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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

SUSAN BITTER SMITH - CHAIRMAN  
BOB STUMP  
BOB BURNS  
DOUG LITTLE  
TOM FORESE

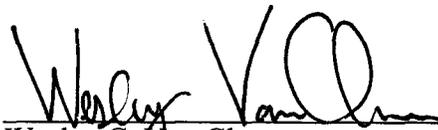
IN THE MATTER OF THE APPLICATION OF  
QUAIL CREEK WATER COMPANY, INC.,  
AN ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE FAIR VALUE OF  
ITS UTILITY PLANT AND PROPERTY AND  
FOR INCREASES IN ITS WATER RATES  
AND CHARGES FOR UTILITY SERVICES  
BASED THEREON.

DOCKET NO. W-02514A-14-0343

**NOTICE OF FILING  
STAFF'S SURREBUTTAL  
TESTIMONIES**

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby files the Surrebuttal Testimony of John A. Cassidy, relating to the cost of capital and revenue rate base design, and the Surrebuttal Testimony of James Armstrong, in the above-referenced docket.

RESPECTFULLY SUBMITTED this 1<sup>st</sup> day of July, 2015.

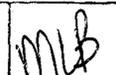
  
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Original and thirteen (13) copies of the foregoing filed this 1<sup>st</sup> day of July, 2015, with:

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Arizona Corporation Commission  
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BEFORE THE ARIZONA CORPORATION COMMISSION

SUSAN BITTER SMITH

Chairman

BOB STUMP

Commissioner

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TOM FORESE

Commissioner

IN THE MATTER OF THE APPLICATION OF )  
QUAIL CREEK WATER COMPANY, INC., AN )  
ARIZONA CORPORATION, FOR A )  
DETERMINATION OF THE FAIR VALUE OF )  
ITS UTILITY PLANTS AND PROPERTY AND )  
FOR INCREASES IN ITS WATER RATES AND )  
CHARGES FOR UTILITY SERVICE BASED )  
THEREON.)

DOCKET NO. W-02514A-14-0343

SURREBUTTAL TESTIMONY

(COST OF CAPITAL)

OF

JOHN A. CASSIDY

PUBLIC UTILITIES ANALYST

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

JULY 1, 2015

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**EXECUTIVE SUMMARY  
QUAIL CREEK WATER COMPANY, INC.  
DOCKET NO. WS-02514A-14-0343**

The surrebuttal testimony of Staff witness John A. Cassidy addresses the following issues:

Capital Structure – Staff recommends that the Commission adopt a capital structure for Quail Creek Water Company, Inc. (“Company”) for this proceeding consisting of 0.0 percent debt and 100.0 percent equity.

Cost of Equity – Staff recommends that the Commission adopt a 9.4 percent cost of equity for the Company. Staff’s estimated cost of equity for the Company is based on the 8.8 percent average of its discounted cash flow method (“DCF”) cost of equity methodology estimates for the sample companies of 8.4 percent for the constant-growth DCF model and 9.1 percent for the multi-stage DCF model. Staff’s recommended cost of equity includes an upward economic assessment adjustment of 60 basis points (0.6 percent). In Staff’s direct testimony the cost of equity was 9.5 percent.

Cost of Debt – Staff recommends that the Commission adopt a 0.0 percent cost of debt for the Company.

Overall Rate of Return – Staff recommends that the Commission adopt a 9.4 percent overall rate of return as compared to 9.5 percent in Staff’s direct testimony.

Mr. Bourassa’s Testimony – The Commission should reject the Company’s proposed 10.0 percent return on equity for the following reasons:

Mr. Bourassa’s DCF model estimates are overstated due to the use of historical stock price appreciation growth as a parameter to measure the dividend growth component in the constant-growth DCF model. Mr. Bourassa’s risk premium model (“RPM”) estimates are overstated due to (i) use of a 30-year U.S. Treasury rate, and not a corporate bond yield, in the computation of the market risk premium (“MRP”) component, and (ii) use of a forecasted risk free rate in the computation of the MRP estimated cost of equity. Mr. Bourassa’s capital asset pricing model (“CAPM”) estimates are overstated due to the use of both a forecasted risk-free rate and an inflated beta coefficient. The current MRP in Mr. Bourassa’s current MRP CAPM model improperly incorporates 3-5 year projected estimates of earnings per share, dividends per share and book value per share.

