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BEFORE THE ARIZONA CORPORATION COMMISSION

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ORIGINAL

In the matter of the Application of EPCOR Water Arizona, Inc., 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 by its Mohave Water District, Paradise Valley Water District, Sun City Water District, Tubac Water District, and Mohave Wastewater District.	**Docket No. WS-01303A-14-0010** **April 17, 2015**

Arizona Corporation Commission
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CLOSING BRIEF

by
James Patterson and Rich Bohman
on Behalf of
the Santa Cruz Valley Citizens Council

On behalf of the Santa Cruz Valley Citizens Council, James Patterson and Rich Bohman hereby file this Closing Brief.
RESPECTFULLY SUBMITTED this 17th day of April, 2015

James Patterson
President
Santa Cruz Valley Citizens Council

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On behalf of the Santa Cruz Valley Citizens Council, James Patterson and Rich Bohman wish to make the following points in our Closing Brief. Item 3 presents new evidence discovered subsequent to our testimonies and ACC hearing appearance.

1. <u>The Cost of Capital and Tubac's Long-Term Debt</u>

A. We reiterate our position that the cost of capital is lower for the Tubac Water District relative to the other districts. This difference arises because of the impact of the low-interest-rate WIFA loan, for which we in Tubac wrote the grant application, and lobbied our elected officials to secure approval. EWAZ treats the WIFA loan as part of the Company's total long-term debt, where it amounts to less than 1/2 of one percent of total LT debt. When the WIFA loan is properly included in its entirety in the Tubac Water District's allocated capital structure, it amounts to more than 86% of LT debt. Consequently, <u>the Tubac District's total cost of capital is approximately 30 basis points less than other districts'</u>.

This 30-basis-point difference is illustrated in the attached table, marked Citizens Council Exhibit B - Cost of Capital (which was submitted as an Exhibit with Summary Testimony at ACC Hearings, March 10, 2015). In order to isolate the effect of the WIFA loan, all of the Company's assumptions other than the location of the WIFA loan were used, including the Company's claimed cost of equity capital, proportions of debt to equity, and proportions of remaining Company-issued LT debt. This Exhibit is meant only to demonstrate the lower cost of debt in Tubac's capital structure, but not our acceptance of the Company's claimed total cost of capital, with which we disagree for the reasons outlined below.

B. We reiterate our position that the Company unjustly inflates its claimed cost of equity capital by adding "business risk" and "credit risk" premiums. Both these premiums are predicated on an assumption that the Company is "small." This definition is achieved in the same manner that the subsidiary of a large company might call itself small — but EWAZ belongs to Epcor Utilities, and the cost of capital, risk premiums, and bond ratings are determined at the parent level. As Epcor defines itself in a March 2014 investor presentation, it is "One Company" with "Three Regions."

The business risk premium claimed by the Company is based on an argument ("increased risk due to small size must be taken into account in the allowed rate of return on common equity" - Ms. Ahern Direct Testimony, Pg. 13) comparing EWAZ's estimated market capitalization of $339 million to a peer group of nine companies with an average market cap of $1.7 billion. But Epcor Utilities, the parent company, where markets determine risk, has equity capital of approximately $1.9 Billion (US), Thus, the Company in fact has an above-average market cap within the peer group. Furthermore, small-company risk premiums are associated with young companies that typically don't pay dividends (EWAZ's most recent annual dividend was over $10 million, and Epcor Utilities' most recent announced dividend was $141 million), and have cash flows that are highly variable or unpredictable. Unlike Epcor — which is diversified in geography, product lines ("water, waste-water, and wires") and customer types — small companies typically are concentrated in product and geography. Furthermore, investors in utilities do so because utilities are a defensive investment, providing stability and more-predictable cash returns to a portfolio.

The Company also receives or is asking for adjustment mechanisms, which companies with normal business risk do not receive. Cost increases that are automatically passed on to customers — adjustors for power, healthcare, declining usage — shield the company from risk. Therefore, the Company should be awarded a lower cost of capital to reflect that lowered risk.

