ORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF EPCOR WATER ARIZONA, INC., 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 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

ORIGINAL

STAFF'S OPENING BRIEF

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby files its opening brief in the above-captioned matter. On any issue not specifically addressed in this brief, Staff maintains its position as represented in its testimony.

I. INTRODUCTION

EPCOR Water Arizona ("EWAZ" or "Company") is an Arizona public service corporation, providing water and wastewater services in several Arizona counties. Through its acquisition of Arizona-American Water Company in 2012, along with its acquisition of Chaparral City Water Company and North Mohave Valley Water Corporation, EWAZ is the largest investor owned water and wastewater provider in Arizona, serving over 180,000 customers. EWAZ is a subsidiary of EPCOR Water (USA) Inc. ("EWUS"), which is a wholly owned subsidiary of EPCOR Utilities Inc. EPCOR Utilities is wholly owned by the City of Edmonton, Alberta, Canada.[1] EPCOR Utilities builds, owns and operates electrical transmission and distribution networks in Canada, as well as water and wastewater treatment facilities and infrastructure in Canada.[2] EPCOR Utilities is the parent company of a number of subsidiary companies. Its primary operating utility subsidiaries

[1] http://corp.epcor.com/about/pages/about.epcor.aspx.
[2] *Id.*

are EPCOR Water Services Inc. ("EPCOR Water"), EPCOR Distribution & Transmission Inc.("EPCOR Distribution"), EPCOR Technologies and EPCOR Energy Alberta Inc. ("EPCOR Energy").[3]

EWAZ operates 15 water and wastewater facilities in Arizona.[4] On March 7, 2014, the Company filed an application for approval of a rate increase for four of its water districts and one of its wastewater districts. The districts included in the rate application are Mohave Water District ("Mohave Water"), Sun City Water District ("Sun City Water"), Paradise Valley Water District ("Paradise Valley Water"), Tubac Water District ("Tubac Water"), and Mohave Wastewater District ("Mohave Wastewater"). According to the Company witness Sheryl Hubbard, the Company is unable to achieve its authorized rate of return on investment and requires additional rate relief.[5]

The Company's current rates were approved for Paradise Valley Water and Tubac Water in Decision No. 71410 (December 8, 2009). The Company's current rates for Mohave Wastewater were established in Decision No. 71410, and amended by Decision No. 74881 (December 23, 2014). The current rates for Sun City Water were approved in Decision No. 72047 (January 6, 2011) and amended by Decision No. 72229 (March 9, 2011) to provide for a low-income program. The current rates for Mohave Water were approved in Decision No. 73145 (May 1, 2012).[6]

The Company, in its application, requested a total revenue increase of $5,458,907, with a requested return on equity of 10.7 percent, resulting in a rate of return ("ROR") of 6.87 percent.[7] The Company also requested the approval of a System Improvement Benefits Charge ("SIB") for Mohave Water, Paradise Valley Water and Sun City Water.[8] Because of several issues with the schedules filed with the Company's application, the Company filed revised schedules on October 14, 2014. By the

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[3] *Id.*

[4] The Company's districts are Agua Fria Water, Agua Fria Wastewater; Anthem Water, Anthem Wastewater, Chaparral City Water, Lake Havasu, Mohave Water, Mohave Wastewater, North Mohave Water, Paradise Valley Water, Sun City Water, Sun City Wastewater, Sun City West Water, Sun City West Wastewater, and Tubac Water. EWAZ acquired Chaparral City Water Company in 2011 (Decision No. 72259) and North Mohave Water Company in 2013 (Decision No. 74174).

[5] Hubbard Direct Test., Ex. A-7 at 2-3.

[6] *Id.* at 2.

[7] *Id.* at 4.

[8] *Id.*

Company's rebuttal case, the Company's requested revenue increase was $4,443,437, with a requested return on equity of 10.55 percent, resulting in a rate of return of 6.81 percent.

II. SUMMARY OF STAFF'S RECOMMENDATIONS

Staff's recommendation for an overall revenue increase is $3,090,380. Staff recommends a 9.5 percent cost of equity and a rate of return of 6.4 percent for each district except for Tubac Water, which Staff recommends an overall ROR of 6.2 percent.[9] Staff's recommended capital structure consists of 59.76 percent debt and 40.24 percent debt for each district except Tubac Water, which Staff recommends a 58.53 percent debt and 41.47 equity.[10]

Staff's final revenue requirement recommendation, with a comparison of the Company's final position, for each system is as follows:[11]

District	Company Final Revenue	Company Final Increase	Company Percentage Increase	Staff Final Revenue	Staff Final Increase	Staff Final Percentage
Mohave Water	$8,254,586	$1,864,809	29.2%	$7,958,767	$1,538,991	24.09%
Paradise Valley	$10,211,661	$554,266	5.7%	$9,648,393	$80,142	0.83%
Sun City	$11,435,427	$1,125,509	10.9%	$11,184,140	$888,476	8.63%
Tubac Water	$833,292	$254,098	43.9%	$813,643	$234,449	40.48%
Mohave Wastewater	$1,499,535	$443,696	42.0%	$1,404,161	$348,322	9.50%

While there were several issues that were resolved during the case, there remain several unresolved issues.

III. RATE BASE ISSUES

Staff recommends an original cost rate base ("OCRB") for Mohave Water of $22,431,899; Paradise Valley Water of $37,188,208, Sun City Water of $25,639,292, Tubac Water of $1,340,786; Mohave Wastewater of $4,863,030.[12] The Company waived a determination of the fair value of its

[9] Cassidy Surrebuttal Test., Ex. S-9 at 1.
[10] *Id.* at 15.
[11] Staff final schedules, CLP-1 for each district, filed April 6, 2015.
[12] Staff final schedules, MJR-3 for each district, filed April 6, 2015.

property using a reconstruction cost new valuation.[13] Hence, the OCRB and the fair value rate base ("FVRB") are the same for purposes of this application. Staff has the following specific areas of concern: asset depreciation many times beyond its original cost, accumulated depreciation on negative plant; debit accumulated depreciation balances; depreciation that was accumulated for non-depreciable assets and other issues of dispute involve cash working capital, the inclusion of regulatory liability for Mohave Water and Sun City, reclassifications of accounts treated as retirements, and lack of timely retirements.[14]

A. Depreciation of Assets Beyond The Useful Life.

One of the most contested issues in this matter concerned the Company's treatment of depreciation expenses and accumulated depreciation.