1     **I.     INTRODUCTION**

2     **Q.     Please state your name, occupation, and business address.**

3     A.     My name is John A. Cassidy. I am a Public Utilities Analyst employed by the Arizona  
4            Corporation Commission ("Commission") in the Utilities Division ("Staff"). My business  
5            address is 1200 West Washington Street, Phoenix, Arizona 85007.

6

7     **Q.     Are you the same John A. Cassidy who filed direct testimony in this case?**

8     A.     Yes, I am.

9

10    **Q.     What is the purpose of your surrebuttal testimony in this rate proceeding?**

11    A.     The purpose of my surrebuttal testimony is to report on Staff's updated cost of capital  
12            analysis with its recommendations regarding Quail Creek Water Company's ("QCW" or  
13            "Company") cost of capital, and to respond to the cost of capital rebuttal testimony of  
14            Company witness, Mr. Thomas J. Bourassa.

15

16    **Q.     Please explain how Staff's surrebuttal testimony is organized.**

17    A.     Staff's surrebuttal testimony is presented in four sections. Section I is this introduction.  
18            Section II discusses Staff's updated cost of capital analysis. Section III presents Staff's  
19            comments on the rebuttal testimony of the Company's cost of capital witness, Mr. Bourassa.  
20            Lastly, Section IV presents Staff's recommendations.

21

1 **II. COST OF EQUITY AND OVERALL RATE OF RETURN**

2 **Q. When filing direct testimony, Staff utilized the 10-year period, 2004-2013, over which**  
3 **to measure historical dividend growth in its constant growth discounted cash flow**  
4 **("DCF") model. Since filing direct testimony, did Staff update its cost of capital**  
5 **model to facilitate the estimation of dividend growth over a different 10-year period?**

6 A. Yes. Staff updated its cost of capital model to allow for the computation of a 10-year  
7 dividend growth rate for each of its sample companies utilizing historical measures of  
8 dividends per share ("DPS"), earnings per share ("EPS") and sustainable growth over the  
9 period 2005-2014.<sup>1</sup> For purposes of computing the dividend growth (g) component in the  
10 constant growth DCF model, Staff relies upon financial data made available by *Value Line*.  
11 Utilizing information provided in *Value Line's* most recent quarterly update for the water  
12 utility industry,<sup>2</sup> Staff was able to update its model in order to obtain historical measures of  
13 DPS, EPS and sustainable growth covering the 10-year period 2005-2014. Staff routinely  
14 performs this update to its cost of capital model on an annual basis once the requisite  
15 financial data for the previous year's operating performance is made available by *Value Line*  
16 for each of Staff's sample companies. Staff does so in order to ensure that the inputs utilized  
17 in its cost of capital model reflect current, rather than stale, information.

18  
19 **Q. When updating its cost of capital model did Staff also make adjustments to projected**  
20 **measures of DPS, EPS and sustainable growth for each of Staff's sample companies?**

21 A. Yes. In its most recent quarterly update for the water utility industry, *Value Line* updated its  
22 projected measures of growth for DPS, EPS and sustainable growth through the period,  
23 2018-2020. Previously, when filing direct testimony, Staff's projected measures of growth  
24 had been based on *Value Line* projections through the period 2017-2019.

---

<sup>1</sup> As noted in Staff's direct testimony, in addition to these three historical measures of growth, Staff's estimated dividend growth (g) rate in the constant growth DCF model incorporates measures of projected EPS, DPS and sustainable growth, as well (*See Cassidy Direct*, p.18, lines 16-19).

<sup>2</sup> *Value Line Investment Survey, Ratings & Reports*, dated April 17, 2015.

