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**BEFORE THE ARIZONA CORPORATION COMMISSION**

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Arizona Corporation Commission
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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**

**EPCOR'S POST HEARING REPLY BRIEF**

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Through this filing, EPCOR Water Arizona Inc. ("EWAZ" or "Company") responds to the Opening Briefs filed by the Arizona Corporation Commission Staff ("Commission Staff"), the Residential Utilities Consumer Office ("RUCO"), and the intervenors in this proceeding. Those briefs highlight the disputes still in existence between the parties, as well as the unsupported nature of the positions that Commission Staff and RUCO have taken in this proceeding in an attempt to reduce the Company's well-supported requested for an increase in rates.

## I. BACKGROUND ON ACCOUNTING RECORDS

Despite an attempt to bolster its unsupported adjustments through rhetoric, the facts contradict the positions taken by RUCO in its Opening Brief. Simply calling a rate case a "train wreck" does not make it so. The Company has been forthcoming about the accounting issues that led to a delay in this case, and it is disappointing that RUCO has taken this position given the effort made by all parties involved in this case. The Company has accepted responsibility for those issues and agreed to an additional 90 days for the processing of this rate case to allow both Commission Staff and RUCO to come to agreement with the Company on the starting balances for the schedules that comprised the Company's application. As Ms. Hubbard explained in her testimony:

> The Company acknowledges that there were some challenges with the plant accounting record keeping that contributed to the difficulty in processing this case in a timely fashion. The Company's willingness to agree to a 90-day delay in the procedural schedule to allow the parties ample time to investigate the revisions to the original application reinforces the Company's willingness to work with all parties involved in the filing.[1]

Ms. Hubbard went on to explain the difficulties that led to these accounting issues:

> In February 2012, EPCOR Water USA ("EWUS") purchased Arizona American Water Company from American Water. At the time of the purchase, the Company was using JD Edwards accounting software and PowerPlant capital asset software to maintain its general ledger accounting and fixed asset (plant) accounting transactions, respectively. The accounting software in use by EPCOR Utilities Inc. ("EUI"), the parent company of EWUS, was ORACLE, which includes general ledger accounting, fixed assets (plant), and inventory (IVARA) modules. All of the existing accounting in place at the time of purchase had to be remapped to the new ORACLE systems and the finance team (finance, accounting and rates personnel) had to convert to using these new systems. In addition, all of the fixed assets had to be remapped and uploaded into the ORACLE fixed asset ("OFA") module.[2]

The Company has repeatedly expressed its appreciation for the work that Staff's and RUCO's analysts performed to come to agreement on the starting balances for the Company's plant accounts. This collaborative effort culminated in the Company's October 14, 2014 filing of revised schedules.[3]

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[1] Exhibit ("Ex.") A-8 at 3-4.
[2] *Id.* at 4.
[3] Transcript ("Tr.") at 492, 850, 1083; Ex. A-1.



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Despite agreement on these initial balances, balances that in some instances included debit balances in accumulated depreciation which initially arose in prior rate cases and continued as part of this rate case, both Commission Staff and RUCO now seek to void those balances contrary to the accounting treatment required by NARUC accounting standards. And, in an apparent effort to avoid the delay and difficulty that Commission Staff and RUCO experienced in auditing these schedules, they both recommend the following for future rate cases:

> EPCOR include in all future rate case applications (for all districts) plant schedules that include plant additions, retirements, and accumulated depreciation balances by year and by NARUC plant account number that reconcile to the prior Commission decision.[4]

The great irony of this recommendation is that the information that this recommendation seeks is identical to the information that the Company and the parties came to an agreement on for purposes of the Company's October 14, 2014 filing. And perhaps most importantly for purposes of the accumulated depreciation discussion, this is the same information that the Company provided with all prior rate case filings and that RUCO's witness, Mr. Michlik, explained as being so helpful in conducting prior rate case audits:

> The Company's predecessor Arizona-American always filed plant addition/retirement and accumulated depreciation schedules by year and by NARUC account number that tied to the beginning balances from the last rate case.[5]

And, during cross examination, Mr. Michlik further confirmed that the information that the Company provided in all prior rates cases would have allowed for a full audit of the Company's plant additions and retirements:

> A. Right. So usually we would look at the beginning balances for plant and accumulated depreciation. We would tie them to the last approved Commission decision. We would also look at the additions and retirements

[4] RUCO Opening Brief at 46; Staff Opening Brief at 11.
[5] Ex. R-9 at 55.

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> that the company made by NARUC account and by year. You know, we cross foot them, foot them across. And at some point, you know, if we think the numbers are good, then we ask the company usually as part of our audit procedure for invoices that would support those plant additions. We would also ask the company why they retired this plant, what were the circumstances involved to satisfy and verify the company's numbers.
>
> . . . .
>
> Q. So with those prior filings, is it fair to say that . . . you had, with those filings, all the information in those initial filings that would have been necessary to perform the type of audit that you have just discussed?
>
> A. Right.[6]

Despite the fact that the parties in all prior rate cases had all of the information required to perform thorough and accurate audits, both RUCO and Commission Staff now claim that those audits must have missed numerous errors in the Company's accounting and that the parties' approval of debit balances in those cases must have resulted from an "oversight." These arguments defy logic and cannot be the basis for voiding the Company's debit balances.

## II. ACCUMULATED DEPRECIATION

### A. Debit Balances

#### 1. The Company Has Complied with NARUC Requirements

Lost in the rhetoric of RUCO's brief are the facts and accounting standards that govern the issue of debit balances and support the Company's accounting. As described throughout this proceeding and in the Company's Opening Brief, debit balances in accumulated depreciation arise for specific accounts when the original cost of plant being retired is more than the accumulated depreciation recorded in that account. As a result, debit balances increase a company's rate base so that it has the opportunity to fully recover the investment in the retired asset that was not yet recovered while providing a return on

[6] Tr. at 408-11.



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that asset until such time as it is fully recovered, which is consistent with utility plant accounting procedures. In accordance with the NARUC Uniform System of Accounts ("NARUC USOA"), proper accounting for plant retirements requires that a utility credit utility plant in service ("UPIS") and debit accumulated depreciation with the original cost of the retired asset.[7] If an asset is retired before the average service life set by the Commission to establish its depreciation rate, the accumulated depreciation recorded on the Company's books for the asset is less than the original cost.[8] Accordingly, the net effect of such a retirement (or group of retirements) is a debit balance for that asset account if the total accumulated depreciation is less than the original cost of the retired asset.[9] As explained by Mr. Guastella in his testimony, this result "is not only common but expected."[10] These debit balances represent "an under-recovery or shortfall in the recovery of the original cost of the assets."[11] On the other hand, in accordance with depreciation principles, methodology, and practice, as reflected in the average service lives and depreciation rates approved by the Commission, the continuing depreciation of specific assets that have survived longer than the average service lives is also required under the NARUC USOA – so that on average the total cost of all assets is recovered. This accounting provides for intergenerational equity in which today's and tomorrow's customers pay their fair share of the original cost.

There can be no dispute by either Commission Staff or RUCO that the accounting methodology used by the Company is required by the NARUC USOA, which the Commission has incorporated into its own rules.[12] Equally important, there can be no

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[7] Ex. A-13 at 2; NARUC Uniform System of Accounts for Class A Water Utilities ("NARUC USOA") at 56 (1996). Excerpts from the NARUC USOA, which is incorporated into the Commission's rules, are attached as Exhibit B to the Company's Opening Brief.
[8] Ex. A-13 at 2.
[9] *Id.* at 2-3.
[10] *Id.* at 3.
[11] *Id.*
[12] AAC R14-2-411.D.2; AAC R14-2-610.D.2; NARUC USOA at 56; Tr. at 851.

dispute that the Commission approved the vast majority of these balances as part of prior Commission decisions. A review of the final schedules submitted by the parties as their final position for Commission approval provides ample evidence for this claim. For example, in the Company's 2008 rate case, which included the Paradise Valley Water District, the Tubac Water District and the Mohave Water District, RUCO, in its final schedules, recommended Commission approval of the following debit balances for the following Company plant accounts:[13]

Mohave Water

| Account | Debit Balance |
|---|---|
| 303300 | $ 10 |
| 304200 | $ 2,403 |
| 340200 | $297,842 |

Paradise Valley Water

| Account | Debit Balance |
|---|---|
| 301000 | $477,338 |
| 339600 | $589,424 |
| 304100 | $100,236 |
| 304200 | $ 85,726 |
| 304500 | $ 4,711 |
| 304700 | $ 17,860 |
| 304800 | $130,219 |
| 311300 | $ 62,665 |
| 331100 | $ 58,521 |
| 341300 | $ 23,834 |
| 341400 | $ 1,182 |

Tubac Water

| Account | Debit Balance |
|---|---|
| 303500 | $ 117 |
| 340100 | $3,742 |
| 342000 | $1,695 |

[13] Ex. A-42; Ex. A-47; Ex. A-53.