The Arizona Administrative Code R14-2-102(A) defines depreciation as "an accounting process which will permit the recovery of the original cost of an asset less its net salvage value over the service life." For example, Staff identified 14 accounts where the recovery was more than the plant costs.[15] Staff recommended that the Company cease this practice of depreciating assets once the original cost of an asset has been recovered through depreciation.[16]

The Company acknowledged that it continued to depreciate assets past their useful lives. As justification, the Company indicated that it was beneficial to the Company because it lessened rate base for future rate cases and freed up cash for internal investment.[17]

In its rebuttal testimony, the Company agreed to cease recording depreciation expense once the underlying plant assets are fully depreciated.[18] The Company also agreed to track assets by vintage year.[19] Staff believes with these corrections, the Company should not over-depreciate assets in the future.

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[13] Hubbard Direct Test., Ex. A-7 at 13.
[14] Rimback Direct Test., Ex. S-14 at 12-13.
[15] *Id.* at Ex. MJR-A.
[16] *Id.* at 12.
[17] Tr. at 24.
[18] Guastella Rebuttal Test., Ex. A-13 at 6.
[19] *Id.* at 8.

B. Accumulated depreciation debit balances.

Staff noted some abnormalities in certain accounts supporting the Company's accumulated depreciation balances. Staff has recommended certain adjustments to remove these balances.[20] The Company has asserted that these balances are appropriate for two main reasons: (1) the balances were the results of early retirements and (2) the balances were approved in the Company's prior rate cases and therefore should remain unchanged.[21]

Numerous early retirements raise a number of questions. Recurring instances on a utility's books and records where the early plant retirements are necessary could be an indication that the depreciation rates being used are inappropriate or do not accurately reflect the estimated economic life of the underlying assets.[22] Staff found a number of errors, such as a transfer that was recorded as a retirement, and amounts posted to the wrong accounts,[23] which cast doubt on the Company's claims that the debit balances resulted from early retirements.

When retiring an asset, the original cost of the asset is credited to the appropriate Uniform System of Account ("USOA") plant account, with the original cost being debited against or removed from the balance of the accumulated depreciation reserve account. To the extent that this asset has not been fully depreciated, the debit to the accumulated depreciation reserve will be greater than the balance in the reserve account. This leaves a debit balance in the accumulated depreciation reserve account.[24] According to the Company, this debit balance has occurred because of early retirements coupled with the use of the group method of depreciation.[25]

Company witness Guastella testified that the debit balances resulted only from early retirements, although he did not investigate the cause for early retirements.[26] Mr. Guastella also argues that to change plant balances that were approved in prior rate cases would constitute retroactive rate making.[27] Correcting mistakes in account balances that were approved in a prior rate order does

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[20] Rimback Direct Test., Ex. S-14 at 19.
[21] Rimback Direct Test., Ex. S-14 at 21-22.
[22] Rimback Surrebuttal Test., Ex. S-15 at 8-9.
[23] Rimback Direct Test., Ex. S-14 at 22; also noted by RUCO witness Coley, Tr. at 434.
[24] Rimback Surrebuttal Test., Ex. S-15 at 8.
[25] Rimback Direct Test., Ex. S-14 at 21.
[26] Tr. at 182.
[27] Guastella Rebuttal Test., Ex. A-13 at 14.

not constitute retroactive ratemaking; no prior rate is being changed. In *Pueblo Del Sol Water Co. v. Arizona Corp. Comm'n,* 160 Ariz. 285, 287, 772 P.2d 1138, 1140 (App. 1988), the Arizona Court of Appeals stated, "Retroactive rate making occurs when the Commission requires refunds of charges fixed by a formal finding which has become final." This is not the case in this proceeding. It is the Company's burden to support its application and that the account balances are reasonable and appropriate.[28]

The Company's argument is that because these accounts were unchanged by the Commission in prior rate decisions, even if these accounts have mistaken entries, there should be no changes. The Company is basically saying that ratepayers must live with mistakes that are to their detriment. This argument ignores the fact that it is the Company's burden to support its application. The Company has failed to do so in this instance. Further, the Company was provided ample opportunity to support the disputed amounts, but declined to do so. In response to a data request from the Residential Utility Consumer Office ("RUCO"), the Company chose not to provide support for these amounts, stating that the amounts were "outside the scope of this proceeding."[29] The Company relented somewhat and provided copies of closing schedules from prior cases during the hearing in a last minute attempt to support its application. Staff's recommended adjustments resulted in an increase to accumulated depreciation in the total amount of $2,826,903, which results in a reduction to rate base by the same amount.[30]

C. Working Cash Capital.

Working Capital is composed of materials and supplies prepayments and cash working capital. Cash working capital is the cash needed by a utility to cover its day-to-day operations. It may either increase or decrease rate base. If the Company's cash expenditures, on an aggregate basis, precede the cash recovery of expenses, investors must provide cash working capital. In that situation, a positive cash working capital requirement exists. On the other hand, if revenues are typically received prior to

[28] Tr. at 1139-40.
[29] Coley Surrebuttal Test., Ex. R-15, Attachment 4.
[30] *See* Staff final schedules for each district, filed April 6, 2015.

when expenditures are made, on average, then rate payers provide the cash working capital to the utility, and the negative cash working capital allowance is reflected as a reduction to rate base.

