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RE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

- SUSAN BITTER SMITH, Chairman
- BOB STUMP
- BOB BURNS
- DOUG LITTLE
- TOM FORESE

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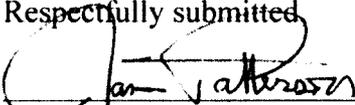
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ORIGINAL

IN THE MATTER OF THE APPLICATION OF)
 EPCOR WATER ARIZONA, INC., FOR A) DOCKET NO. WS-01303A-14-0010
 DETERMINATION OF THE CURRENT FAIR)
 VALUE OF ITS UTILITY PLANT AND)
 PROPERTY AND FOR INCREASES IN ITS) NOTICE OF FILING DIRECT
 RATES AND CHARGES FOR UTILITY SERVICE) TESTIMONY OF JAMES S.
 BY ITS MOHAVE WATER DISTRICT, SUN CITY) PATTERSON ON BEHALF OF
 WATER DISTRICT, TUBAC WATER DISTRICT,) THE SANTA CRUZ VALLEY
 MOHAVE WASTEWATER DISTRICT AND SUN) CITIZENS COUNCIL
 CITY WASTEWATER DISTRICT)

The Santa Cruz Valley Citizens' Council ("SCVCC") hereby provides notice of filing of the Direct Testimony of James S. Patterson on behalf of SCVCC.

Dated this 20th day of January 2015.

Respectfully submitted


 Jim Patterson, President-Elect
 Santa Cruz Valley Citizens Council

The original and thirteen (13) copies of the foregoing will be filed this 20th day of January 2015 with

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Arizona Corporation Commission
DOCKETED
JAN 20 2015

DOCKETED BY 

A copy of the same will also be emailed or mailed that same date to:

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1 **DIRECT TESTIMONY OF JAMES S. PATTERSON**
2 **REGARDING THE TUBAC WATER DISTRICT**
3 **ON BEHALF OF**
4 **THE SANTA CRUZ VALLEY CITIZENS' COUNCIL**
5 **DOCKET NO. WS-01303A-14-0010**

6
7 **I. BACKGROUND, QUALIFICATIONS AND EXPERIENCE**

8
9 **Q1. PLEASE STATE YOUR NAME AND ADDRESS.**

10 A1. My name is James Patterson. My address is PO Box 1983, Tubac, Arizona.
11

12 **Q2. WHO DO YOU REPRESENT, AND IN WHAT CAPACITY?**

13 A2. I am the president-elect of the Santa Cruz Valley Citizens Council (Citizens Council), a
14 400+ member, non-profit organization formed to inform our membership on issues affecting the
15 community, and to advocate on their behalf. A significant portion of our membership is served by
16 Epcor Water, and we are participating on their behalf.
17

18 **Q3. PLEASE DESCRIBE YOUR PROFESSIONAL EXPERIENCE AND EDUCATION.**

19 A3. I spent most of my career in corporate communications and investor relations. In my
20 capacity of directing investor relations, I worked with the chief financial officer and finance staff,
21 and represented the company with investors, brokers, and portfolio managers. I received my B.A.,
22 summa cum laude, in marketing and journalism from Wayne State University. I earned my
23 M.B.A., with distinction, from the University of Michigan School of Business, with a
24 concentration in finance and accounting.
25

26 **II. TUBAC WATER SYSTEM PROFILE**
27
28

1 **Q4. DESCRIBE THE SYSTEM OPERATED BY EPCOR'S TUBAC WATER**
2 **DISTRICT.**

3 A4. The system serves 596 connections with 26 miles of main spanning two sides of an
4 interstate highway. Approximately 85 percent of the customers are residential, 15 percent
5 commercial. In 2010, due to the EPA's lowered maximum contaminant level for arsenic, a \$2
6 million arsenic treatment plant was installed.

7
8 **Q5. IN THE CONTEXT OF EPCOR ARIZONA, WHY IS THIS RELEVANT?**

9 A5. Because of the district's small customer base, the Company's claimed expenses, utility
10 plant-in-service and resulting revenue requirement place an extraordinarily high rate burden on
11 Epcor's Tubac District customers. For example, monthly average and median 5/8" residential use
12 is 8,348 gallons and 5,000 gallons, respectively. Monthly average- and median-use bills would
13 increase 88% and 85%, respectively, to \$100.76 and \$77.89.

14
15 **Q6. WHAT CAN BE DONE TO MITIGATE THE IMPACT OF RATE INCREASES?**

16 A6. Because of the magnitude of the increase, extra scrutiny should be given to the company's
17 claimed cost of capital, claimed expenses such as labor, rent, insurance, chemicals, and particularly
18 depreciation. In this regard, the Citizens Council is in the process of preparing data requests to
19 further understand various aspects of some expense and rate-base claims. To the extent that the
20 company's revenue request is granted, the effect on Tubac customers would result in "rate shock."
21 Therefore, a phase-in period, discussed below, should be considered.