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Not only do those schedules identify these specific balances, they also identify additions and retirements by year since the prior rate case.[14] RUCO cannot now claim with any credibility that these were simply "oversights" by its analysts.

### 2. Commission Staff's and RUCO's Positions Are Not Supported by Accounting Standards or Legal Requirements

Although these balances were both recommended for approval and approved in prior cases, RUCO and Commission Staff now seek to void all of the debit balances. Conspicuously absent from the briefs of RUCO and Commission Staff is any accounting standard that requires or even allows the type of treatment that RUCO and Commission Staff seek to impose upon the Company. To the contrary, the NARUC USOA affirmatively recognizes the finality of accounting treatment given by the Commission of accumulated depreciation from prior periods.[15] In the most recent *Goodman Water Company* rate case, the Commission, at the urging of Commission Staff, recognized the limitations placed upon prior period adjustments:

> Staff claims that there is no accepted methodology, in either NARUC's Uniform System of Accounts ("USOA") or in Generally Accepted Accounting Principles ("GAAP"), for either voiding or deferring accumulated depreciation (i.e. depreciation that has already occurred). Staff asserts that the USOA and GAAP indicate that reversal of accumulated depreciation is improper.[16]

Staff further argued that, unless an error could be shown, accumulated depreciation amounts which were properly recorded should not be "manipulated."[17]

In an apparent attempt to circumvent the finality required by the NARUC USOA, Commission Staff and RUCO claim that these debit balances must be "mistakes" or "errors" because they are "abnormal" or "improper". RUCO argues numerous times that

[14] *Id.*
[15] NARUC USOA, Accounting Instruction 8 (attached to Company's Opening Brief as Exhibit B).
[16] Decision No. 72897 at 14-15.
[17] *Id.* at 15.



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RUCO's recommended approval of these debit balances in multiple rates cases must have been an "oversight".[18] In another flurry of rhetoric and without support, RUCO claims that these balances are "a sure sign of a long history of improper and/or erroneous accounting errors or at the very least poor bookkeeping".[19] However, as noted above, when the record of the parties' positions in these prior cases is examined, these arguments fall apart as it is clear that all of the debit balances were clearly set forth by the Company in its initial filings and clearly recommended by the parties for Commission approval.[20] As the Company demonstrated in great detail during its rebuttal case, RUCO's own analyst adopted these debit balances and in almost all cases specifically included entries for retirements that led to these debit balances.[21] Claiming now that these balances resulted from "analyst oversight" lacks any credibility.

Unless an error can be shown, proper accounting does not allow for the Commission to undo balances previously approved and recorded by the Company.[22] It became abundantly clear during the testimony in this proceeding that RUCO spent countless hours seeking errors in the Company's filings—in many cases examining prior workpapers from the Company and from RUCO's own analysts.[23] RUCO and Staff, following detailed examination of balances in this case, did uncover certain minor inconsistencies in the current plant balances.[24] Those have been adjusted in the Company's Final Schedules and are no longer at issue.[25]

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[18] RUCO Opening Brief at 10, 13.

[19] RUCO Opening Brief at 13. A close review of RUCO's brief demonstrates that this claim relies on two statements relating to debit balances for land accounts approved by the Commission in prior decisions. Those accounts total $70. And without support, RUCO argues that "what RUCO can determine through the course of this proceeding and its investigation into this matter, this [] argument explains the majority of the abnormal debit balances accumulated depreciation balances." RUCO Opening Brief at 15-16.

[20] Exs. A-41 through A-55.

[21] Ex. A-42; Ex. A-44; Ex. A-47; Ex A-50; Ex A-53; Tr. at 1089-99; 1105-08; 1115-16; 1119-20.

[22] NARUC USOA, Accounting Instruction 8.

[23] Tr. at 461-63, 465-67, 468, 471-72, 474, 508.

[24] Ex. R-33; RUCO's Schedules; Staff's Schedules.

[25] Company's Schedules.

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Although the Company does have the burden to show changes to its plant and depreciation schedules from the last rate case, logic dictates that the Company does not have a burden to disprove general, unsubstantiated accusations that errors must exist in the Company's prior accounting, particularly, when as here, these balances have been fully litigated in prior rate cases. Such an approach would be contrary to the presumptive finality of Commission decisions, as well as requirements of the NARUC USOA, which governs utility accounting and is required by the Commission for water and wastewater utilities.[26]

RUCO, in its own brief, supports this conclusion, which is consistent with Commission statutes regarding the finality of Commission decisions:

> **If [a party] disagree[s] with a prior Commission Decision**, they should have appealed it or sought relief prior to now. Simply ignoring a prior Commission Decision and seeking to change it in the next rate case by disregarding the prior Commission directive and making a different recommendation than the last decision is problematic. It shows little regard for compliance with a Commission decision and if nothing is done, places into question the conclusiveness [] of Commission Decisions.[27]

Although the Commission has broad authority to amend its prior decisions, the burden is on the party seeking to modify the Commission's decision to show that such a modification is in the public interest.[28] And, in this specific instance, when a party seeks to require a prior period adjustment, that party must demonstrate there is an error in a company's accounting records.[29] In this case, RUCO's and Commission Staff's elimination of approximately $2.8 million in accumulated depreciation and corresponding rate base is not supported by a finding of any error in the Company's accounting records and cannot be accepted. The specific adjustments proposed by RUCO and Commission

[26] AAC R14-2-411.D.2; AAC R14-2-610.D.2; NARUC USOA at 56; *see also* A.R.S. §§ 40-252; -253.
[27] RUCO Opening Brief at 31.
[28] A.R.S. §§ 40-252; -253; *Miller v. Ariz.Corp. Comm'n*, 227 Ariz 21, 24, 251 P.3d. 400, 404 (Ct. App. 2011).
[29] NARUC USOA Accounting Instruction 8.

Staff not only violate the required accounting under the NARUC USOA, but also violate the concept of depreciation that has been accepted and implemented under the NARUC USOA for approximately 100 years.[30]

### 3. If the Commission Determines that the Debit Balances Should be Addressed, the Balances Must be Amortized Over a Period of Years to Allow for Recovery

As explained by Mr. Guastella in his testimony, the Commission's prior decisions reflect the proper and normal accounting for retirements, as required by the NARUC USOA.[31] The Company continues to believe that, consistent with NARUC accounting and the group method, the most appropriate approach is to keep these accurate balances until group depreciation provides recovery of the unrecovered amounts. If, however, the Commission determines that another approach should be utilized, it must establish a regulatory asset and amortize the unrecovered amounts to expense over a period of time with average unamortized balances included in rate base.[32] The recovery of the investment that was retired before the end of its useful life would be spread over the remaining average service life by applying the group depreciation rates authorized by the Commission for that asset group.[33]

As described by the Company during this proceeding, the majority of the debit balances coming into existence since the last rate case relate to early retirements in the Mohave Wastewater District.[34] There is no dispute that these recent retirements have occurred and have been accounted for properly.[35] Therefore, by way of example, if the Commission desired to address these specific retirements, it would look at the Account

[30] Ex. A-14 at 2-3.
[31] Ex. A-13 at 3-5.
[32] Ex. A-9 at 9-11; Ex. A-13 at 5.
[33] Ex. A-9 at 9.
[34] Ex. A-9 at 1, Exhibit SLH-3RJ; Ex. A-55; Tr. at 132.
[35] RUCO questions the adequacy of the Company's insurance policies. However, this is not a basis for voiding this valid retirement. As Ms. Hubbard explained, this retirement resulted from a flood and there is no evidence in the record that the Company did anything wrong in relation to this casualty. Tr. at 133.