1 **Q. After updating Staff's cost of capital model in the manner described above, was there**  
2 **a change to the expected dividend growth (g) rate in Staff's constant-growth DCF**  
3 **model?**

4 A. Yes, in updating its cost of capital model, Staff's expected dividend growth rate fell from 5.9  
5 percent to 5.6 percent, a downward change of 30 basis points. As shown in Schedule JAC-8  
6 filed in Staff's direct testimony, the dividend growth (g) rate in Staff's constant-growth DCF  
7 model had previously been 5.9 percent. As shown in Surrebuttal Schedule JAC-8, however,  
8 Staff's newly updated sample average dividend growth (g) rate is 5.6 percent.

9  
10 **Q. Having updated Staff's cost of capital model utilizing the most recent *Value Line* data**  
11 **for Staff's seven sample companies, was Staff able to determine if the 30 basis point**  
12 **reduction to Staff's expected dividend growth (g) rate, from 5.9 percent to 5.6 percent,**  
13 **was attributable to changes in historical measures of dividend growth or changes to**  
14 **projected measures of dividend growth?**

15 A. The 30 basis point reduction to Staff's expected dividend growth rate is entirely attributable  
16 to changes in *Value Line's* projected measures of dividend growth for Staff's sample  
17 companies.<sup>3</sup>

18  

---

<sup>3</sup> A comparison of the data presented in Schedules JAC-8, as filed in Staff's Direct and Surrebuttal testimonies, clearly indicate that the 30 basis point change to Staff's dividend growth rate is attributable to reductions in measures of projected growth, and not to measures of historical growth. Specifically, when comparing the two Schedules JAC-8, reductions to *Value Line's* projected estimate of EPS growth (6.5 percent in Direct versus 5.1 percent in Surrebuttal) and Staff's projected estimate for sustainable growth (7.0 percent in Direct versus 6.1 percent in Surrebuttal) essentially account for the entire 30 basis point change. This is because the reduction to Staff's historical sustainable growth estimate (5.5 percent in Direct versus 4.8 percent in Surrebuttal) was offset by gains to Staff's historical EPS growth estimate (7.1 percent in Surrebuttal versus 6.5 percent in Direct) and historical DPS growth (3.8 percent in Surrebuttal versus 3.7 percent in Direct). As can be seen, there was no change to *Value Line's* projected DPS growth estimate (6.4 percent in both Direct and Surrebuttal).

1 Q. In performing its annual update to Staff's cost of capital model, did Staff incorporate a  
2 normalization adjustment to the 2014 EPS reported by *Value Line* for SJW  
3 Corporation (one of Staff's sample companies) and, if so, why?

4 A. Yes, Staff made a normalization adjustment to the \$2.54 annual EPS figure reported by *Value*  
5 *Line* for SJW Corporation ("SJW") in 2014 to give recognition to a one-time, nonrecurring  
6 increase in reported EPS in the third quarter of that year. Specifically, in the third quarter of  
7 2014, *Value Line* reported SJW's quarterly EPS to be \$1.88, a figure which exceeds by a wide  
8 margin the *annual* EPS reported for SJW in each of the two prior years, 2013 (\$1.12) and 2012  
9 (\$1.18). As noted in an earlier *Value Line* quarterly update for SJW,<sup>4</sup> this "whopping increase"  
10 to third quarter earnings was the result of "SJW's recognition of \$58.2 million in revenues due  
11 the company for expenses incurred in previous years," the delayed recovery of which "was  
12 the reason for the previous four quarters having negative year-over-year comparisons." *Value*  
13 *Line* stated that it did not back out any portion of the profits reported in Q3 of 2014 as a  
14 nonrecurring item because "they were earned by the utility's main business during the course  
15 of normal operations... [but] recognized all at the same time."