22
23 **III. COST OF CAPITAL ASSUMPTIONS**

24
25 **Q7. HAS THE COMPANY'S LONG-TERM DEBT COST OF CAPITAL BEEN**
26 **SUBSTANTIATED?**

27 A7. In our opinion, not as of this time. Specifically, there is a discrepancy between the interest
28

1 rates shown for Epcor's USA Notes on Schedule D-2, Page 1 revised, and the coupon rates shown
2 in the company's Dec. 15, 2011, announcement of the placement of the Notes. A data request is
3 being prepared asking the company to reconcile the two sets of numbers.

4
5 **Q8. IS THE TOTAL-COMPANY LONG-TERM DEBT COST OF CAPITAL**
6 **APPLICABLE TO TUBAC?**

7 A8. We believe that a question exists as to whether a WIFA loan (for the Tubac Arsenic
8 Treatment Facility), for which we successfully wrote the application and lobbied our
9 representatives, should be included in the company's total long-term debt, where it is a small
10 proportion of the total, or whether it should be applied only to Tubac, where it is a significant
11 portion of the long-term debt total. The effect would be to lower the cost of capital for the Tubac
12 district. The Citizens Council is preparing a data request to gather more information relevant to
13 this topic and may address it in surrebuttal.

14
15 **Q9. WHY SHOULD A SMALL-COMPANY RISK PREMIUM BE ATTACHED TO**
16 **THE COMPANY'S COST OF EQUITY CAPITAL?**

17 A9. In her direct testimony, Pauline Ahern, a paid consultant to the Company, treats Epcor
18 Arizona as a separate entity and therefore a small company. But as Epcor describes itself in a 2014
19 investor presentation, it is "one company" with three regions. It is one company with more than
20 \$4.5 billion (US) in assets, more than \$1.6 billion (US) in revenue, and equity of approximately
21 \$1.9 billion (US). The company has an S&P investment grade bond rating of BBB+. Extrapolating
22 risk at the regional level is faulty reasoning for the purposes of these proceedings.

23 Furthermore, the reason small companies have an additional risk-premium attached is that
24 they typically don't pay dividends and have cash flows that are highly variable, unpredictable, or
25 nonexistent. Small companies typically have concentrations of product and geography. Epcor, by
26 contrast, the "one company," has a diversity of customer types (residential and commercial, water,
27 waste-water, and "wires"), and serves a broadly diversified geography in Canada and the U.S.

28

1 Epcor has stable, relatively predictable cash flows. And, Epcor pays its single shareholder a
2 predictable (and increasing) dividend — \$141 million last year. Therefore, Epcor is in a much
3 lower risk category than the typical small company. We believe the risk premiums added to the
4 Company's cost of equity capital, which are predicated on "small-company" metrics, should be
5 denied.

6
7 **Q10. ARE THERE OTHER FACTORS THAT AFFECT THE COMPANY'S CLAIMED**
8 **COST OF CAPITAL?**

9 A10. We note that the company is asking for adjustment mechanisms for some of its costs,
10 including power and health care. These costs should be viewed as normal costs and risks of doing
11 business. Particularly the health care adjustment mechanism, an area where cost inflation has been
12 slowing for the past five years, is an unusual pass-through by any company. If cost increases
13 become a direct pass-through to customers, then business risk is transferred away from the
14 Company, and in turn Epcor should be granted a lower cost of capital. Furthermore, if adjustment
15 mechanisms are approved, then they should be "symmetrical," meaning the Company can't just
16 benefit on the upside but must provide refunds when costs decrease.

17 In addition, we note that the Company is shielded from some of the risk of bad debt
18 expense by an inflator to the Gross Revenue Conversion Factor used to gross up the Operating
19 Income Deficiency and arrive at the gross revenue requirement. Again, the Company is shielded
20 from something considered normal business risk, and should not have a risk premium added to its
21 computed cost of equity capital.

22
23 **IV. AMORTIZATION OF CHEMICALS COST**

24
25 **Q11. HOW IS THE COMPANY TREATING ITS DEFERRED COSTS RELATED TO**
26 **ARSENIC MEDIA REPLACEMENT?**

27 A11. The company has deferred \$101,712 in arsenic media costs (see Schedule C-2, page 27).

1 They are proposing amortizing this cost over two years by adding \$50,856 to Operating Expense
2 for the purpose of determining rates.

3
4 **Q12. IS THIS A TEMPORARY EXPENSE THAT IS REMOVED FROM "OPERATING**
5 **EXPENSES" AND RATES ONCE THE AMORTIZATION PERIOD CONCLUDES?**

6 A12. It appears that under the Company's proposal the answer to the question is "No." More
7 specifically, there appears to be no mechanism to reflect a rate reduction once the amortization
8 period ends. If this expense were removed, it would result in a reduction to each customer's
9 billings (on a simple arithmetic basis) of \$85 per year.