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380100 - Treatment and Disposal Equipment, which has an average service life of 27.78 years (a depreciation rate of 3.60%).[36] The retirement amounts, $467,154 and $1,209, would be treated as an extraordinary event and reclassified to a regulatory asset account and amortized at the same rate as the depreciation rate of 3.60% to Depreciation and Amortization expense.[37] The impact of this reclassification would increase the revenue requirement for Mohave Wastewater by $16,861 ($468,363 x 3.6%) annually for the remaining service lives of these assets.[38] Although RUCO concedes in its Opening Brief that there were legitimate retirements, it makes no distinction when it recommends that the Commission void all debit balances.

RUCO also continues to argue against debit balances in any account with a 0% depreciation rate, particularly the Organization account in the Paradise Valley Water District ($477,283). This issue is a red herring. As Ms. Hubbard explained during the hearing, this amount arose in the Company's 2005 rate case out of differences between the Company's general ledger and its fixed asset accounting system.[39] The parties in the 2005 rate case agreed that this amount should be placed in the Organization account to allow for an increase of $477,283 to the Company's plant balance.[40] Although RUCO argued throughout the hearing in the current rate case that this amount could not be valid, it quickly accepted the Company's explanation for that amount following Ms. Hubbard's testimony and admitted that the Commission had approved it.[41] As Ms. Hubbard explained, this amount could have been made as a miscellaneous line item adjustment to accumulated depreciation, which would have had the same result.[42] This amount is part of the Company's rate base on which it is entitled to a return. Therefore, if the Commission

[36] Ex. A-9 at 10.
[37] *Id.*
[38] *Id.*
[39] Tr. at 1142-46; Ex. A-56.
[40] *Id.*
[41] Tr. at 1203-04.
[42] Tr. at 1146-47.

seeks to address this amount, it should be treated as an adjustment to the total accumulated depreciation balance as described by Ms. Hubbard.[43] The elimination of this amount as proposed by RUCO and Commission Staff would result in confiscation by the Commission.

**B. Credit Balances**

As with the debit balances, the record is clear that the Company applied the depreciation rates approved by the Commission to the accounts that currently have accumulated depreciation balances that are greater than the associated plant balances, also referred to as net book values less than $0, or credit net book values.[44] Net book values less than $0 (or credit net book values) arise when certain plant remains in service beyond its estimated service life.[45] In accordance with NARUC requirements, the amount of depreciation expense recorded on fully depreciated accounts is a credit to accumulated depreciation and, therefore, a reduction to rate base.[46] Therefore, contrary to the allegations of RUCO, there was no adverse impact on customers arising from these accounts. In fact, customers received an additional benefit through the reduction in rate base that the additional accumulated depreciation provided.

As noted above, there is no evidence that the Company applied any incorrect depreciation rates to the accounts that currently have accumulated depreciation balances that are greater than the associated plant balances.[47] Further, there is no dispute that the customers paid the rates approved by the Commission.[48] Finally, there is no dispute that the Company earned less than its authorized return in all of the districts that are part of this rate case.[49]

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[43] *Id.*
[44] Ex. A-9 at 12; Tr. at 491, 845.
[45] Ex. A-8 at 13; Ex. A-9 at 20.
[46] Ex. A-13 at 6-7; Ex. A-9 at 20.
[47] Ex. A-9 at 12; Tr. at 491, 845.
[48] Tr. at 491, 845.
[49] Company's Schedules, Schedule A-1 (for each district).

Despite these facts, RUCO seeks to refund to customers amounts related to these credit balances by creating a regulatory liability.[50] As Commission Staff notes in its Opening Brief, Arizona courts have recognized that retroactive ratemaking exists when "the Commission requires refunds of charges fixed by a formal finding which has become final."[51] The regulatory liability that RUCO seeks to create is a classic example of retroactive ratemaking as it seeks to credit back to customers amounts that the Company properly charged under prior Commission decisions. RUCO's approach also constitutes single issue ratemaking, as RUCO has not examined any other expense items to determine if the Company has under-earned on those items. For these reasons, it must be rejected.

**1. The Company's Agreement on a Going Forward Basis**

The Company has agreed on a going forward basis to cease depreciating those accounts that are fully depreciated. This agreement resulted in a reduction of approximately $385,000 to the Company's requested revenue increase.[52] Contrary to Staff's assertion in its Opening Brief, however, the Company has not agreed to track assets by vintage year.[53] Such tracking is not required to accomplish the goals of Staff's adjustment when, as here, group depreciation is being used. Staff cites to Mr. Guastella's testimony in relation to this issue.[54] However, a review of his testimony makes clear that the Company did not agree on the vintage year tracking of assets and specifically argued against it:

> **Q. MS. RIMBACK HAS RECOMMENDED THAT THE COMPANY TRACK PLANT ASSETS BY VINTAGE YEAR OF PURCHASE IN ORDER TO ASSURE THAT THE COMPANY IS NOT OVER DEPRECIATING OR EXPENSING DEPRECIATION ON FULLY**

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[50] Ex. R-14 at 32-34.
[51] *Pueblo Del Sol Water Company*, 160 Ariz. 285, 287, 772 P.2d 1138, 1140 (Ct. App. 1988); Staff Opening Brief at 5-6.
[52] Ex. A-1; Company's Schedules.
[53] Staff Opening Brief at 4.
[54] *Id.*

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**DEPRECIATED ASSETS. WOULD YOU COMMENT ON HER RECOMMENDATION?**

> A. Yes. On a positive note, I am assuming that this recommendation is consistent with Ms. Rimback's recommendation that the Company stop depreciating primary plant accounts once the entire account is fully depreciated, with which I have agreed. On the other hand, I am also assuming that she is not suggesting that depreciation expense be based on an asset-by-asset calculation, which would be incorrect for the reasons I just discussed above in addressing RUCO's improper proposal to adjust depreciation expense for the depreciation accruals on individual retirement units of plant that have survived longer than the average service life applicable to the primary plant account as a group.[55]

For the reasons set forth in Mr. Guastella's testimony, the Company requests that the Commission not order it to track assets by vintage year as Staff recommends.

## III. POST-TEST YEAR PLANT

The Company and Commission Staff continue to recommend identical amounts for post-test year plant additions.[56] As noted by Commission Staff in its Opening Brief, all of the Company's post-test year projects "consisted of revenue neutral replacements of current facilities to provide service to existing customers."[57] These projects "are critical to ensuring the delivery of safe and reliable water service to [the Company's] customers, they are significant investments that were completed within 12 months of the test year in this proceeding and they are in use and providing benefit to [the Company's] customers."[58]

RUCO attacks Commission Staff's approach to post-test year plant. According to RUCO, Staff testified that it "had not made a determination if this plant was used and useful, at least from an engineering perspective."[59] Of course, this argument ignores Mr. Thompson's supplemental testimony in which he specifically found that all post-test year

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[55] Ex. A-13 at 8.

[56] Ex. S-1 at Exhibits MST-1 to -4; Thompson Supplemental Direct Testimony at 6; Staff's Schedules at Sch. MJR-4 (for each district).

[57] Staff Opening Brief at 9 (citing Ex. A-7 at 15).

[58] Ex. A-17 at 2.

[59] RUCO Opening Brief at 7.



