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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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ORIGINAL

IN THE MATTER OF THE APPLICATION OF UTILITY SOURCE, LLC, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANTS AND PROPERTY AND FOR INCREASES IN ITS CHARGES FOR UTILITY SERVICE BASED THEREON.

DOCKET NO. WS-04235A-13-0331

STAFF'S REPLY BRIEF

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby files its Reply Brief in response to briefs filed by Utility Source, L.L.C. ("Company") and the Residential Utility Consumer Office ("RUCO").

I. COST OF EQUITY.

In its closing brief RUCO continues to recommend a cost of equity and overall cost of capital of 9.25 percent.[1] RUCO asserts this is comparable to Staff's cost of capital number of 9.20 percent without the 60 basis point economic assessment adjustment.[2] RUCO is critical of Staff's economic assessment adjustment apparently because it is based on a blanket policy decision from the Director's Office and there is no mathematical analysis or computation to support the 60 basis point adjustment.[3] However, RUCO made a similar adjustment to its cost of capital recommendation of 9.25 percent by using a comparable earnings adjustment.[4] RUCO increased its cost of equity recommendation by 70 basis points so that it equaled the low end of the comparable earnings range that RUCO calculated.[5] In other words, Staff, RUCO, and the Company all made adjustments to their final cost of equity results to arrive at a recommendation each is offering in this case. RUCO's unadjusted number is 8.55 percent, Staff's unadjusted number is 9.2 percent, and the Company's

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[1] RUCO's Closing Brief at 11.
[2] *Id.*
[3] *Id.*
[4] Tr. Vol. III at 512.
[5] Tr. Vol. III at 513.

unadjusted number is 10.3 percent. These numbers were then adjusted by 60 to 70 basis points to arrive at each party's recommendation for what they believe is a reasonable cost of equity recommendation.

It is unremarkable that parties made adjustments to their final cost of equity calculations since that is part of the professional judgment that is necessary. It is because all of these adjustments are similar that the focus should be on the underlying cost of equity results, the professional judgment used in making their adjustment and the ultimate recommendations being offered in this case. However, because these adjustments are all based on the judgment of the respective parties it is appropriate to questions the judgment of the Company in increasing its cost of equity recommendation by 70 basis points. Mr. Bourassa acknowledged in his rebuttal testimony that he did not make a "specific size adjustment" for the Company and simply "pointed out the differences in risk" stemming from the Company's "higher business risk, operating leverage, and liquidity."[6] Now the Company appears to argue in its Post-Hearing Brief that the 70 basis point adjustment is a size adjustment.[7] In particular, the Company asserts that its position recognizes the significant business and investment risk facing small utilities.[8]

The Company cites to a California Public Utilities Commission study and decision, in part, regarding the riskiness of small utilities compared to larger utilities in support of an upward size risk adjustment.[9] There are several points to make regarding this California decision. First, and most obviously, it is a California decision, and not a decision from this Commission. Second, in California the California Public Utilities Commission has established a generic range for the overall rate of return for class C and D water utilities. In Arizona the Commission has not established this type of mechanism. Third, this decision of the California Commission is from the 1990's and the California Commission also adopted the use of the CAPM model for developing the cost of equity recommendations. Finally, and most importantly, it is not altogether clear that the California Commission increased the cost of capital numbers due to size risk per se, but perhaps more so to

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[6] Bourassa COC Rebuttal at 19.
[7] Company's Post-Hearing Brief at 13.
[8] *Id.*
[9] Bourassa Rebuttal COC at 22.

assist the smaller utilities in complying with recent EPA Safe Drinking Water amendments. In Arizona, the Commission has developed other methods of addressing these types of regulatory issues such as the Arsenic Cost Recovery Mechanism. In other words, the California decision does not definitively recognize a direct link between size and risk as it relates to establishing cost of equity recommendations. This is reflected in the fact that the California Public Utilities Commission recognized other means of providing relief to smaller water utilities, i.e. rate design that incorporates a higher percentage of fixed cost recovery in the monthly minimum, the creation of memorandum accounts to track unanticipated costs of repairs, and step increases based on the consumer price index. Further, it is important to note that to date the Arizona Commission has not recognized a size risk phenomenon, and that the Company is a regulated monopoly that has the ability to seek relief by filing a rate application.