10
11 **V. EXPENSE COMPARISON WITH A NEARBY WATER SYSTEM**

12
13 **Q13. IS THERE ANY WAY TO COMPARE THE EXPENSES CLAIMED BY EPCOR**
14 **WITH ANOTHER COMPANY'S REPORTED EXPENSES?**

15 A13. Yes. In fact, there is another water system in Tubac, the Baca Float Water Company (Baca
16 Float). Baca Float filed a rate application with the Corporation Commission on December 30,
17 2014, so current comparisons are available and relevant. In making comparisons, the sizes of the
18 two companies, measured by number of customers, gallons pumped, and miles of water
19 distribution pipe, must be considered. Citizens Council Exhibit A lists some comparative expenses
20 for Epcor Water Tubac District and Baca Float Water, and provides direct comparisons on a per-
21 customer or per-million-gallons pumped basis.

22
23 **Q14. DESCRIBE THE PRIMARY DIFFERENCES IN THE TWO WATER SYSTEMS**
24 **THAT AFFECT EXPENSES.**

25 A14. Epcor's water system in Tubac has 596 customers, pumped approximately 84.5 million
26 gallons in the test year, and has approximately 26.1 miles of distribution main. Baca Float Water
27 has 411 customers, pumped approximately 24.6 million gallons in the test year, and has 6.5 miles
28

1 of distribution main. Both systems treat for arsenic.

2
3 **Q15. PLEASE CITE SOME EXAMPLES OF EXPENSES ADJUSTED FOR**
4 **CUSTOMERS SERVED OR GALLONS PUMPED.**

5 A15. In several major expense categories, Epcor Water's (Tubac District) cost per customer or
6 cost-per-million gallons pumped are notably higher than Baca Float's. For example, Epcor's
7 Power & Fuel expenses, per customer, are 139% higher than Baca Float's. Epcor's Rents &
8 General Office expenses, per customer, are 143% higher than Baca Float's. Epcor's general
9 "human" costs of providing service (i.e. Labor and Outside Services) are 3% higher than Baca
10 Float's. But adding the costs of Corporate Allocation and Customer Accounting, for which Baca
11 Float either has none or incorporates them into Labor and Outside Services, and Epcor's claimed
12 expenses, per customer, are 34% higher than Baca Float's. Lastly, Epcor's cost of Arsenic Media
13 Replacement, per million gallons pumped, runs 27% higher than Baca Float's.

14 Based on these differences in comparable expenses, the Citizens Council believes that
15 Epcor's claimed expenses are either inflated or that the Company is inefficiently controlling its
16 costs.

17
18 **VI. EFFECT OF PROPOSED RATE INCREASE**

19
20 **Q16. IS IT THE POSITION OF THE CITIZENS COUNCIL THAT AN 88% INCREASE**
21 **TO THE WATER BILL OF THE AVERAGE 5/8"-METER RESIDENTIAL CUSTOMER**
22 **CONSTITUTES RATE SHOCK?**

23 A16. Yes, as I have previously indicated in this testimony. In addition, the Citizens Council
24 further recommends that any significant increase in rates for Tubac customers that might be
25 authorized by the Commission should be phased in over several years, with the provision that the
26 Company receives no recovery of any foregone revenues.

1 **VII. CONCLUSION**

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Q17. IS THERE ANYTHING YOU WISH TO ADD TO YOUR DIRECT TESTIMONY?

A17. Yes. The Citizens Council is in the process of preparing data requests to enable us to further examine various aspects of claimed expenses, rate-base and cost of capital assumptions. Therefore, we may offer further testimony in the sur-rebuttal phase.

The Citizens Council, on behalf of its members, also believes Commissioners should consider implementation of fully consolidated rates. We advocate for the long-term goal of rate-consolidation across all of Epcor's districts, bringing that practice in line with that of other utilities, such as telephone and electric. Consolidation would benefit both the company and its customers. We refer to, as precedent, the recent decision in which an interim step toward consolidation was approved for Epcor Waste Water.

Q18. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A18. Yes

Citizens Council Exhibit A

Expense Comparison - Epcor Water Tubec v. Baca Float Water Co.

Expense	Epcor Water - Tubec	Baca Float Water Co.	Cost per Epcor Customer	Cost per Baca Customer	% Difference per Customer	Epcor Cost per Million Gal.	Baca Cost per Million Gallons	% Difference per Million Gallons
Customers	596	411						
Gallons Pumped (Millions)	84.52	24.62						
Labor	179,440	73,091						
Outside Services	26,569	65,342						
Sub-Total	206,009	138,433	\$345.65	\$336.82	3%			
Corporate Allocation	40,098	0						
Customer Accounting	23,588	0						
Total	269,695	138,433	\$452.51	\$336.82	34%			
Power (& Fuel)	32,022	9,254	\$53.73	\$22.52	139%			
Chemicals - Arsenic Media Replacement	46,000	10,510				\$544.25	\$426.89	27%
Rents	7,566	4,351	\$12.69	\$10.59	20%			
General Office	29,316	6,134	\$49.19	\$14.92	230%			
Total	36,882	10,485	\$61.88	\$25.51	143%			