The Company has requested working capital comprised of amounts for prepaid expenses, material and supplies inventory and a cash working capital allowance.[31] Staff did not adjust the prepaid expense and material and supplies inventory.[32] However, Staff made an adjustment to the cash working capital component by excluding rate case expense.[33]

As Staff testified, rate case expense is comprised of a non-cash amortization expense in future operating years and non-cash expenses are excluded from the cash working capital allowance calculations.[34]

The Commission rejected the inclusion of regulatory expense for the Company's Chaparral District. In Decision No. 74568, citing the testimony of RUCO witness Michlik which stated that "rate case expense is an expense properly normalized over a period of years, not amortized, for recovery through rates," the Commission found that it was not appropriate to include rate case expense in the calculation of working capital.[35]

D. Contributions in Aid of Construction ("CIAC") removal attributed to Construction Work in Progress ("CWIP").

While Staff had originally opposed this adjustment, Staff is now in agreement with the Company. CIAC represents funds or plant provided to a utility by parties other than investors. Typically funds received as CIAC are used to build plant, which ultimately is included in a utility's rate base. CIAC is deducted from rate base. Plant that is under construction, CWIP, is not included in rate base. The Company has asserted that CIAC as it is relates to CWIP should not be deducted from rate base until the plant is in service (i.e., no longer CWIP) and the depreciation expense on the CIAC related plant begins to accrue. Ms. Hubbard testified that to do otherwise would result in a mismatch.[36] The Company asserts that it has received CIAC for plant not yet completed and reflected

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[31] Hubbard Direct Test., Ex. A-7 at 18-19.
[32] Rimback Direct Test., Ex. S-14 at 25.
[33] *Id.* at 27.
[34] *Id.*
[35] Decision No. 74568 at 13.
[36] Tr. at 118.

in its rate base. The Company further states that since the CIAC removed is for developer-funded projects still in CWIP, which is not an addition to rate base, then related CIAC should not be a reduction in the rate base calculation.[37] Staff agrees with the Company. Staff recommends that the amount of developer funded CIAC funds which the Company asserts are in CWIP at the end of the test year (including post-test year plant) be excluded from the CIAC balances used to calculate a reduction to rate base.[38] The adjustments to rate base are:

Mohave Water	$ 69,169
Mohave Wastewater	$227,674
Paradise Valley Water	$43,632
Sun City Water	$845,933
Tubac Water	$74,010

E. AFUDC 24-month deferral.

EWAZ proposes a 24-month deferral of post in-service AFUDC financing and depreciation, starting with day one of a test year and continuing up to the time the Commission issues a decision, but for no more than 24 months.[39] Staff opposes the deferral and recommends its rejection.[40] The Company has requested this deferral as a way to address regulatory lag.[41] The Company has structured its proposal based on a Staff Memorandum submitted in Docket No. 09-0077 on March 19, 2012.[42] The Staff Memorandum resulted from a series of workshops conducted in 2010 and 2011.[43] Those workshops were intended to address alternative methods of financing to help achieve the Commission's objectives of encouraging the acquisition of troubled water companies and developing a regional infrastructure.[44] According to Staff, the 24 month deferral mechanism was recommended by Staff at that time as an alternative to a Distribution System Improvement Charge ("DSIC")

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[37] Hubbard Rejoinder Test., Ex. A-9 at 13.
[38] Rimback Surrebuttal Test., Ex. S-15 at 13-14.
[39] Hubbard Direct Test., Ex. A-7 at 16.
[40] Rimback Direct Test., Ex. S-14 at 25.
[41] Hubbard Rebuttal Test., Ex. A-8 at 15.
[42] *Id.* at 16.
[43] *See* Docket No. 13-0118, Tr. at 921.
[44] Staff Report in Global Water Docket No. SW-02445A-09-0077, Ex. A-33.

mechanism that was then being considered. [45] The Commission did not adopt the Staff proposal.[46] The Commission ultimately approved a SIB mechanism in lieu of DSIC for several water companies.[47]

Staff is also concerned that this extraordinary treatment would allow the Company to include an additional return of AFUDC on its plant that is in service but has not been placed into rate base in a rate case along with the associated depreciation expense.[48] Further, the Company would continue to receive a return on any plant which is being replaced by the construction and is not fully depreciated.[49]

The Company contends that this deferral is different from a SIB because the SIB is limited to replacing mains, meters, hydrants, services and valves.[50] The Company's proposed deferral would encompass other types of plant. In the Company's view, its alternative and the SIB are not mutually exclusive.[51] The Company requested a similar deferral for its Chaparral District and the Commission rejected such deferral.[52]

F. Post Test Year Plant.

The Company has requested the inclusion of approximately $12 million in post test year plant additions that were completed as of the end of the test year but as were still in CWIP.[53] The Company also included projects that were still in CWIP but scheduled to be completed by June 30, 2014.[54] According to Company witness Hubbard, all the projects consisted of revenue neutral replacements of current facilities necessary to provide service to existing customers.[55] Company witness Worton testified that all post test year plant requested for inclusion was completed by June 30, 2014.[56]

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[45] *See* Docket No. 13-0118; Tr. at 829.
[46] Tr. at 925.
[47] Global Water Co. (Dec. No. 74364); Arizona Water Co. (Dec. No. 73938, 74081); Litchfield Park Service Company (Decision No.74437).
[48] Rimback Direct Test., Ex. S-14 at 25.
[49] *Id.*
[50] Hubbard Rebuttal Test., Ex. A-8 at 17.
[51] *Id.*
[52] Tr. at 121; Decision No. 74568 at 12.
[53] Hubbard Direct Test., Ex. A-7 at 15.
[54] *Id.*
[55] *Id.*
[56] Worton Rebuttal Test., Ex. A-16 at 5-6.

The Company classified these projects as Investment Projects and Recurring Projects. Investment Projects ("IPs") are defined as non-routine projects that have a defined life and require funding greater than of more than $100,000.[57] The Company requested approximately $6.8 million in IPs for inclusion. Recurring Projects ("RPs") are projects that are more routine in nature or involve the replacement of existing assets required for normal business operation are smaller and are less than $100,000 per project.[58] The Company requested approximately $5.3 million in RPs for inclusion.