16  
17 In making its normalization adjustment, Staff assumed that, in the absence of this one-time  
18 event, SJW's EPS in Q3 of 2014 would have been \$0.43, not \$1.88, and that the \$1.45 residual  
19 one-time EPS windfall ( $\$1.88 - \$0.43 = \$1.45$ ) should be distributed over 5 quarters (Q3 & Q4  
20 of 2013, and Q1, Q2, & Q3 of 2014). Accordingly, Staff allocated \$0.58 (2/5ths of this  
21 windfall) to the reported \$1.12 2013 EPS figure and reduced the reported \$2.54 EPS figure  
22 for 2014 by this same \$0.58 amount to a level of \$1.96 ( $\$2.54 - \$0.58 = \$1.96$ ). Failure to  
23 make such a normalization adjustment to SJW's reported \$2.54 2014 EPS would serve to  
24 skew the data such that the 10-year compound annual EPS growth rate for SJW over the

---

<sup>4</sup> *Value Line Investment Survey, Ratings & Reports*, dated January 16, 2015.

1           2005-2014 period would not be representative of SJW's actual compound annual earnings  
2           growth over this time period.

3  
4           **Q.    What impact, if any, did Staff's normalization adjustment to SJW's reported 2014 EPS**  
5           **have upon Staff's estimated sample average 5.6 percent constant growth DCF**  
6           **dividend growth (g) rate in this docket?**

7           A.    Ultimately, Staff's normalization adjustment to SJW's reported 2014 EPS had *no effect* upon  
8           Staff's estimated dividend growth (g) rate in this docket. As shown in column [D] of  
9           Surrebuttal Schedule JAC-5, after making the above referenced normalization adjustment  
10          Staff determined that SJW experienced 10-year compound annual EPS growth of 8.5 percent  
11          (8.46 percent rounded to two digits) over the period 2005-2014, resulting in a 7.1 percent  
12          (7.10 percent rounded to two digits) historical sample average 10-year EPS growth rate over  
13          this same period. As shown in column [B] of Surrebuttal Schedule JAC-8, this 7.1 percent  
14          historical EPS growth rate was a contributing factor to Staff's overall 5.6 percent (5.56  
15          percent rounded to two digits) estimated dividend growth (g) rate. In the alternative, had  
16          Staff made no normalization adjustment to SJW's reported \$2.54 EPS in 2014, Staff  
17          determined that on a pro forma basis Staff's estimated 10-year historical growth rate would  
18          have remained at 5.6 percent (5.63 percent rounded to two digits), based upon (i) an 11.31  
19          percent compound annual EPS growth rate for SJW over the 10-year period 2005-2014 and  
20          (ii) a 7.51 sample average 10-year EPS growth rate over this same period of time.

21

1 **III. STAFF RESPONSE TO COMPANY'S COST OF CAPITAL WITNESS MR.**  
2 **THOMAS J. BOURASSA**

3 **Q. In Rebuttal (p. 4), Mr. Bourassa is critical of Staff's recommendation that the**  
4 **Company be required to rebalance its capital structure prior to the filing of its next**  
5 **rate case. Specifically, he states that the Company disagrees with Staff's**  
6 **recommendation, and argues that a decision as to the appropriate mix of debt and**  
7 **equity capital to be employed in the capital structure is best left to management.**  
8 **How does Staff respond?**

9 A. Staff agrees that management should have primary responsibility for determining the  
10 appropriate capital structure mix to be employed by a regulated utility/public service  
11 company. However, when the capital structure employed by a regulated utility is 100.0  
12 percent equity, then for rate-making purposes Staff believes it is appropriate for this  
13 Commission to require the Company to rebalance its capital structure. As noted in Staff's  
14 Direct,<sup>5</sup> the cost of debt is less than the cost of equity, and given the capital intensive nature  
15 of the water utility industry, exclusive use of equity capital to fund plant infrastructure  
16 requires ratepayers to pay a proportionately higher cost of service than had the plant been  
17 funded with a mix of both debt and equity capital. Staff's recommendation that QCW  
18 rebalance its capital structure is prospective in nature. As noted in Staff's direct testimony,<sup>6</sup>  
19 there have been two recent instances in which Robson-owned utilities have filed financing  
20 applications requesting Commission authorization to rebalance their capital structures for the  
21 express purpose of increasing the debt component.<sup>7</sup>

<sup>5</sup> See Cassidy Direct (Cost of Capital), p. 9, lines 12-23.