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plant was used and useful.[60] RUCO's argument also ignores the site visits performed by its own engineering witness, Mr. Radigan, in which he confirmed that he had no basis to indicate that any post-test year plant was not in service. After confirming that the Company had been "very forthcoming" during all of his site visits, Mr. Radigan testified as follows:

> Q. Okay. And you mentioned earlier that you had made some determinations regarding used and usefulness. Do you recall that testimony?
>
> A. Yes.
>
> Q. Did you make any findings that any plant that the company was seeking in post-test year plant was not actually in service?
>
> A. No.[61]

Although RUCO ignores Mr. Thompson's site visits and supplemental testimony, there can be no dispute that Mr. Thompson conducted a thorough review of the Company's post-test year plant and verified that the plant is in service and used and useful.[62] Ms. Rimback also confirmed that the Company has supported post-test year plant additions through invoices in the same manner as it does for test year plant additions.[63]

RUCO also claims that the inclusion of all of the Company's post-test year projects violates Commission policy. However, this argument ignores the Commission's recent decision in the Chaparral City Water Company case. In that case, the Commission agreed with Commission Staff's recommendation to include all post-test year projects completed within 12 months of the end of the test year, including the same types of recurring projects that the Company and Commission Staff are recommending to be included in this case.[64] Consistent with Commission requirements that pro forma adjustments be known and

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[60] Thompson Supplemental Direct Testimony at 6.
[61] Tr. at 915.
[62] Thompson Supplemental Direct Testimony.
[63] Tr. at 824, 831.
[64] Decision No. 74568 at 5-6.

measurable, all of these projects were completed and providing service to test year customers prior to the end of the 12 month period following the test year.[65] Contrary to RUCO's arguments, the plant additions in this case are revenue neutral, and the fact that certain of the additions may also reduce water loss does not change the nature of the projects.[66] These projects are replacing existing infrastructure to provide service to **test year customers;** they do not address growth.[67] Accordingly, in the same way that the Commission approved these projects in the Chaparral City Water Company decision, it should approve them here.

## IV. COST OF CAPITAL

### A. Cost of Debt

Although EPCOR Water Arizona Inc. is one corporate entity with multiple districts, Commission Staff and the Santa Cruz Valley Citizens Council ("SCVCC") recommend a different capital structure and a different cost of capital for the Tubac Water District.[68] According to Commission Staff, only the capital structure for the Tubac Water District should include the WIFA loan applicable to that district and its associated cost of debt.[69] Commission Staff also utilizes the interest rate for the WIFA loan (3.938%) to compute a cost of debt rate of 4.0% for the Tubac Water District.[70] SCVCC recommends that the overall cost of capital for the Tubac Water District be reduced by thirty basis points to account for the lower interest rate of the WIFA loan.[71]

In most circumstances, it would be inappropriate for the Commission to adopt a cost of capital that is different for one district within the EPCOR Water Arizona Inc. structure. Unlike other utilities which are composed of multiple corporate entities (*e.g.,* Global

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[65] *Id.* at 6.
[66] Ex. A-17 at 2-3.
[67] *Id.*
[68] Staff Opening Brief at 13-15; SCVCC Opening Brief at 1-2.
[69] Staff Opening Brief at 13-15.
[70] *Id.*
[71] SCVCC Opening Brief at 1.



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Water), EWAZ is one corporate entity with one capital structure and one cost of capital. In this case, however, the Company does recognize the efforts that the SCVCC and others undertook to help secure the WIFA loan in an effort to address the unique circumstances of the financing of the arsenic remediation project for the Tubac Water District. Given these unique circumstances, in this case, the Company does accept a unique cost of capital and capital structure as recommended by Commission Staff for the Tubac Water District.

If the Commission is inclined to adopt such an approach, the Company strongly believes that the approach utilized by the Commission Staff is more appropriate than that utilized by SCVCC in determining the impact of the WIFA loan on the cost of long term debt and the overall cost of capital.

**B. The Commission Should Adopt a Cost of Equity of 10.55 Percent.**

A review of the parties' Opening Briefs makes clear that the record contains ample support for the Company's recommended cost of equity of 10.55%. Ms. Ahern, unlike Commission Staff, relied upon multiple models in her analysis, which is consistent with the Efficient Market Hypothesis and which gives her analysis diversity and appropriate and broad-based perspective.[72] When all models are used, which is appropriate for a cost of capital analysis, a conservative analysis leads to a well-supported recommendation of 9.72% before necessary adjustments are made.[73] Following the inclusion of those adjustments, Ms. Ahern's analysis fully supports a recommendation of 10.55% as set forth below:[74]

| | Proxy Group |
|---|---|
| Discounted Cash Flow Model | 8.52% |
| Risk Premium Model | 10.97% |
| Capital Asset Pricing Model | 9.72% |

[72] Ex. A-32 at 19-41.
[73] Ex. A-33 at Ex. PMT RT-1, Sch.9.
[74] *Id.*



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| | |
|---|---|
| Indicated Common Equity Cost Rate (before Adjustments) | 9.72% |
| Credit Risk Adjustment | 0.24% |
| Business Risk Adjustment | 0.30% |
| Indicated Common Equity Cost Rate | 10.26% |
| Recommended Common Equity Cost Rate (rounded) | 10.25% |
| Adjusted to include one-half of Staff's 60 basis point economic risk adjustment | 10.55% |

As seen from the table above, Ms. Ahern's analysis relied upon multiple models, including the DCF, the Risk Premium Model, and the CAPM. Ms. Ahern's CAPM analysis is bolstered by the examination of Empirical CAPM (ECAPM) in conjunction with standard CAPM.[75] ECAPM addresses the tendency for standard CAPM to be skewed in the water industry where betas vary significantly from 1.0.[76] As explained by Ms. Ahern, the average ECAPM cost rate is 9.94%, while the median is 10.01%, which provides broader support for her recommendation.[77]

Ms. Ahern's Risk Premium analysis also includes multiple models, which further bolster her recommendation. Her analysis includes the adjusted total market approach, which uses five different sub-models, leading to a cost rate of 9.82%.[78] Ms. Ahern incorporates the Predictive Risk Premium Model (PRPM™), a model that incorporates actual results of investor behavior rather than subjective judgments.[79] As discussed by Ms.

[75] Ex. A-32 at 36; Ex. A-33 at 40.
[76] Ex. A-33 at 40-41.
[77] Ex. A-33 at Ex. PMA RT-1 Sch. 9. The Company inadvertently used ECAPM figures from Ms. Ahern's Direct Testimony in its Opening Brief.
[78] Ex. A-32 at 26-35; Ex. A-33 at Ex. PMA RT-1 Sch. 9.
[79] Ex. A-32 at 32-35.

Ahern in her direct testimony, the average PRPM™ for the proxy group is 12.43% and the median is 11.35% for the nine water companies.[80]

**1. Forward-Looking Data Should Be Used in Determining an Appropriate CAPM**

It is undisputed that investors, who make decisions based on expected benefits, are forward looking.[81] Ms. Ahern explained this in detail in her testimony:

> The cost of capital, including the cost rate of common equity, is expectational in that it reflects investors' expectations of future capital markets, including an expectation of interest rate levels, as well as risks. In addition, ratemaking is prospective in that the rates set in this proceeding will be in effect for a period of time in the future. . .
>
> Similar to forecasts of EPS growth rates; investors are also aware of the accuracy of past forecasts, whether for earnings or dividends growth or for interest rates.[82]

The forward-looking approach used by Ms. Ahern in her analysis is the primary reason that the Company's CAPM analysis (9.72%), rather than RUCO's historical looking CAPM analysis (7.48%), should be used.[83] Commission Staff also argues that the Company should use current rates, rather than the forecasted risk free rate, in its analysis.[84] However, for the reasons discussed above, Staff's argument is without support.

As set forth in the Company's Opening Brief, Mr. Mease's failure to use forward looking data in his CAPM analysis leads to flawed results.[85] When corrected to account for appropriate forward-looking data, his CAPM results are adjusted to 9.73%, and the average of all three of his analyses (DCF, CAPM and CE) produces a common equity cost rate of 9.79%, prior to being adjusted for business risk, credit risk, and economic risk.[86]

[80] Ex. A-33 at Ex. PMA RT-1 Sch. 9. The Company inadvertently used PRPM figures from Ms. Ahern's Direct Testimony in its Opening Brief.
[81] Ex. A-34 at 19.
[82] Ex. A-33 at 34.
[83] Ex. A-33 at 33-38.
[84] Staff Opening Brief at 18.
[85] RUCO incorrectly argues that Ms. Ahern averaged historical and projected interest rates. However, during the hearing, Ms. Ahern struck from the record those portions of her testimony, so there is no record support for that claim.
[86] Ex. A-33 at 42-43.

