illegal and should be rejected.

7
8 **5. THERE IS NO CASE LAW WHICH SUPPORTS A MECHANISM LIKE THE SIB**
9 **UNDER THE CIRCUMSTANCES OF THIS CASE**

10 RUCO is unaware of any case law which would support an argument that the SIB is
11 constitutional under the circumstances of this case. Staff, in its Reply Brief distinguishes the
12 relevant cases as they relate to the DSIC – the same distinctions can be said for the SIB. In
13 *US West Communications, Inc. v. Arizona Corp. Comm'n*, 201 Ariz. 242,245-46,34 P.2d
14 351,354-55 2001), the Arizona Supreme Court addressed the issue of whether the
15 Constitutional mandate that requires the Commission find fair value applies to the
16 Commission's method of setting rates for competitive local exchange carriers. The Commission
17 determined that the fair value methodology applies to monopoly situations, whereas it is
18 inappropriate when the concern is a competitive utility. *Id.*, 201 Ariz. at 246, 34 P.2d at 355.
19 This case is clearly distinguished from the present as the Company is a monopoly and not a
20 competitive utility.

21 In *Arizona Community Action Ass'n. v. Arizona Corp. Comm'n.*, 123 Ariz. 228,599 P.2d
22 184 (1979), the Court considered a Company's methodology to determine an increase based
23 solely on the Company's common equity falling below a certain level. The Court determined

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⁴ Staff was concerned about the element of single issue ratemaking as concerns the DSIC in the underlying case.

1 that the Company's methodology was not constitutional because the Company had the ability to
2 influence the return on equity which would be beneficial only to shareholders. Id. At 231, 599,
3 P.2d at 187.

4 The case law in Arizona does not appear to spell out exactly what fair value is. We know
5 that there is no exact formula to find fair value. We also know that fair value must be found.
6 The cases do shed some light on what fair value is not – it is not single issue ratemaking which
7 is what the SIB is. The SIB runs afoul of Arizona Constitution's requirement of fair value.

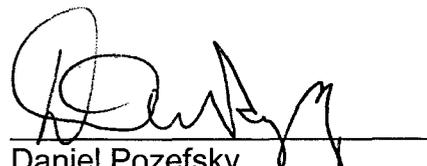
8 **6. THE SIB IS NOT IN THE PUBLIC INTEREST**

9 There are numerous reasons why RUCO does not believe the Settlement is in the public
10 interest. The SIB is illegal in Arizona, and hence not in the public interest. The SIB does not
11 adequately compensate ratepayers for the shift in risk that will result – a five percent efficiency
12 credit is a paltry quid pro quo - all one needs to do is look at Exhibit A-3 to put it into
13 perspective.

14 **7. CONCLUSION**

15 For all of the above reasons the Commission should reject the Phase 1 step-increase.

16 RESPECTFULLY SUBMITTED this 7th day of August, 2014.

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20 Daniel Pozefsky
21 Chief Counsel
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