Staff witness Mary Rimback testified that she reviewed the invoices relating to the RPs.[59] While Staff witness Michael Thompson conducted a review of the IPs, during the hearing there appeared to be some confusion regarding the RPs. Staff indicated that it would conduct an additional inspection of certain RPs to clear up any confusion surrounding Staff's recommendations regarding the inclusion of post test year plant. During the week of March 23, 2015, Mr. Thompson visited four EWAZ Districts. The four districts that were visited were Mohave Water, Mohave Wastewater, Paradise Valley Water, and Sun City Water.[60] The purpose of the visits was to confirm the used and useful status of the Districts' RPs. The confirmation process involved the selection of a random number of RPs from each district, coupled with a visual/physical inspection. Mr. Thompson concluded that the RPs were used and useful.[61]

Staff recommends the inclusion of the post test year plant as requested by the Company.

G. Regulatory Liability.

The Company included, as a regulatory liability, $106,450 for Mohave Water, and $90,329 for Sun City Water.[62] The Company has low-income programs in Sun City Water and Mohave Water. The programs are funded through a Commission authorized surcharge assessed to usage in the highest block tier. The Company testified that the low income programs for Mohave Water and Sun City Water took some time to garner participation, which resulted in the over collection. Staff removed

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[57] *Id.* at 3.
[58] *Id.*
[59] Tr. at 864.
[60] Staff did not inspect the Tubac system; the projects requested for inclusion by the Company were small.
[61] Thompson Supplemental Direct Test., filed April 8, 2015.
[62] Rimback Direct Test., Ex. S-14 at 31-32.

those amounts, as there was no Commission decision authorizing such treatment.[63] Staff recommended that these amounts over-recovered be included in revenues received by each district in the test year and the over-recovered amounts be amortized over 3 years.[64] The Company agreed with this treatment.[65]

H. Record Keeping.

Because of the problems Staff encountered with the Company's application, particularly in the Company's accumulated depreciation subaccounts, Staff has recommended that the Company, in its succeeding rate applications, file plant and accumulated depreciation schedules by year, by NARUC account number.[66]

IV. OPERATING INCOME

A. Arsenic Media Replacement.

Staff previously recommended that arsenic media replacement be treated as a capitalized item and recovered through depreciation expense.[67] Based on Company witness Bradford's testimony, Staff agrees with the Company that this is more appropriately accounted for as an operating expense. Staff provided for an allowance for chemical expense to cover the cost of the arsenic media on an annual basis.[68] Staff's recommendation provides for a normalized level of checmical expense of $66,342 to cover the on-going cost of the arsenic media of approximately $46,000 per year, plus $20,242 per year to provide recovery of past media costs of $101,712 over a 5-year period.[69] As a normalized expense these amounts would not be subject to true-up in a future case.

B. Tank Maintenance (Paradise Valley).

For Paradise Valley Water, the Company had proposed $2,601,920 over 14 years for annual tank maintenance expense of $185,851.[70] Staff recommended $121,943 for annual tank maintenance

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[63] *Id.*
[64] *Id.*
[65] Hubbard Rebuttal Test., Ex. A-8 at 22.
[66] Rimback Direct Test., Ex. S-14 at 11.
[67] Rimback Direct Test., Ex. S-14 at 33.
[68] Payne Surrebuttal Test., Ex. S-13 at 15.
[69] *Id.*
[70] Stuck Direct Test., Ex. A-18 at 5.

expense for the Paradise Valley Water.[71] After further review, Staff revised its expense amount recommendation to $123,658 per year for a total of $1,731,208.[72] Staff recommends a fourteen (14) year period for the tank maintenance program. Staff further recommends that EWAZ file with Docket Control, as a compliance item in this docket by December 31st of each year, documentation demonstrating the status of the storage tank maintenance plan and the storage tank on which maintenance has been completed.[73] The Company accepted Staff's recommendations.[74]

C. Incentive Compensation.

The Company's request for incentive compensation is reflected in two expense accounts. For the employees located in Arizona, the incentive compensation is included in the Labor Expense and includes the Arizona employees and an allocated share of the EPCOR Water US employees' incentive compensation.[75] Incentive Compensation for employees located in Canada, which is referred to as At-Risk Compensation, is reflected in the Corporate Allocation line item on the Company's income statement.[76]

The Company has recommended $207,765 in the Labor Expense, of the total Arizona incentive compensation of $801,710.[77] Staff has recommended $114,381 for the Labor expense, 50 percent of the requested expense, proposing that the expense be split between the ratepayer and the shareholders.[78] For the Corporate Allocation, Staff has recommended 50 percent of the requested expense. Staff reasoned that the compensation programs benefit both the shareholder and the ratepayer.

V. COST OF CAPITAL

The cost of equity is the rate of return that investors expect to earn on their investment in a business entity given its risk. In other words, the cost of equity to the entity is the investors' expected rate of return on other investments of similar risk. As investors have a wide selection of stocks to

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[71] Thompson Direct Test., Ex. S-1, MST-2 at 17; Payne Direct Test., Ex. S-12 at 37.
[72] Thompson Surrebuttal Test., Ex. S-3 at 2.
[73] Thompson Direct Test., Ex. S-1, MST-2 at 2.
[74] Stuck Rejoinder Test., Ex. A-20 at 1.
[75] Hubbard Rejoinder Test., Ex. A-9 at 20.
[76] *Id.* at 21-22.
[77] *Id.*
[78] Payne Surrebuttal Test., Ex. S-13 at 7-8.

choose from, they will choose stocks with similar risks but higher returns. Therefore, the market determines the entity's cost of equity.