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**2. Use of the PRPM™ Bolsters the Accuracy of the Company's Recommendation**

Both Commission Staff and RUCO argue that because PRPM™ results exceed the results of the others models, the Company's use of this model is results-based. According to Commission Staff, the Company is "unable to accept" its results, so it relies upon the PRPM™ and other adjustments.[87] Commission Staff is correct that the Company did not accept the use of limited results, but Commission Staff's arguments, and those of RUCO, again miss the point. Ms. Ahern uses multiple models, which is appropriate for a cost of capital analysis. And, the same type of results-based argument that the parties use against the PRPM™ could be levied against the DCF—*i.e.* "its use is just a means to lower results." The fact that the PRPM™ results are higher does not mean it should not be relied upon. The converse is true of the DCF model. And, RUCO's own use of the Comparable Earnings, which properly leads to higher results than RUCO's other models (and leads to results that are almost identical to the Company's Risk Premium analysis), contradicts RUCO's own claims about selective use of models.[88]

As Ms. Ahern explained in her testimony, the results of the PRPM™ are not always higher than the results of other models.[89] Rather, the PRPM™ "directly measures investors' assessment of risk by evaluating the returns and equity risk premiums based upon the pricing decisions investors make based upon their risk expectations."[90] Unlike the DCF and the CAPM, which provide estimates of investor behavior based on certain assumptions, the PRPM™ "directly assesses the outcomes of investor behavior."[91] In certain instances, those results will be lower than other models and in certain instances those results will be higher than other models. Investor behavior will control.

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[87] Staff Opening Brief at 17-18.
[88] RUCO's Comparable Earnings analysis leads to a cost of equity recommendation of 10.9%.
[89] Ex. A-33 at 54.
[90] *Id.*
[91] *Id.*



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**3. Adjustments Must be Made to Address the Differences Between the Company and the Proxy Group and to Address Economic Conditions.**

Each of parties that submitted testimony in this proceeding on the cost of equity relies upon the use of proxy groups to reach its recommendations. However, by failing to make any credit risk or business risk adjustments to their analysis, RUCO and Commission Staff ignore the differences between their proxy groups and the Company. These adjustments are necessary in order to properly recommend a cost of equity for the Company and cannot be ignored by the parties or the Commission.

**a. Credit Risk Adjustment**

Based on an analysis of the differences between the Company and the proxy group, a credit risk adjustment of 24 basis points is warranted based on the Company's likely bond rating compared to the proxy group.[92] Although RUCO claims that the Company has not adjusted its recommendation on this issue, that is not the case. Ms. Ahern originally recommended a credit risk adjustment of 44 basis points, but adjusted that recommendation to 24 basis points following an upward adjustment to the parent company's bond rating.[93]

Interestingly, an examination of RUCO's own brief and testimony supports this credit risk adjustment. RUCO concedes that the Company's likely bond rating would be A- (S&P):

> The recent rating agencies reports and upgrades [are] an indication of the business and financial strength of EWAZ's parent Company. The business and credit risk of a wholly-owned, cost of service based, rate regulated monopoly utility operating in the U.S. such as EWAZ is comparable to that of its parent.[94]

If this is indeed the case, then an adjustment must be made to address the difference between the credit risk of the proxy group and that of the Company.

[92] *Id.* at 31.
[93] *Id.*
[94] RUCO Opening Brief at 50 (citing Ex. R-32 at 16).

**b. Business Risk Adjustment**

In addition to the credit risk adjustment, a business risk adjustment of 30 basis points is warranted based on the Company's small size compared to the proxy group.[95] In its continued attack on the payment of dividends by utilities, RUCO argues that, because the Company pays out more than 80% in dividends, in contrast to approximately 55% for the proxy group, a business risk adjustment is not appropriate.[96] This implies that dividend payouts are measures of risk. However, there is no support for that nexus nor does RUCO's argument support such a claim. An investor, including a parent company, receives a return in the form of dividends and in the form of appreciation in value of its invested capital. Therefore, if, for example, an investor expects a return of 10%, the investor may expect 3% in dividend income and 7% in growth of invested capital. If, however, the company only earns 6%, the company will likely pay out a larger portion of its income in dividends. In truth, the payment of higher dividends is often a sign that an investment is riskier than an investment in a company that earns it authorized return.[97]

RUCO also incorrectly argues in its brief that the Company is outperforming the proxy group, and, therefore, a business risk adjustment is not appropriate.[98] This statement is without support and factually incorrect. As Ms. Ahern described in her testimony, the Company's earned return on equity for the five years ending 2012 was 2.4% while the proxy group's was 8.26%.[99] Similarly, for the same period, the Company's funds from operations as a percentage of total debt was 1.76% and the proxy group's was 17.82%.[100] Clearly, the Company is underperforming the proxy group, which further bolsters the need for a business risk adjustment.

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[95] Ex. A-33 at 31.
[96] RUCO Opening Brief at 49.
[97] RUCO also fails to recognize that a reduction in the payment of dividends leads to a higher equity percentage for a utility and therefore, a higher cost of capital. So, by paying dividends, the capital structure is kept in balance.
[98] RUCO's Opening Brief at 50.
[99] Ex. A- 32 at Ex. PMA DT-2, Sch. 4 at 2-3.
[100] *Id.*



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Staff also claims in its Opening Brief that the business risk adjustment proposed by the Company is countered by Mr. Cassidy's "empirical research".[101] What Commission Staff does not note, however, is that the only empirical evidence provided is found in articles written by Professor Wong and by Paschell and Hawkins. Ms. Ahern addressed fully the weaknesses in the Wong article as part of her rebuttal testimony, which included a scholarly article by Dr. Zepp challenging and disputing the result of Professor Wong's study.[102] In short, "Professor Wong's study is flawed because she attempts to relate a change in size to beta, while beta accounts for only a small percentage of diversifiable company-specific risk."[103] Furthermore, a complete reading of the Paschell and Hawkins article demonstrates that it actually supports a business risk adjustment for purposes of a cost of capital analysis:

> Measured properly, small company stocks have proven to be more risky over a long period of time than have larger company stocks. This makes sense due to the various advantages that larger companies have over smaller companies. Investors looking to purchase a riskier company will require a greater return on investment to compensate for that risk. There are numerous other risks affecting a particular company, yet the use of a size premium is one way to quantify the risk associated with smaller companies.[104]

**c. Staff's Economic Risk Adjustment Should Be Used**

Although RUCO challenges Staff's economic risk adjustment of 60 basis points, it is an adjustment that this Commission has recognized in multiple instances.[105] This adjustment is not duplicative of the business risk adjustment or credit risk adjustment. Unlike the two prior adjustments, which account for the differences between the Company and the proxy group, this adjustment addresses the risks faced by the water industry in

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[101] Staff Opening Brief at 19.
[102] Ex. A-33 at 50.
[103] *Id.*
[104] *Id.* at 51 (citing Paschall and Hawkins, "Do Smaller Companies Warrant a Higher Discount Rate for Risk," CCH Business Valuation Alert Vol. 1, Issue No. 2, Dec. 1999).
[105] Decision No. 74084 at 22; Decision No. 74294 at 53; Decision No. 74097 at 20-21.



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totality.[106] This adjustment is particularly needed in light of the growing risks to the water industry in the West due to water supply, drought and shortage issues. Although Staff utilized a 60 basis point adjustment to its cost of capital recommendation, Ms. Ahern applied one-half of this adjustment to her updated common equity cost rate of 10.25%, which resulted in a 10.55% common equity cost rate as the appropriate rate for EWAZ in the current economic and capital market environment.[107]

For all of these reasons, the Commission should adopt the Company's recommended cost of capital of 10.55%.

## V. 24-MONTH DEFERRAL OF AFUDC AND DEPRECIATION

Commission Staff and RUCO continue to muddle the Company's request for a 24-month deferral with the Company's request for a SIB mechanism. Although both, at least in part, seek to address regulatory lag, they are not duplicative. Approval of the Company's request in this case for a 24-month deferral includes no costs recovered through the use of the proposed SIB mechanism. The Company's request is based on the Commission Staff's 2012 Staff Report and seeks to accomplish the same goals set forth in Staff's proposal: (1) mitigate "the effects of carrying costs of net plant additions between rate proceedings" and (2) mitigate the impact of depreciation expense that the Company must begin to record without recovery on plant that is put into service between rate cases.[108] Recognition of the impacts of this regulatory lag on the Company and approval of the Company's 24-month deferral request in rates would allow for the recovery of the deferred carrying costs (AFUDC) and depreciation throughout the test year beginning on the first day of the test year, which in this case is July 1, 2012.[109] As requested by EWAZ, the deferred amount would include AFUDC and depreciation on plant placed in service

[106] Ex. S-8 at 39; Tr. at 693, 696, 705.
[107] Ex. A-33 at 60.
[108] Ex. A-38 at 2-3.
[109] Ex. A-8 at 7, 18.