Ms Ahern also attempts to extrapolate a credit rating for EWAZ, assigning it a lower rating than the parent company, saying: "smaller companies have less financial flexibility... ." She imagines that EWAZ, were it rated, would be assigned BBB, a "less credit worthy, or riskier, bond/credit rating category than that of the the proxy group of nine water companies" (Ahern Direct Testimony, Pg. 16). The proxy group has an average rating of A+/A. Epcor Utilities, the parent company, has an S&P credit rating of A-, a solid investment-grade rating.

Based on the preceding discussion, at least 75 basis points associated with these claimed risk premiums should be disallowed from the Company's claimed cost of equity capital.

2. The Impact and Reasonableness off Corporate Allocations

Even with adjustments made by Staff and RUCO (in their testimonies) to the Company's corporate allocations pool, Tubac would still be burdened with as much as $148 thousand for layers of corporate overhead. This dollar amount exceeds the Operating Income Deficiency as calculated by Staff. When corporate allocations are removed from the Tubac Water District's cost structure, Tubac's cost per customer or cost per million gallons pumped become competitive with those of a similarly situated company, Baca Float Water. At some point the buck should stop, and that point should be Epcor Water Arizona. Additional corporate layers are simply investors, and their return should be solely in the form of dividends and gains on investment.

3. Need for Additional Storage

In his Direct Testimony (Engineering Report for the Tubac Water District - Executive Summary, Recommendations), Staff utilities engineer Michael Thompson recommends as a compliance item to this docket at least 100,000 gallons of additional storage "to serve the present customer base and any reasonable growth."

We submit the following evidence discovered subsequently to our submission of testimonies.

In 2009, ACC Staff Engineer Dorothy Hains similarly recommended additional storage for the Tubac Water District. At that time, the recommendation was based on the impression that Well #3 was inactive and would be out of service for an extended period of time.

On June 1, 2009, staff filed an amended report (attached) titled:

AMENDED STAFF REPORT FOR ARIZONA-AMERICAN WATER COMPANY'S APPLICATION FOR AUTHORITY TO INCUR LONG-TERM DEBT THROUGH THE WATER INFRASTRUCTURE FINANCE AUTHORITY OF ARIZONA (DOCKET NO. WS-01303A-09-0152)

in which staff withdrew its recommendation for additional storage, saying:

"At the time Staff was preparing its Engineering Report and analysis it was Staff's understanding that the Company's third well (Well #3) had not been and would not be in service for an extended period due to sand infiltration and high levels of bacteria in the water produced.

"On May 28, 2009, the Company informed Staff that the third well was now producing water that meets water quality standards and as a result this well was returned to service as of April 29, 2009.

"Based on this new information Staff now concludes that <u>the Tubac water system has adequate existing water production capacity</u> (810 GPM) <u>and storage capacity</u> (50,000 gallons) <u>to service existing customers plus reasonable growth</u>." [emphasis added]

In an exception to the Recommended Opinion and Order dated May 22, 2009 (filed May 28, 2009, on the same Docket No. WS-01303A-09-0152, and attached to this Closing Brief) which required the Company (Arizona American Water) to construct additional storage, the Company wrote:

"In the Tubac Water District, Arizona-American placed Well #3 back in service on April 29, 2009. Arizona-American had not made Staff aware of the additional capacity available from Well #3, which has a pumping capacity of 180 gpm, and, therefore, Staff's recommendation for additional storage did not account for the additional capacity provided by this well. Once the arsenic remediation project is complete, Arizona-American intends to take Well #2 out of service; however, <u>the additional capacity provided by Well #3 will then provide sufficient capacity without the need for additional</u>

storage. As a result of the additional capacity provided by Well #3, Staff has indicated that it will re-examine whether new storage should be required at this time. For these reasons, Arizona-American respectfully requests that the Commission amend the ROO to remove this condition from the final Order in this matter." [emphasis added]

Between the time these two filings were submitted by ACC Staff and the Company, growth in the Tubac Water District has amounted to approximately 7 - 8 connections, according to Table D in Mr. Thompson's testimony. Projected growth, according to the same Table D, is already overstated by more than 16 connections, indicating that the recommended additional storage capacity predicated on "reasonable growth" is also overstated.