<sup>6</sup> See Cassidy Direct (Cost of Capital), p. 10, lines 4-9. It should be noted that in Staff's direct testimony, the docket citations given for to the two Robson-owned utilities are to rate cases filed by Pima Utility Company (Docket No. W-02199A-11-0329, et al.) and Lago Del Oro Water Company (Docket No. W-01944A-13-0215). Properly cited, the references should be to the financing application filed by each Robson-owned utility, which are as follows: Pima Utility Company (Docket No. W-02199A-11-0403, et al.); and Lago Del Oro Water Company (Docket No. W-01944A-13-0242).

<sup>7</sup> In the Pima Utility Company financing case (Docket No. W-02199A-11-0403, et al.), the company's application requested authorization to issue evidence of indebtedness in the amount of \$8,370,000. Of this total, (i) \$4,370,000 was replacement debt to refinance existing debt at a reduced interest rate, (ii) \$1,500,000 was new debt used to fund infrastructure improvements, and (iii) \$2,500,000 was new debt used to buy back equity capital to effectuate a rebalancing

1 **Q. In Rebuttal (p. 4, lines 1-3), Mr. Bourassa points out that Staff did not define the term**  
2 **“balanced.” Can Staff provide insight as to what it believes the appropriate debt and**  
3 **equity capital mix in a rebalanced capital structure for QCW might reasonably be**  
4 **expected to be?**

5 A. In view of the fact that two other Robson-owned utilities, Pima Utility Company (“Pima”)  
6 and Lago Del Oro Water Company (“LDO”), have recently requested and been granted  
7 Commission authorization to rebalance their capital structures, Staff believes that the  
8 authorized capital structure used to set rates in the most recent rate docket for each of these  
9 Robson-owned utilities would provide a reasonable proxy for what QCW’s rebalanced capital  
10 structure might be.

11  
12 **Q. Are Pima and LDO comparable in size to QCW?**

13 A. Yes, they are, for like QCW, both Pima and LDO are Arizona Class “B” utility companies.  
14

15 **Q. For ratemaking purposes, what capital structure was used by the Commission to**  
16 **establish the currently authorized rates for Pima Utility Company (Docket No. W-**  
17 **02199A-11-0329, et al.) and Lago Del Oro Water Company (Docket No. W-01944A-13-**  
18 **0215)?**

19 A. In Decision No. 73573 (dated November 21, 2012), the Commission authorized rates for  
20 Pima were established based upon a capital structure consisting of 35.4 percent debt and 64.6

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of Pima’s capital structure and reflect a higher amount of debt. The Commission authorized Pima’s proposed financing in Decision No. 73078 (dated April 5, 2012). In the Lago Del Oro financing case (Docket No. W-01944A-13-0242), the company’s application requested authorization to issue evidence of indebtedness in the amount of \$3,900,000 stating that “this funding will be used to repay the shareholders for this asset purchase and rebalance the Company’s capital structure to reflect a higher amount of debt.” The plant to be acquired had been purchased on a deferred basis from an affiliate (Saddlebrooke Development) at original cost of \$3,887,998; however, because the affiliate’s original cost figure did not reflect accrual of accumulated depreciation of the assets from the time they were placed into service until the date of purchase, Staff recommended a reduction in the loan amount to \$2,751,411. Lago Del Oro agreed with Staff’s recommendation, and the Commission authorized the company’s proposed financing in the amount of \$2,751,411 in Decision No. 74450 (dated April 18, 2014).