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throughout the test year and for the following 12 months (*i.e.* the 24-month period requested here).[110]

The impact of this regulatory lag can be demonstrated by looking at the cost of $1 million dollars of investment placed in service when a rate decision is issued 24 months after the first day of the test year. For every $1 million of investment at a 6.81% cost of capital (debt and equity as requested by the Company), and a composite depreciation rate of approximately 3%, the annual lost revenue to the Company is approximately $157,000 of revenue, or $13,080 per month.[111] As set forth in the Company's Final Schedules, EWAZ's deferral request is in the amount of $1,666,289, with a requested amortization of $49,659.[112] These amounts reflect actual additions to plant during the 24-month deferral period commencing July 1, 2012 and ending June 30, 2014.

Contrary to the implication by Commission Staff and RUCO, this request in no way seeks to recover amounts that would be recovered by EWAZ under the SIB mechanism.[113] In this case, there is absolutely no overlap as the Company's calculation does not include the time period in which the SIB mechanism would be in place.[114] The SIB mechanism would not begin until after the Commission issues a decision in this proceeding which cannot occur before June 30, 2014 as that date has already passed.

Commission Staff also claims that approval of this request would provide "extraordinary" treatment for this plant and could lead to over-recovery if replaced plant had not been fully depreciated.[115] Since the plant additions that are the subject of the deferral request were placed in service prior to June 30, 2014, the parties to this proceeding were able to fully investigate any "extraordinary" treatment. Since there were no such

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[110] *Id.* at 16.
[111] *Id.* at 15.
[112] Company's Schedules. These amounts are adjusted from the amounts shown in the Company's rebuttal testimony given changes made during the rejoinder phase of the case.
[113] Ex. A-8 at 17-18.
[114] *Id.*
[115] Staff Opening Brief at 9.

allegations made during the proceeding, Commission Staff's claim should be rejected. Contrary to Commission Staff's assertion, there is nothing "extraordinary" about providing a reasonable opportunity for a Company to recover the full cost of its investment as the Company is entitled to a recovery on and of its investment, even if that plant is retired. This approach is consistent with the NARUC accounting standards.

## VI. INCENTIVE COMPENSATION

Both Commission Staff and RUCO continue to argue that the Commission should decrease the Company's test year expenses (both labor expense and corporate allocation expense) relating to incentive compensation. In fact, RUCO believes that the Company should not recover any incentive compensation related to its corporate allocation expense.

RUCO cites to prior Commission decisions in relation to incentive compensation for gas and electric utilities. As recognized by RUCO in its Opening Brief, however, a large component of those plans was tied to financial performance.[116] For example, in the Southwest Gas compensation plan, two of the five factors related to the utility's return of equity.[117] In the UNS Electric compensation plan, 30% of the plan was tied to financial performance.[118]

As RUCO concedes in its Opening Brief, historically, the Commission has authorized the Company to recover all incentive compensation not tied to financial performance.[119] In recognition of the importance of incentive compensation, the Commission has declined to disallow any incentive compensation not tied to financial performance, because incentive compensation expense is "closely tied to salary expense."[120] In this case, the Company has removed from its request all incentive compensation tied to financial performance (10% of the total plan), so that is no longer at

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[116] RUCO Opening Brief at 34-35.
[117] Decision No. 68487 at 18.
[118] Decision No. 70360 at 21.
[119] Decision No. 72047 at 50-51.
[120] *Id.* at 51.

issue.[121] The remainder of the Company's incentive compensation plan is based on activities in the areas of Health and Safety, Operational Efficiency and Customer Service. Each category is weighted equally at 30%.[122] These measures drive performance to engage and focus all employees on improving performance as a utility service provider. They do so, as recognized by the Commission in prior cases, in the same way that salary and wages drive this behavior. As such, they should be treated by the Commission in the same manner, and the Company should be authorized recovery of these amounts.

As noted by the Company in its testimony and in the Opening Brief, EPCOR's corporate culture stresses the importance of working safely and responsibly.[123] EPCOR also monitors capital and operational expenditures to motivate employees to complete projects on time and under budget.[124] EPCOR has been able to work proactively to limit operational expenses, and because of that, many of the costs included in this rate application have increased at a pace that is at or below the rate of inflation. All of these metrics work together to provide benefits to customers.[125] And, contrary to the comments of RUCO in its Opening Brief, the Company's customers are satisfied with the Company's performance. In a 2013 survey, 82% of those surveyed indicated satisfaction with the Company's performance. This percentage increased in a recent survey. Although RUCO argues that a large portion of the Company's customers are not satisfied, this resulted from a misreading of the survey results.[126] Rather, a vast majority of customers are satisfied with the Company's performance, which demonstrates that these incentives are working.

[121] Ex. A-9 at 22. The removal of the financial component weakens the relevance of other non-water utility decisions in which a large financial component was at issue.
[122] Ex. A-8 at 24; Ex. R-24 at 22-23, Ex. RCS-5(Public).
[123] Ex. A-7 at 4-7.
[124] Ex. R-24 at 23; Ex. RCS-5 (Public).
[125] Ex. A-7 at 4-5.
[126] Admittedly, the Company's written data response was not clear on this point. However, the actual survey results, which were also provided as part of that data response, make the actual results clear: "Over eight out of ten customers (82%) give EPCOR Water a satisfactory rating with 70 percent offering a very satisfied (25%) or extremely satisfied (45%) rating." Response to RUCO DR 35.04.

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Ultimately, these amounts are no different than a labor expense and should be treated in the same manner.

## VII. ACCUMULATED DEFERRED INCOME TAX ("ADIT")

Accumulated deferred income taxes ("ADIT") reflect the timing difference between when income taxes are calculated for ratemaking purposes and the actual federal and state income taxes are paid by the Company. The timing difference is primarily due to the fact that straight line depreciation is used for ratemaking purposes, whereas the Company utilizes accelerated depreciation for income tax reporting purposes.

As it has always done, the Company included all recorded ADIT as of the end of the test year in this case in the calculation of rate base.[127] This calculation is based on the amounts in the Company's corporate income tax return and is allocated to the districts by use of a 4-factor allocator based on net plant, general metered customers, labor and O&M (excluding labor).[128] ADIT related to bonus depreciation for all of EWAZ's assets placed in service during 2013 and eligible for bonus depreciation was appropriately recorded on the Company's books when the election to take bonus depreciation on the Company's 2013 tax return occurred in September of 2014.[129] Contrary to RUCO's claim, there is no matching issue in these calculations, and there is not an issue with the Company's accounting practice in relation to ADIT. Accelerated depreciation, including the election to take bonus depreciation when appropriate, is always used by the Company in computing its tax liability for tax purposes. The impact of the accelerated depreciation, including bonus depreciation, on ADIT has typically been limited to the ADIT recorded on the Company's books as of the end of the test year, which is the basis of the ADIT included by the Company in this case.

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[127] Ex. A-9 at 17.
[128] *Id.*
[129] *Id.*

## VIII. SIB MECHANISM

RUCO commences its arguments against the SIB by claiming that "[w]hen a Company has not maintained its infrastructure up to industry standards," the Commission should not "reward" the Company with a SIB.[130] As with much of RUCO's Opening Brief, there is no record support for a claim that the Company has not maintained its systems in accordance with industry standards. In fact, neither Commission Staff's nor RUCO's engineering experts testified that the system is not being maintained.[131] Further, the SIB mechanism is not a "reward" as RUCO claims. Rather, it is a sensible approach to addressing the ever-growing infrastructure needs in the utility industry, including those of the Company, and for addressing concerns regarding rate gradualism.

In this case, EWAZ has provided extensive information in relation to SIB Table I, setting forth in detail all SIB projects that the Company intends to complete.[132] EWAZ prepared and submitted an extensive SIB Eligibility Report supporting in detail the need for the SIB mechanism in each of the districts.[133] Based on its review and analysis of all of the information submitted, Commission Staff has concluded that EWAZ has met the criteria for the SIB mechanism established by this Commission.