Because little has changed since the 2009 filings, which concluded *"the Tubac water system has adequate existing water production capacity and storage capacity to service existing customers plus reasonable growth,"* we believe the recommendation for additional storage capacity for the Tubac Water District is debatable. Therefore, we request that any requirement for additional storage be delayed and separated from the current case, so that adequate consideration may be given to the issues of need, capacity, location, and cost.

4. Rate Shock and The Need for Phased-In Increases

We reiterate our position that EPCOR's Tubac Water District already experiences "rate shock" with the average residential customer on a 5/8 inch meter paying $53.57 for 8,343 gallons per month. If the Tubac Water District's rates were to increase at all, especially if the increase amounted to the most recent EPCOR proposal of 61% (to $86/ month for the average residential user), it would only exacerbate the financial burden to customers who already pay significantly more than any other EPCOR Arizona water district in this case.

We believe if any rate increase is approved, there must be a phased-in approach spanning at least three years, with no recovery of foregone revenue. Precedent exists whereby provisions of this nature were established by the ACC in order to seek a "just and reasonable" approach in a rate case involving Global Water approximately two years ago. A phased-in approach should also be granted because the Tubac Water District expects an additional surcharge for the next three years to repay $101,712 of deferred arsenic media costs. EPCOR's Tubac District's small customer base of 596 meters represents approximately 4/1000's of EPCOR's total water customers; therefore any modest attempt to alleviate the burden of a rate increase on Tubac customers would be negligible on their overall income statement.

5. Rate Disparity and the Case for Future Consolidation

We have stated several times throughout our previous testimony that the disparity in rates paid by EPCOR's Tubac customers versus other EPCOR Arizona Water Districts is significant. We pay on average about 3 ½ times what other districts in this case pay for the same volume of water. The primary reason for this is due to our small customer base, which has remained relatively unchanged because any growth has been offset by some residents opting to put in private wells. Tubac and Santa Cruz County in general have not seen anywhere near the economic recovery experienced in the Phoenix or Tucson areas over the last few years. Any rate increase at this time will hurt potential growth in areas serviced by EPCOR and could result in a decline in customer base.

The outlook is not good without some form of rate consolidation that would establish parity for EPCOR's Tubac customers with those of EPCOR's other Arizona water districts. This approach would follow the practice of other types of utilities. It would benefit all of EPCOR's Arizona customers since back-office and rate-case costs would be reduced by such a streamlined operation. Consolidation would more fairly allocate expenses across the districts similar to the way insurance and medical premiums are billed. <u>We urge the Arizona Corporation Commission to consider consolidation of all EPCOR's water districts in the near future.</u>

Citizens Council Exhibit B - Cost of Capital

Epcor Claimed

Total Company	Amount	% of Total Capital	Cost Rate	Weighted Cost	% of LT Debt	% of LT Debt w/o WIFA
LT Debt	231,761,134	59.84%	4.29%	2.57%		
Epcor 30yr. Note as % of total LT Debt	98,000,000				42.28%	42.42%
Epcor 10yr. Note as % of total LT Debt	133,000,000				57.39%	57.58%
WIFA Loan	761,134				0.328%	
Equity	155,533,624	40.16%	10.55%	4.24%		
Total	387,294,758			6.80%		
Tubac District						
Lt Debt	877,898	59.84%	4.29%	2.57%		
Equity	589,153	40.16%	10.55%	4.24%		
Total	1,467,051			6.80%		

Tubac District with WIFA

	Amount	**Rate**	**Weighted Cost**
WIFA Loan	761,134		
WIFA as % of LT Debt*	86.7%	3.94%	2.044%
Remainder - Epcor Debt	116,764		
Epcor LT as % of LT Debt*	13.3%		
Epcor 30yr. Note		5.02%	0.283%
Epcor 10yr. Note		3.77%	0.289%
Tubac Cost of LT Debt			2.616%
Weighted Cost of Tubac Debt			2.268%
Epcor Equity		10.55%	4.24%
Tubac Total Cost of Capital			6.505%
See Epcor rej. Sched. D-2		Difference	**0.299%**

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MEMORANDUM

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TO: Docket Control

FROM: Ernest G. Johnson
Director
Utilities Division

DATE: June 1, 2009

RE: AMENDED STAFF REPORT FOR ARIZONA-AMERICAN WATER COMPANY'S APPLICATION FOR AUTHORITY TO INCUR LONG-TERM DEBT THROUGH THE WATER INFRASTRUCTURE FINANCE AUTHORITY OF ARIZONA (DOCKET NO. WS-01303A-09-0152)

Background

The above referenced report was originally docketed on May 13, 2009. On May 14, 2009, Staff filed an amended report correcting a typographical error. In its report Staff recommends approval of the Arizona-American Water Company ("Arizona-American" or "Company") application.