For all five districts, Staff recommends a cost of equity ("COE") of 9.5 percent.[79] For four of EWAZ districts, Mohave Water, Mohave Wastewater, Paradise Valley and Sun City, Staff recommends that the Commission adopt a consolidated 6.4 percent overall ROR based on a capital structure comprised of 59.76 percent debt and 40.24 percent equity. For Tubac Water, Staff recommends that the Commission adopt a 6.2 percent overall ROR based on a capital structure comprised of 58.53 percent debt and 41.47 percent equity. Staff's cost of equity is based on 8.9 percent average DCF cost of equity estimate, with Staff's 60 basis point (0.60 percent) upward economic assessment adjustment.[80]

A. Capital Structure.

Staff recommends two different capital structures be used for purposes of setting rates. For the Company's Mohave Water, Mohave Wastewater, Paradise Valley Water and Sun City Water districts, Staff recommends a consolidated June 30, 2013 test-year end capital structure consisting of 59.76 percent debt and 40.24 percent common equity.[81] It should be noted that Staff's recommended June 30, 2013 test-year end capital structure for these four districts is identical to that proposed by the Company using a projected test-year end capital structure.

For Tubac Water, Staff recommends a June 30, 2013 test year-end capital structure consisting of 58.53 percent debt and 41.47 percent common equity, updated to reflect amortization of Water Infrastructure Financing Authority of Arizoan ("WIFA") loan debt principal through December 31, 2014.[82] For all districts, Staff's recommended capital structure is based upon the long-term debt and common equity balances reported at the district level as of the June 30, 2013 test-year end, as shown in the Company's Schedule D-1 Revised (Page 2). Staff excludes the short-term debt reported at the

[79] Cassidy Surrebuttal Test., Ex. S-9 at 1.
[80] *Id.* at 15.
[81] Cassidy Direct Test., Ex. S-8 at 15.
[82] *Id.*

district level in the Company's Schedule D-1 Revised (Page 2) as of the test-year end from its recommended capital structure for each district, as the short-term debt matured on January 15, 2014.[83]

The Company proposed a projected test year capital structure for its districts, rather than the actual capital structure.[84] The Company proposes to have the same capital structure for all of its districts.[85] However, the Company proposed a slightly different capital structure for Tubac Water. The debt component in the Tubac Water capital structure is comprised, in part, of long-term debt obtained from the WIFA.[86] This low-cost debt was obtained to finance the construction of an arsenic treatment facility in 2009. The Company indicated that the capital structures for each of its five districts in this proceeding had been allocated based on rate base, with the debt component being comprised of replacement debt issued to facilitate the acquisition of its EWAZ properties from Arizona-American.[87] Tubac Water represented an exception to this general practice, as the low-cost WIFA debt was reserved for inclusion in the Tubac Water capital structure "to provide the benefit of this low cost financing to the customers for which the financing was incurred." The Company-proposed capital structure for this district is different from that of the other four EWAZ districts in this proceeding because of the WIFA loan.[88]

Staff was concerned with the manner in which EWAZ computed the dollar value of reported long-term debt and common equity in the projected test-year end capital structure for each district. As shown in the Company's Schedule D-1 Revised (Page 2) for each district, the reported June 30, 2013 test-year end capital structure is comprised of long-term debt, short-term debt, and stockholders' equity, while the projected test-year end capital structure for each district consists only of long-term debt and stockholders' equity. However, despite the absence of short-term debt in the projected test-year end capital structure, for each district the total combined dollar amount of debt and equity capital reported is the same in both the June 30, 2013 test-year end and projected test-year end capital structures. EWAZ achieves this result by making a pro rata allocation of short-term debt reported in

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[83] *Id.*
[84] Company Schedule D-1 (Revised).
[85] *Id.*
[86] The Commission approved this WIFA loan debt in Decision No. 71168.
[87] Cassidy Direct Test., Ex. S-8 at 9-10.
[88] *Id.* at 10.

the test-year end capital structure to the long-term debt and stockholders' equity balances reported in that same test year end capital structure. By doing so, AWAZ artificially inflates the carrying value of both long-term debt and common equity in its proposed projected test-year end capital structure for each district. This methodology overstates the Company-proposed weighted cost of debt for Tubac Water, because of the presence of low-cost WIFA debt in the capital structure.[89]

Staff's recommended capital structures are more appropriate, therefore recommends their adoption.

B. Cost of Debt.

At the parent level, the Company proposes an overall cost of debt of 4.29 percent. At the district level, EWAZ proposes this same 4.29 percent cost of debt for each of the five districts in this proceeding, as shown in Schedule D-1 Revised (Page 2).

For Mohave Water, Mohave Wastewater, Paradise Valley and Sun City, Staff recommends a cost of debt of 4.3 percent.[90] For Tubac Water, Staff recommends a cost of debt of 4.0 percent.[91] Staff's recommended cost of debt for Tubac Water is based upon the actual carrying values of long-term debt within the Tubac Water district as of the end of test year, updated to reflect the outstanding principal balance of WIFA loan debt as of December 31, 2014.

Staff's recommended 4.0 percent cost of debt for Tubac Water represents a weighted average cost, computed by applying the 3.938 percent WIFA loan cost rate to the outstanding principal balance of WIFA debt as of December 31,2014 ($711,467), and applying the 4.291 percent replacement debt cost rate to the dollar balance of long-term replacement debt ($180,170) allocated to Tubac Water on the basis of rate base.[92]

The long-term debt component in the capital structures of the other four EWAZ districts (Mohave Water, Mohave Wastewater, Paradise Valley Water and Sun City Water) consists entirely (i.e., 100 percent) of higher cost, replacement debt allocated to each on the basis of rate base for

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[89] *Id.* at 11.
[90] *Id.* at
[91] *Id.*
[92] *Id.* at fn 25.

purposes of this rate proceeding.[93] In contrast, WIFA debt comprised 80.86 percent ($761,134/$941,304) of total long-term debt in Tubac Water's capital structure as of the June 30, 2013 test-year end. Thus, higher cost replacement debt allocated on the basis of rate base represents only 19.14 percent (1.0 - .8086 = .1914) of total long-term debt in the Tubac Water capital structure.[94]

C. Cost of Equity.

The Discounted Cash Flow ("DCF") method of stock valuation is based on the theory that the value of an investment is equal to the sum of the future cash flows generated from the investment discounted to present time. The method uses expected dividends, market price and dividend growth rate to calculate the cost of capital. In calculating the cost of equity, Staff used two variations of the DCF model, the constant growth model and the single stage model.[95]