Beyond the Company inappropriately increasing its cost of equity results by 70 basis points due to its size, as addressed more fully in Staff's post hearing brief, the Company also chose models and inputs for models that skew the results upward to ultimately arrive at an 11 percent cost of capital recommendation. Staff on the other hand, with the 60 basis point economic assessment adjustment, is recommending a more realistic 9.8 percent cost of equity. This recommendation compares to the proxy group when you factor in the differences in capital structure between the Company and the proxy group. Because the Company is comprised of 100 percent equity, it is subject to less risk than the companies in the proxy group because they have capital structures that are comprised of both debt and equity. This, therefore, warrants a lower cost of capital recommendation.

II. WASTEWATER RATE DESIGN.

Staff's rate design provides a measure of rate stability for the Company. Staff would note that it has utilized a commodity charge for all customers other than the residential ones. RUCO has been critical of Staff's wastewater rate design utilizing a Natural Resources Defense Council Study ("NRDC Study") on volumetric pricing for sewer services.[10] There are some issues with purely volumetric wastewater rate design. Primarily not all the water used by a household ends up in the sewer. RUCO's own witness attested to the potential issues in linking the wastewater charge to only

[10] Ex. RUCO-7.

volumetric rates.[11] This was further confirmed by Mr. Fallon who regularly waters his lawn.[12] However, the problem is unlikely to work in reverse other than when there is severe flooding.

To remedy this disparity the NRDC Study recommends using a meter reading from winter months when outdoor use is the lowest.[13] While RUCO's witness mentioned such an option there is no indication RUCO has recommended that as part of its wastewater rate design.[14] The NRDC Study trumps the need for conservation over what is reasonable. The customers are already being encouraged to conserve by the inverted tier rate design in wastewater. How exactly is a full commodity wastewater rate going to encourage them to conserve more? With no fixed charge there is no rate stability in the wastewater design. Even the NRDC Study recognizes the importance of at least a partial fixed charge structure "...in order to ensure a stable revenue stream."[15]

Staff discussed in the initial brief that the Company has not established any basis for there to be different costs for wastewater based on the type of commercial business.[16] Additionally RUCO has made a similar argument that there are additional costs for some types of wastewater. While there may be increased costs to process certain types of wastewater there is nothing to show what those costs are and how they would be established. Without engineering data to demonstrate the increased demand from certain customers it is unreasonable to create added charges without the proper information to establish those costs.

III. STANDPIPE.

Both the Company and RUCO oppose Staff's recommendation regarding the treatment of the Company's standpipe operations. The Company takes a pragmatic approach asserting the standpipe began operations in September, 2014 and the test year in this case is 2012 and therefore neither the post test year plant nor the revenues derived from that plant should be included in this case.[17] However, if the Commission ignores this new revenue stream from the standpipe operations, the rates that will be set won't accurately reflect the economic environment and financial picture that will

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[11] Tr. at 444-445.
[12] Tr. at 416-417.
[13] Ex. RUCO-7 at 3.
[14] Tr. at 445.
[15] Ex. RUCO-7 at 4.
[16] Staff's Post-Hearing Brief at 12.
[17] Company Post-Hearing Brief at 8.

actually exist when the new rates go into effect since the date of the order will be well after the September 2014 date the standpipe went into operation.

The Company further asserts that Staff's proposal is "defying rate-making standards and logic" and "creates mismatches by allocating costs and expenses in the 2012 test year to the standpipe that began in late 2014."[18] This argument is somewhat disingenuous considering in the Company's last rate case the Company included pro forma revenues from the equivalent of 350 customers that did not exist in the test year but were anticipated to connect to the system over a year-year period of time following the new rates going into effect. The Company also included all of Deep Well No. 4 in rate base, despite not being used and useful during that earlier test year.[19]

There are two points that are not in dispute. Deep Well No. 4 was used in the test year, and will be necessary during at least the summer months in order to support the standpipe operations. So there is no denying that it was used and useful during the test year and will be necessary to support the standpipe operations.[20] It is also not in dispute that to add the entire amount of this well in rate base would dramatically increase the rates in this case. Under both the Company's position and RUCO's position, the Company would not be earning any return on and of its investment in the well even though the well is necessary for the provision of service in the test year.