As it has done in every case in which a SIB has been at issue, RUCO continues to put forth its rejected legal arguments in opposition to the SIB. The Commission has rejected these arguments in multiple proceedings.[134] Without repeating all of those legal arguments here, EWAZ notes that it supports and incorporates the legal conclusions in the Commission decisions and continues to believe that the SIB mechanism will withstand any legal challenge if RUCO continues to challenge the SIB mechanism in the appellate courts.

[130] RUCO Opening Brief at 52.
[131] Later in its Opening Brief, RUCO argues that the "systems have been well maintained." RUCO Opening Brief at 55.
[132] Ex. A-24.
[133] Ex. A-25.
[134] *See, e.g.*, Decision Nos. 74568, 73938, 74081, 74364.

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The testimony of a representative of those impacted by the SIB mechanism is worth repeating. During his testimony, Mr. Eisert acknowledged the issues associated with aging infrastructure and the need to address these issues proactively, in the Sun City Water District:

> [W]e are of the opinion that we do need, the company needs a proactive plan, you know, to move forward. And that may be part of what the SIB is all about. There are different, there are different areas I believe that we could work out given the Commission would be amenable to those types of things. So rather than wait until things are broken, we may want to be able to somehow come up with a plan that is proactive in getting these things done ahead of time.[135]

For all of these reasons, the Commission should adopt the SIB mechanism in these districts, as proposed by the Company and supported by Commission Staff.

## IX. OTHER KEY ISSUES IN DISPUTE

### A. Rate Design

Staff claims that its rate design will support the "statewide effort to improve water efficiency."[136] While that is indeed the case, Staff's rate design does not strike the proper balance between conservation and revenue stability. Commission Staff's proposed tiered rates make it extremely difficult, if not impossible, for EWAZ to achieve its authorized revenue requirement.[137] The Company's proposed rate design, which will also appropriately incent conservation, recovers a smaller, and more appropriate, percentage of metered revenues from the highest commodity rate, whereas Commission Staff's proposed rate design recovers a greater percentage.[138]

In a very recent decision, the Commission rejected Commission Staff's proposed minimum monthly charge and adopted the utility's proposed monthly usage charge, which

[135] Tr. at 576.
[136] Staff Opening Brief at 21.
[137] Ex. A-27 at 14.
[138] Company's Schedules, H Schedules; Staff's Schedules; H Schedules.



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sought to recover equal amounts from the monthly usage charge and the commodity charge:

> We believe a rate design that would allow Park to generate 50 percent of its authorized revenue from the monthly usage charge and 50 percent from commodity charges provides a steady, reliable revenue stream, but yet still allows customers to lower their water bills through conservation.[139]

The same issues that the Commission recognized in those cases exist in this case, but to an even greater degree given the larger size of the Company as compared to other water utilities. Accordingly, it is appropriate for the basic service charge to be at the levels recommended by the Company and appropriate for the Commission to adopt the Company's proposed tiers so that the Company will have greater revenue stability and an opportunity to earn its authorized return.

**B. Declining Usage**

The Company's declining usage adjustment is based upon known and measurable impacts on revenues since the last rate case.[140] Both residential and non-residential customer classes show trends in declining usage and it is not unreasonable to expect further reductions in per customer usage in the future.[141] The empirical data demonstrates that conservation-oriented rate designs are working, and recent events in the West relating to water restrictions highlight the on-going trend toward water conservation. Given the water shortages experienced in the southwestern United States, it is likely that the need for conservation will increase, which places additional burden on the Company and further bolsters the argument for inclusion of this adjustment. Staff, based on its review of the Company's data, concurs that a declining usage adjustment is appropriate.[142] For these

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[139] Decision No. 75046 at 8.
[140] Ex. A-29 at 1-2.
[141] *Id.* at 2.
[142] Ex. S-18.

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reasons, it is appropriate to include a declining usage adjustment as proposed by the Company and Commission Staff.

**C. CIAC in CWIP**

Commission Staff confirms its support for the Company's position on this issue in its Opening Brief.[143] RUCO makes a passing reference to this issue in its Opening Brief but provides little argument to which the Company can respond. The adjustment made by the Company, and accepted by Commission Staff, preserves the matching principle by removing the CIAC and its associated amortization until such time as the depreciation on the related plant is included as an expense which occurs when the developer-funded CWIP is completed and placed in service.[144] Developer-funded CWIP does not accumulate any allowance for funds used during construction (AFUDC) and the Company does not earn anything on the developer-funded projects either while they are in CWIP or when they are completed and transferred into plant in service.[145] The Company continues to support these adjustments and asks that the Commission adopt them.

**D. Rate Case Expense**

RUCO seeks to penalize the Company for initial accounting issues by reducing the Company's rate case expense.[146] The Company is not seeking to recover any more than the amount of expenses actually incurred for rate case expense.[147] In fact, it is likely that the Company's request will not cover all regulatory expenses incurred in this proceeding. And, the amount requested by the Company is reasonable regardless of the Company's initial accounting issues. As demonstrated by the number and breadth of the issues set forth in this brief, this is a complex case with multiple intervenors requiring extensive work by all parties, including the Company.

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[143] Staff's Opening Brief at 7-8.
[144] Ex. A-8 at 20.
[145] *Id.* at 21.
[146] RUCO Opening Brief at 47.
[147] Ex. A-11 at 8.



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**E. Cash Working Capital**

An allowance for cash working capital recognizes that there may be a lag between the time when an expense is paid for and the time when that expense is recovered. Rate case expense fits this definition. The Company must pay for rate case expense items when they are incurred. However, the Company does not recover those expenses until rates are paid by customers over time. The Company has historically used the annual amortization amount of rate case expense as the basis for this expense because this is the manner in which the Commission historically authorizes recovery of this expense item.[148] The fact that this expense is amortized is not a basis to exclude it from the calculation of cash working capital.[149]

The Commission should also reject RUCO's treatment of bad debt expense. The Company's calculation of bad debt expense is based on actual debts written off on uncollectible accounts which represent a loss of revenue to the Company and should be included in the calculation of the cash working capital.[150]

**F. CAP and GSF Surcharge**

RUCO continues to ignore the overwhelming policy reasons supporting the continued use of the CAP Surcharge and GSF Surcharge mechanisms. Both mechanisms allow for the timely recovery of CAP-related expenses that are not within the Company's control and provide customers with important pricing signals associated with this source of water.[151] In addition, there are several uncertainties that exist today that were not contingencies at the time of the Commission's issuance of Decision Nos. 72046 and 71481.[152] These include the future of the Navajo Generating Station, as well as the potential for shortages of CAP water. As shortages are triggered on the Colorado River, which some estimate may be as soon as 2017, the cost to deliver CAP water will increase.

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[148] Ex. A-8 at 19.
[149] *Id.*



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This cost will be absorbed by all of the users, and based on the testimony provided in this case, all parties recognize that CAP costs will continue to increase over time.[153]

The Company has been very forthcoming about its prior failures to file annual adjustments prior to 2010 for its CAP Surcharge (Paradise Valley Water District) and its GSF Surcharge (Sun City Water District).[154] Following the recognition of those failures in 2010, the Company refunded amounts to customers and since that time has improved its internal process for calculating and filing the annual adjustment to the surcharges each year.[155] Commission Staff has testified that the Company is in compliance with the provisions of these prior orders and supports the continued use of these surcharges in recognition of the strong policy reasons favoring these surcharges for the continued purchase of this critical resource.[156]

The current CAP Surcharge calculation for the Paradise Valley Water District includes an adjustment that reduces purchased water charges by $179,225, which has been referred to as Power Cost Savings.[157] Power Cost Savings were occurring through 2008 due to an exchange of CAP water with well water from Salt River Project.[158] Since that time, the exchange and the associated cost savings have not occurred. Instead, EWAZ is storing and recovering its CAP water.[159] As a result, the Power Cost Savings should be removed from the Paradise Valley CAP Surcharge calculation as proposed by the Company.