Staff estimated the Company's cost of equity indirectly, using a representative sample group of seven publicly-traded water utilities as a proxy, taking the average of the sample group to reduce the sample error resulting from random fluctuations in the market at the time the information is gathered.[96]

The results of Staff's constant growth DCF analysis is 8.6.[97] Staff's Staffs multi-stage DCF estimate is 9.2 percent. Staff's overall DCF estimate is 8.9 percent.[98] Staff then added a 60 basis point economic assessment adjustment in consideration of the relatively uncertain status of the economy and the market that currently exists.[99]

In its rebuttal, the Company has recommended an ROE of 10.55 percent for an overall ROR of 6.81 percent.[100] The Commission should reject the Company's ROE recommendation because in calculating that recommendation the Company has used a series of adjustments that have had the effect of increasing the value of the ROE calculation. Those adjustments in the Predictive Risk Premium Model (PRPM™), combined with upward basis point adjustments for credit risk, business

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[93] *Id.* at 16-17.
[94] *Id.* at 17.
[95] *Id.* at 24-25.
[96] *Id.* at 23.
[97] *Id.* at 36.
[98] *Id.*
[99] *Id.* at 39.
[100] Ahern Rebuttal Test., Ex. A-33 at 59-60.

risk, and economic assessment the economic assessment adjustment serve to increase the Company's ROE recommendation.[101]

Despite the Company's testimony that the DCF represents a model that is flawed and somewhat antiquated,[102] Company witness Ahern presented a cost-of-equity analysis that relied both on a DCF Model and on several corroborating cost-of-equity models, including two versions of the capital asset pricing model ("CAPM"), the traditional CAPM and the Empirical CAPM and two versions of the Risk Premium Models, including the PRPM.[103] The Company used nine water companies for its proxy group. The results, using the single stage constant growth method of the DCF, produced an average of 8.8 percent.[104] Ms. Ahern then chose the median, 8.52 percent. Staff used seven water companies in its proxy group. Staff's DCF calculation yielded an ROE of 8.9%, which is more than the Company's use of the median. According to Ms. Ahern, the median is used because of the broad range of results produced by the different methods.[105]

The Company's DCF analysis, before adjustments, results in a lower ROE than of the ROEs indicated by Staff's DCF analysis or that of RUCO. RUCO's DCF analysis resulted in an average ROE of 8.74 percent.[106]

The Company also performed analyses using the CAPM and a Risk Premium Model.[107] The Company's CAPM analysis produced an ROE of 9.72 percent.[108] The Company's Risk Premium Model using an adjusted total market approached produced an ROE of 9.82 percent.[109] The Company's unadjusted results are close to Staff's recommendation.

It appears that the Company, unable to accept these results, attempts to increase its ROE results by using a combination of the PRPM and a number of upward adjustments. When the Company included the PRPM methodology in the calculation of its corroborating models, the results

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[101] *Id.*
[102] Ahern Rejoinder Test., Ex. A-34 at 16.
[103] Tr at 612.
[104] Ahern Rebuttal Test., Ex. A-33, Ex. PMA-RT 1, Sch. 9.
[105] Tr. at 625.
[106] Meese Surrebuttal Test., Ex. R-22 at 4.
[107] Ahern Rebuttal Test., Ex. A-32, PMA RT 1-9.
[108] *Id.*
[109] *Id.*

of those models increase substantially. For example, the results of the Risk Premium increase from 9.82 percent to 11.35 percent from 9.82 percent.[110]

While acknowledging that the most commonly used common-equity models in the regulation of utilities are the DCF and CAPM,[111] the Company is urging the adoption of the PRPM. The PRPM model is a common-equity model developed by current and former employees of AUS Consultants, a firm that represents utilities in regulatory proceedings.[112] The PRPM was developed from the work of Robert F. Engle, who shared the Nobel Prize in Economics in 2003 for methods of analyzing economic time series with time-varying volatility ("ARCH") with ARCH standing for auto regressive conditional hetereoskedasticity.[113] The PRPM model analyzes predicted volatility based on previous volatility plus previous prediction error. According to Ms. Ahern, the model has been presented in approximately sixteen jurisdictions, including Arizona.[114] The model has not gained widespread acceptance among those jurisdictions. The Maine Public Utilities Commission declined to adopt the methodology, stating that: "We are not convinced that we should accept results based on a newly derived analytical model that has not yet been rigorously vetted."[115]

The PRPM produces cost of equity estimates that are consistently higher than the models that are most commonly used by state commissions to estimate the cost of equity. When comparing the estimated cost of equity using the DCF and the CAPM to the PRPM, a series of charts found in an article co-authored by Ms. Ahern demonstrate that the PRPM produces a higher average indicated ROE than both the DCF or the CAPM, the longer used and more accepted cost of equity models.[116]

Among other problems identified by Staff is the use of a forecasted risk free rate. As Staff witness Cassidy testified, the appropriate risk-free interest rate to be used is the current rate borne by investors in the marketplace.[117] Ms. Ahern's use of a forecasted risk-free rate serves to overstate the

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[110] Ahern Rebuttal Test., Ex. A-33, Ex. RT Sch. 9.
[111] Ahern Direct Test., Ex. A-32 at 19.
[112] Tr at 628.
[113] Ahern Direct Test., Ex. A-32 at 27-28.
[114] Company Response to Staff Data Request, Ex. S-6.
[115] March 25, 2014 Order of Maine Public Utilities Commission.
[116] Richard A. Michelfelder, Pauline M. Ahern, Dylan W. D'Ascendis, Frank J. Hanley, *Comparative Evaluation of the Predictive Risk Premium Model, The Discounted Cash Flow Model and the Capital Asset Pricing Model for Estimating the Caost of Common Equity,* March 2013, Ex. S-5.
[117] Cassidy Direct Test., Ex. S-8 at 59.

estimated market cost of equity derived from her PRPM, CAPM and ECAPM models. As of March 6, 2015, the yield on a 30-year Treasury security was 2.83 percent,[118] significantly lower than Ms. Ahern's forecasted risk free rate of 4.31 percent.