Staff had further recommended that the Company install at a minimum, an additional 500,000 gallons of storage capacity prior to April 30, 2010. Staff concluded that the Company needed the additional 500,000 gallons storage capacity to meet demand. At the time Staff was preparing its Engineering Report[1] and analysis it was Staff's understanding that the Company's third well (Well #3) had not been and would not be in service for an extended period due to sand infiltration and high levels of bacteria in the water produced.[2]

On May 28, 2009, the Company informed Staff that the third well was now producing water that meets water quality standards and as a result this well was returned to service as of April 29, 2009.[3]

Analysis and Conclusions

Based on this new information Staff now concludes that the Tubac water system has adequate existing water production capacity (810 GPM[4]) and storage capacity (50,000 gallons) to service existing customers plus reasonable growth.

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[1] On April 8, 2009 the Staff Engineering Report was completed.

[2] In addition the Company planned to remove its second well (Well #2) from service. The Company decided it was not cost effective to treat the water produced by this well which contained arsenic at a level exceeding the arsenic maximum contaminant level ("MCL").

[3] The latest lab result for arsenic in the third well is 3 μg/l which is below arsenic MCL. The Company reported that the third well is producing water at 180 gallons per minute.

Recommendations

Staff recommends removal of the requirement to add 500,000 gallons of additional storage capacity and removal of the compliance items related to this requirement.

EGJ:DMH:red

Originator: Dorothy Hains

Attachment: Original and Thirteen Copies

[4] 810 GPM contains 630 GPM from blending untreated water with treated water from the arsenic treatment plant and 180 GPM from the third well.

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Docket No. WS-01303A-09-0152

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OPEN MEETING AGENDA ITEM

0000098534

EXCEPTION

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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
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Arizona Corporation Commission
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APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORPORATION, FOR AUTHORITY TO INCUR LONG-TERM DEBT THROUGH THE WATER INFRASTRUCTURE FINANCE AUTHORITY OF ARIZONA.	DOCKET NO. WS-01303A-09-0152 **EXCEPTIONS**

Arizona-American Water Company respectfully files these limited exceptions to the Recommended Opinion and Order dated May 22, 2009 ("ROO"). At page 7, lines 25-26, the ROO requires Arizona-American Water Company to construct, at a minimum, an additional 500,000 gallons of storage capacity by April 30, 2010. Following receipt of the ROO, Arizona-American met with members of Commission Staff on May 28, 2009, to discuss this condition. **In the Tubac Water District, Arizona-American placed Well #3 back in service on April 29, 2009. Arizona-American had not made Staff aware of the additional capacity available from Well #3**, which has a pumping capacity of 180 gpm,[1] and, therefore, Staff's recommendation for additional storage did not account for the additional capacity provided by this well. Once the arsenic remediation project is complete, Arizona-American intends to take Well #2 out of service; however, **the additional capacity provided by Well #3 will then provide sufficient capacity without the**

[1] Well #3 meets the federal arsenic standard, so arsenic remediation for this well is not an issue.

LEWIS AND ROCA LLP LAWYERS

need for additional storage.[2] As a result of the additional capacity provided by Well #3, Staff has indicated that it will re-examine whether new storage should be required at this time. For these reasons, Arizona-American respectfully requests that the Commission amend the ROO to remove this condition from the final Order in this matter.

Arizona-American appreciates the timely manner in which this docket has been processed, and with the amendment proposed in these Exceptions, very much looks forward to moving forward with this financing and the benefits that it will provide to customers in the Tubac Water District.

DATED this 29th day of May, 2009.

LEWIS AND ROCA LLP

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COPY of the foregoing hand-delivered this 29th of May, 2009, to:

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[2] Additional storage required by future growth in this District should be provided by private development.

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