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[150] *Id.* at 20.
[151] Ex. A-21 at 13.
[152] *Id.* at 10-11
[153] *See, e.g.,* Ex. R-9 at 33.
[154] Ex. A-21 at 5, 14; Ex. A-22 at 6.
[155] Ex. A-22 at 6; Ex. A-23 at 3.
[156] Ex. S-16 at 14-15; Tr. at 880.
[157] Ex. A-21 at 16.
[158] *Id.* at 16-17.
[159] *Id.*

**G. Tank Maintenance (Paradise Valley)**

RUCO claims that the Company has not invested the funds authorized for tank maintenance.[160] This claim ignores the Company's testimony on this very issue.[161] As Mr. Stuck explained in his rebuttal testimony, tank maintenance expenditures vary by year depending on the number and size of the tanks to be maintained.[162] The amount used for tank maintenance expense averages those amounts over a period of years, and by the end of that term of years, the total amount will be spent by the Company. And, to protect customers against any potential underspending on these amounts, the Company has agreed to RUCO's recommendation for a true up after the end of the fourteen year program.[163]

Commission Staff, based on a thorough examination of the tanks by Mr. Thompson, and consistent with the approach approved by the Commission in prior cases, recommends the approval of this plan and the inclusion of the requested amounts as an expense item.[164] The Company continues to agree with the amount proposed by Staff.[165]

**H. Tubac Rate Base and Arsenic Media**

The Company remains hopeful that Commission Staff will accept the Company's position with regard to amounts that should remain in rate base for the Tubac Water District. However, to date, Staff has yet to respond to this issue. Staff recommends removal from rate base of $178,533 ($249,315-$70,762) currently included in Account 320200 Water Treatment Equipment-Media.[166] Although this account includes arsenic media, it also includes an allocation of treatment plant engineering costs and overhead incurred during the construction of the arsenic treatment plant, and, therefore, it is not

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[160] RUCO Opening Brief at 39.
[161] Ex. A-19 at 3-4; A-20 at 2. In the Sun City Water District, the average amount spent to date exceeds the amount in tank maintenance expense from the prior rate case. Ex. A-19 at 3-4.
[162] Ex. A-19 at 3-4.
[163] Ex. A-20 at 2-3.
[164] Ex. S-1, PV District Engineering Report at 17-18; Ex. S-3 at 1-2.
[165] *Id.*
[166] Ex. A-9 at 16; Ex. S-15 at 15; Tr. at 47.



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appropriate to remove the entire amount.[167] As set forth in the Company's Schedules, once all proper adjustments are made, the amount of $172,839 ($249,315-$76,476) should remain in rate base as part of Account 320100 Water Treatment Equipment-Non Media.[168]

The Company has proposed, and RUCO has agreed, that arsenic media replacement costs of $101,712 should be recovered through a surcharge mechanism over a three-year period.[169] These arsenic media replacement costs were deferred pursuant to the Company's Tubac Arsenic Cost Recovery Mechanism ("ACRM") and reflected in the Company's initial application as deferred debits in the rate base Schedule B-1 and should not be confused with the amounts in Account 320200 discussed above. The Company continues to recommend that a three year surcharge be used rather than Staff's proposal. The amount of this surcharge is set forth in Mr. Bourassa's rebuttal testimony.[170]

**I. Tubac Storage Tank**

Commission Staff recommends that the Company be required to install an additional storage tank in the Tubac Water District.[171] The Company does not object to this requirement, but should be allowed to conduct a hydraulic study to ensure that the storage tank is sized correctly so that the tank is not overbuilt.[172]

Commission Staff also recommends that this docket be left open for the sole purpose of allowing the Company to include the new storage tank in rate base at the time that it is completed.[173] Finally, Commission Staff recommends that the Company be required to utilize its own funds for this storage tank (rather than debt) to ensure that it is

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[167] Ex. A-9 at 16.
[168] *Id.*; Ex. A-2.
[169] Ex. A-6 at 2.
[170] Ex. A-28 at Ex. TJB-3R.
[171] Ex. S-1, Ex. MST-4.
[172] Ex. A-5 at 5.
[173] Tr. at 874, 887.



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done on time and correctly.[174] The Company does not object to these two recommendations in relation to the Tubac storage tank.

### J. Power Cost Adjustor Mechanism (PCAM) and APS Forecasted Costs

The best means to send appropriate price signals to customers is to enable companies to pass through cost increases and decreases in a more timely fashion.[175] In recent decisions, the Commission has continued to recognize the benefits of these types of mechanisms.[176] The Commission has also placed requirements on these mechanisms, and the Company accepts those requirements in this case.[177] The Company agrees that its PCAM should be based on gallons pumped, rather than gallons sold, and also accepts the following requirements from the recent *Litchfield Park Service Company* decision: (1) that the Company provide an annual report on purchased power; and (2) that Commission Staff calculate an annual increase or decrease, and provide a Recommended Opinion and Order for Commission approval within 30 days of the Company's annual report.[178]

RUCO argues that the Commission should not adopt this mechanism because power rates are likely to increase.[179] This is not a reason to reject this request, but rather a further basis to support it. In addition, RUCO's claim that increased efficiency will not benefit customers is factually incorrect. If the Company is more efficient, this will decrease the amount passed through to customers.

RUCO also argues in its Opening Brief that there is no basis to include the projected increase in APS power costs if the Company is granted a PCAM.[180] The Company strongly disagrees with this point, as the power cost expense set forth in the Company's base rates will serve as the baseline for the Company's PCAM. Therefore, it is

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[174] Tr. at 885-87.
[175] Ex. A-7 at 22-23.
[176] *See, e.g.,* Decision No. 74437 (Aug. 18, 2014) at 10.
[177] *Id.*
[178] *Id.*
[179] RUCO Opening Brief at 31, 43.
[180] RUCO Opening Brief at 31.

appropriate to set the initial cost at the Company's requested amount to provide for a more accurate baseline for the PCAM, as well as the appropriate price signal to customers upon adoption of rates in this case.

In accordance with the Commission's support of purchase power adjustors for water and wastewater utilities, Commission Staff continues to recommend approval of the Company's request. For these reasons, the Company requests that the Commission approve its PCAM.

**K. Affordable Care Act Adjustor**

Medical costs for employees continue to be a volatile and unpredictable component of the Company's expenses.[181] The volatility and unpredictability of these health care costs makes them appropriate for an adjustor mechanism. This mechanism would allow adjustment based on increases or decreases in medical costs for employees.[182] An adjustor mechanism would provide protection for both the Company and customers for changes in this expense item.[183]

As discussed in the testimony of Ms. Hubbard, medical costs are based on employee levels and also include some individual selection criteria.[184] An average cost per employee would be used to determine the known and measurable expense.[185] The Company recommends using the average cost per employee and the current employee count as the base and provide an adjustment when the average cost per employee changes.[186] Because the employee count would be limited to the number in the test year, it would provide the Company with an incentive to control increasing employee levels, which translates into lower costs for customers.[187]

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[181] Ex. A-7 at 24.
[182] *Id.*
[183] *Id.*
[184] *Id.*
[185] *Id.*
[186] *Id.*
[187] *Id.*

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### L. Property Tax Expense

RUCO disputes the Company's calculation of property tax expense.[188] The Company assessment ratio reflects the ratio that will be in effect for 2015, whereas RUCO's reaches beyond that timeframe. By averaging the assessment ratio for three years into the future as RUCO proposes, property tax expense for the adjusted test year is understated. The Company's assessment ratio is not outdated as RUCO claims; rather, it is the ratio that will be in effect at the time that new rates go into effect, which is fair for both the Company and customers.[189]

### M. Accounting Compliance Requirements

As noted above, the Company has accepted responsibility for the accounting issues that arose with its initial application. Ultimately, the Company provided the type of schedules that both RUCO and Commission Staff required for this proceeding and which RUCO and Commission Staff seek for future proceedings. RUCO recommends that the Commission order the Company to file an accounting action plan and order that the Company be audited by an independent accounting firm. The Company strongly objects to these recommendations as they are unnecessary for future rate cases. As noted above, the issues that arose were a result of the transition from American Water to EPCOR ownership and will not be an issue in the future. In addition, the Company is already audited by an external accounting firm as part of the annual audit for EPCOR Utilities Inc., so any additional audit requirement is not necessary and will only result in additional expense for the Company's customers.

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[188] RUCO Opening Brief at 41.
[189] Ex. A-11 at 17.

RESPECTFULLY SUBMITTED this 30th day of April, 2015.

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