It is not readily apparent why the PRPM produces results that exceed those produced by the CAPM and DCF. Staff would contend that a methodology that produces comparably higher rates would appear to conflict with the most basic tenets of rate regulation, i.e., that a utility should be provided with rates that will allow it an opportunity to earn a return that is comparable to those of similarly situated enterprises.[119]

After Ms. Ahern had proposed her indicated common equity cost rate, she then adjusted that ROE rate upward by proposing additional adjustments. Each of those adjustments is unreasonable and unnecessary.

The Company had initially sought a credit risk adjustment of 44 basis points to reflect the lower credit rating that EWAZ's ultimate parent, EPCOR Utilities, Inc. might receive based upon the BBB+ credit rating that had been assigned by Standard & Poor's.[120] However, S&P upgraded the credit rating of EPCOR Utilities to A-. The Company in Rebuttal reduced its recommendation to 24 basis points, on recognition of the upgrade.[121]

The Company has also requested a business risk adjustment of 30 basis points because of the Company's size. Such an adjustment is not warranted. As noted by Mr. Cassidy, empirical research has demonstrated that a small company risk premium adjustment to the cost of equity is unwarranted for regulated utilities.[122] Further, as noted by S&P regarding EPCOR Utilities: "Based on our criteria, we assess industry risk for regulated utilities as very low risk...this results in an excellent business risk profile."[123] The Commission has consistently rejected risk adjustments for small firm size,[124] and Staff recommends that it be rejected in this case.

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[118] Tr. at 643.
[119] "...the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks." *Federal Power Commission v Hope Natural Gas*; 320 U.S. 571, 603, (1944).
[120] Ahern Direct Test., Ex. A-32 at 16, 42.
[121] Ahern Rebuttal Test., Ex. A-33 at 26.
[122] Cassidy Direct Test., Ex. S-8 at 82.
[123] *Id.*
[124] *Id.* at 84.

VI. SYSTEM IMPROVEMENT BENEFITS MECHANISM

The Company has requested a SIB mechanism for Mohave Water, Paradise Valley and Sun City.[125] The proposed SIB mechanism is designed to allow the Commission to authorize the Company to recover between rate cases, through a surcharge, the pre-tax return on investment and depreciation expense associated with the specific water infrastructure projects, net of associated plant retirements, which have been submitted for review in this rate proceeding and which the Company plans to complete and place in service, to serve existing connections, prior to the Company's next rate case filing. Under the proposed SIB mechanism, the projects will be subject to a usefulness and prudency review in the Company's next rate case, and any approved surcharges will be subject to true-up and refund. Staff has reviewed the Company's requests and recommends its approval. Staff has developed Plans of Administration and recommends that those Plans be approved by the Commission.[126] RUCO continues to oppose the SIB, asserting, among other things, that the mechanism does not comport with the legal requirements of the Arizona Constitution because there is no fair value determination.[127] The SIB provides ample opportunity for the Commission to ascertain the Company's fair value rate base and, thereby, complying with the requirements of the Arizona Constitution.

The Company is required to provide updated financial information (including a balance sheet, income statement, earnings test schedule, rate review schedule, revenue requirement calculation, surcharge calculation, adjusted rate base schedule, etc.) as part of the filing package each time it seeks Commission authorization to enact a SIB surcharge. This information will enable the Commission to update the fair value rate base finding and determine the impact of the revenues (with the addition of the proposed SIB) on the Company's fair value rate of return. The SIB surcharge cannot go into effect without a Commission order and, ultimately, the Commission may terminate the SIB at any time.

The Commission has broad discretion in the methods used to determine fair value. As our Supreme Court has recognized, "the commission in exercising its rate-making power of necessity has

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[125] Coleman Direct Test., Ex. A-24 at 2-3.
[126] Thompson Direct Test., Ex. S-21, MST -1 at 28, MST-2 at 21, MST-3 at 21.
[127] Mease Direct SIB Test., Ex. R-18 at 4.

a range of legislative discretion . . .." *Simms v. Round Valley Light & Power Co., 80 Ariz.* 145, 154, 294 P.2d 378, 384 (1956). The SIB Plan of Administration clearly defines the information necessary to allow the Commission to make a fair value finding, something RUCO seemingly ignores. Staff has reviewed the Company's SIB mechanism and recommends that the mechanism be approved.

VII. RATE DESIGN

Staff's recommended rate structures for all water districts use multi-tier inverted block commodity rates.[128] Staff's recommended rate design spreads the commodity rates among the blocks to provide support for the statewide effort to improve water efficiency.[129]

A. Water Districts.

Mohave Water District: The Company's proposed rates would, increase the typical 5/8-inch meter residential bill with median usage of 5,000 gallons from $17.32 to $25.19, for an increase of $7.87 or 45.44 percent. Staff's recommended rates would increase the typical 5/8-inch meter residential bill with a median usage of 5,000 gallons from $17.32 to $21.60, for an increase of $4.28 or 24.73 percent.[130]

Paradise Valley Water District: The Company's proposed rates would increase the typical 5/8-inch meter residential bill with median usage of 10,000 gallons from $36.65 to $39.76, for an increase of $3.11 or 8.50 percent. Staff's recommended rates would have no impact to the typical 5/8-inch meter residential bill.[131]

Sun City Water District: The Company's proposed rates would increase the typical 5/8-inch meter residential bill with median usage of 6,000 gallons from $15.72 to $19.17, for an increase of $3.45 or 21.98 percent. Staff's recommended rates would increase the typical 5/8-inch meter residential bill with a median usage of 6,000 gallons from $15.72 to $17.31, for an increase of $1.60 or 10.15 percent.[132]

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[128] Tsan Direct Test., Ex. S-16 at 2.
[129] *Id.*
[130] Baxter Revised Surrebuttal Test., Ex. S-18 at 4.
[131] *Id.*
[132] *Id.*

Tubac Water District: The Company's proposed rates would increase the typical 5/8-inch meter residential bill with median usage of 5,000 gallons from $36.40 to $77.89, for an increase of $41.49 or 113.98 percent. Staff's recommended rates would increase the typical 5/8-inch meter residential bill with a median usage of 5,000 gallons from $36.40 to $56.57, for an increase of $20.17 or 55.40 percent.[133]

Mohave Wastewater District: Mohave's proposed rate design is similar to present rate design which is based largely on flat monthly rates.[134] The Company proposed a flat monthly service charge of $82 per Equivalent Residential Unit ("ERU") for all customers, except Large Commercial customers. Large Commercial customers would pay $3.31 (per 1,000 gallons) in addition to a $105.69 flat monthly rate. The Company proposed no change in Effluent charge.