The question is from a ratemaking perspective how much of the well should be included in rates and which rates should be designed to include this investment? Staff's proposal addresses these two issues. As explained in the initial brief, 30% of Deep Well No. 4 should be included in designing the stand alone revenue requirement and the resulting standpipe rate. Similarly, as noted by the Company, Staff allocated 25 percent of the mains, 50 percent of the rate case expense for the water division, and 25 percent of the other expenses to the standpipe rate.[21] While the Company is generally critical of the allocations, it does not dispute them in a significant way, and does not propose alternative allocations. Instead the Company chose to simply argue Staff's position should not be adopted. Therefore these are the only allocations percentages in the record. Importantly, the

[18] Company's Post-Hearing Brief at 8.
[19] Decision No. 70140.
[20] Tr. Vol. I at 33, Tr. Vol. III at 559.
[21] Company's Post-Hearing Brief at 9.

Company will still recover all of these expenses and its investment on and of the standpipe facility, and a portion of Deep Well No. 4. Those recoveries will simply, and rightfully, be received from standpipe customers through the standpipe rate that Staff is recommending.

Ultimately the Company claims Staff's proposal is "inconsistent with common practices" and is "simply conjecture."[22] Interestingly, the Company cites to testimony provided by RUCO and an Idaho case to support this proposition.[23] Although that case is not precedent in Arizona, a closer reading of it supports Staff's proposal in this case. The Court in *Utah Power & Light Co. v. Idaho Public Util. Comm.* determined that adjustments that the Idaho Commission made could not be said to be "future or unknown" or that the inclusion of the plant in question "solely conjectural" because it was not supported by the evidence and transpired prior to the commission entering its order. [24] That situation is eerily similar to what has transpired in this case.

RUCO argues that Staff's standpipe recommendation should be rejected, asserting primarily that Staff's alternative to the administrative law judge's request is too cumbersome, involves too many assumptions and resembles a mini SIB. [25] It is curious that RUCO does not support this proposal because it includes a portion of a necessary asset in rates while shielding the residential ratepayers from the effects. Also, this treatment lowers the rates to the residential customers by allocating reasonable portions of rate base and expenses from residential customers to the standpipe rate. Without this treatment the residential rates would be higher. In other words, Staff's recommendation captures the additional revenues associated with the standpipe which is to the benefit of the other customer classes and allocates a portion of the test year expenses and rate base to the standpipe rate.

Strangely RUCO asserts that Staff's alternative is too cumbersome, when in fact once the rate is set, it is no different than any other rate set in this case, which once approved would be charged by the Company until new rates are authorized be the Commission in the subsequent rate case. Then in the next rate case this can be addressed more holistically.

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[22] *Id.* at 10.
[23] *Id.* at 9.
[24] Utah Power & Light Co. v. Idaho Pub. Utilities Comm'n, 102 Idaho 282, 284, 629 P.2d 678, 680 (1981).
[25] RUCO's Closing Brief at 12-13.

Instead both the Company and RUCO similarly propose that either Staff could ask the Commission to order the Company file a rate case or that the Company on its own volition would file a rate case if its revenues exceeded the revenue requirement by 10 percent.[26] Interestingly, if the Company's recommendation were adopted it is very likely that once the new rates go into effect the revenues may almost immediately exceed the 10 percent trigger point with the actual standpipe revenues the Company has already experienced to date. Likewise RUCO suggests that "if Staff believes the Company is over-earning, they can ask the Commission to order the Company to file a rate case."[27] Unfortunately, RUCO has provided no detail regarding how the Company's potential over-earning would be measured which is a concern to Staff.[28] Further, RUCO has been very critical of the application of "earnings tests" in other dockets.[29]

RUCO also suggests an alternative treatment wherein the Commission excludes the three summer months in which Deep Well No. 4 would be used, and only include 75 percent of the standpipe and related costs of the standpipe in rate base.[30] According to RUCO this would result in only 75 percent of the revenues from the standpipe being included.[31] RUCO also adds that if demand is an issue the Commission could order the Company not to run its standpipe in the summer months, as part of a curtailment plan.[32] However, RUCO's alternative is not clearly or completely explained. RUCO did not provide any schedules that demonstrate exactly how this alternative would function. Given the significance of Deep Well No. 4 and the revenue that the new standpipe facility is

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[26] RUCO's Closing Brief at 12, Company's Post Hearing Brief at 10.
[27] RUCO's Closing Brief at 12.
[28] Tr. Vol. III at 710.
[29] *See e.g.* Arizona Water Docket W-01445A-11-0310.
[30] RUCO's Closing Brief at 13-14.
[31] *Id.* at 14.
[32] *Id.*

generating, Staff has presented the only viable treatment that properly balances the interests of the Company and the ratepayers.

RESPECTFULLY SUBMITTED this 17th day of April, 2015.

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