Under Staff's proposed rates, large commercial customers would pay $2.9880 (per 1,000 gallons) in addition to a $93.99 flat monthly rate.[135] Staff recommends no change in Effluent charge.[136]

The Company's proposed rates would increase the monthly bill (per ERU) for a residential customer under the flat monthly fee rate by $25.05, or 44.30 percent, from $56.55 to $81.60.[137] Staff's recommended rates would increase the monthly bill for a residential customer under the flat monthly fee rate by $19.44, or 34.38 percent, from $56.55 to $75.99.[138]

VIII. OTHER ISSUES

A. Tubac Storage.

Staff recommends that the Company install at least an additional 100,000 gallons of storage capacity in Tubac Water.[139] The Company's Tubac system is made up of three zones. The water system has one storage tank with a total storage capacity of approximately 50,000 gallons located in Zone 3. Zone 1 and 2 do not have storage tanks. Staff concluded that based on peak month usage and

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[133] *Id.* at 5.
[134] Id. at 11.
[135] Staff's Final Schedules for Mohave Wastewater, BAB-1.
[136] Tsan Direct Test., Ex. S-16 at 11.
[137] Bourassa Rebuttal Test., Ex. A-28, Schedule H-3.
[138] Baxter Surrebuttal Test., Ex. S-17 at 5.
[139] Thompson Engineering Direct Test., Ex. S-1, MST-4 at 2.

the number of connections, the water system does not have adequate storage capacity to serve the present customer base and any reasonable growth. Company witness Troy Day acknowledged that the Company has been aware for several years that additional storage was needed in Tubac Water.[140]

In the Company's Rejoinder, the Company proposed to recover the cost associated with adding the additional storage through a surcharge, similar to the Arsenic Cost Recovery Mechanism.[141] Staff is opposed to a surcharge but recommends that the Company be allowed to recover the cost of the tank by placing the storage tank into rate base and adjusting rates accordingly. To qualify for this treatment, the Company would need to submit an Arizona Department of Environmental Quality Approval of Construction by June 30, 2016, with such costs verified and found to be reasonable. The docket would need to remain open to allow for the inclusion of the tank into rate base and the corresponding adjustment to rates.

B. Declining Use Adjustment.

The Company proposed an adjustment to address the decline in water usage.[142] In this case, Staff adjusted the consumption portion of the billing determinants to reflect the amount of decreased usage.[143] Staff believes it is more appropriate to adjust rate design based on the decrease in commodity revenue. Therefore, Staff has calculated a declining usage rate based on commodity revenues resulting in a 3.14 percent decrease for Mohave Water, a 0.52 percent decrease for Paradise Valley, a 1.86 percent decrease for Sun City Water, and a 6.70 percent decrease for Tubac Water applied to the commodity portion.[144]

Staff's rate design recognized these adjustments for Mohave Water, Sun City Water and Tubac Water by placing the increase into the monthly minimums. However, for Paradise Valley water the adjustment was made in the top two highest tiers of the commodity rates.[145]

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[140] Tr. at 255.
[141] Bradford Rejoinder Test., Ex. A-6 at 3.
[142] Murrey Direct Test., Ex. A-10 at 15.
[143] Tr. at 1000.
[144] Baxter Revised Surrebuttal Test., Ex. A-18 at 2.
[145] *Id.*

C. Central Arizona Project ("CAP") Surcharge for Paradise Valley Water and the Groundwater Saving Fee ("GSF") Mechanism for Sun City /GSF Surcharge.

1. Sun City Water GSF.

The GSF mechanism was approved by the Commission to allow for the complete recovery of CAP related expenses so that the Company could continue to retain its CAP allocation and recover the associated expenses.[146] In Decision No. 72046, the Commission ordered Sun City Water District, in its next application, to file "a description of how to include in base rates the CAP capital and delivery charges along with the offsetting replenishment credits and the elimination of the GSF surcharge."[147] The Company proposed to retain the GSF mechanism.[148] Staff concluded that because of the changes in the CAP related amounts, it would be appropriate to retain the mechanism.[149]

2. Paradise Valley Water CAP Surcharge.

The CAP surcharge mechanism was approved to allow for the recovery of CAP-related expenses so that the Company could retain its CAP allocation for Paradise Valley Water.[150] In Decision No. 72208, the Commission ordered Paradise Valley Water, in its next rate application, to file "the inclusion in base rates of the CAP capital and delivery charges and the elimination of the CAP surcharge." Staff concluded that because of the changes in the CAP related amounts, it would be appropriate to retain the mechanism.[151]

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[146] Lenderking Direct Test., Ex. A-21at 3.
[147] Tsan Direct Test., Ex. S-16 at 15.
[148] Lenderking Direct Test., Ex. A-21 at 5.
[149] Tsan Direct Test., Ex. 5-16 at 15.
[150] Lenderking Direct Test., Ex. A-21 at 12.
[151] Tsan Direct Test., Ex. S-16 at 14.

VIV. CONCLUSION

Staff respectfully requests that the Commission adopt its recommendations on the disputed issues for the reasons stated above and the testimony provided.

RESPECTFULLY SUBMITTED this 17th day of April, 2015.

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