1 percent equity.<sup>8</sup> In Decision No. 74564 (dated June 20, 2014), the Commission authorized  
2 rates for LDO were established based upon a capital structure consisting of 29.0 percent debt  
3 and 71.0 percent equity.<sup>9</sup> Based upon the relative weightings of debt and equity capital  
4 among these two Robson-owned utilities, an average (i.e., arithmetic mean) capital structure  
5 would be comprised of 32.2 percent debt and 67.8 percent equity.<sup>10</sup>

6  
7 **Q. In Rebuttal (p. 4, lines 11-21), and apparently within the context of addressing Staff's**  
8 **recommended prospective rebalancing of QCW's capital structure, Mr. Bourassa**  
9 **raises the issue of small size, suggesting that this is a relevant consideration when**  
10 **determining the appropriate equity ratio for a firm. In doing so, he cites a study by**  
11 **Scott and Martin<sup>11</sup> whose findings suggest that smaller firms found it prudent to**  
12 **"offset higher business risks related to being small by reducing financial risk." How**  
13 **does Staff respond?**

14 **A.** Mr. Bourassa's discussion appears to be a rationalization for QCW maintaining a 100.0  
15 percent equity capital structure, and his analysis is flawed for two reasons. First, the study he  
16 cites to concerns itself with "unregulated firms in twelve industries," and not to regulated  
17 public utilities which have been granted natural monopoly status and operate in an  
18 environment free of competition. For obvious reasons, business risk exposure is significantly  
19 greater for firms operating in a competitive environment than for firms (i.e., regulated  
20 utilities) which do not, and for this reason Mr. Bourassa's attempt to extrapolate the findings  
21 of a study concerned with unregulated firms and apply them to regulated public utilities is  
22 improper. Second, and assuming for a moment that what Mr. Bourassa says is true, "that  
23 smaller utilities seek to maintain higher equity ratios to help offset the higher business risks,"<sup>12</sup>

<sup>8</sup> See Commission Decision No. 73573, p. 29, lines 20-22.

<sup>9</sup> See Commission Decision No. 74564, pp. 14-15, Finding of Fact No. 60.

<sup>10</sup> Debt  $((.354 + .29)/2) = .322$ , or 32.2 percent; Equity  $((.646 + .71)/2) = .678$ , or 67.8 percent.

<sup>11</sup> Scott, D.F. and J.D. Martin, "Industry Influence on Financial Structure," *Financial Management*, Spring 1975, pp. 67-71.

<sup>12</sup> See Bourassa Direct, p. 4, lines 20-21.

1 this then begs the question, "Why did QCW's sister-utilities, Pima and LDO, seek  
2 authorization to rebalance their capital structures when they are comparable in size to  
3 QCW?"

4  
5 **Q. Does an election on the part of Pima and LDO to rebalance their respective capital**  
6 **structures render moot the small size argument put forth by Mr. Bourassa for QCW in**  
7 **Rebuttal?**

8 A. Yes, by virtue of QCW being comparable in size to both Pima and LDO.

9  
10 **Q. In closing on the issue of capital structure mix, in view of Mr. Bourassa's assertion**  
11 **that management should decide the appropriate mix of debt and equity capital to be**  
12 **used to fund plant infrastructure, how does Staff respond to the statement made by**  
13 **Mr. Ray L. Jones in Rebuttal<sup>13</sup> that payments made to QCW affiliates for deferred**  
14 **plant purchases must wait "until such time QCW has available funds to pay the**  
15 **affiliate for the design-build contracting service provided?"**

16 A. Incurring an obligation to pay for capital projects and then just waiting until cash is available  
17 to pay for these liabilities is not an acceptable business plan. Rather than waiting until QCW  
18 had "available funds," management could instead have elected to purchase the plant utilizing  
19 low cost debt rather than higher cost equity. As noted in Mr. Bourassa's Rebuttal,<sup>14</sup> interest  
20 rates are expected to rise, which suggests that had QCW elected to finance the acquisition of  
21 these deferred asset purchases with debt, QCW's overall cost of service would have already  
22 been reduced and the benefit to be derived by ratepayers would be reflected in the rates to be  
23 set in this docket. In failing to avail itself of debt financing to purchase these plant assets  
24 QCW could, presumably, have to pay a higher cost of debt in the future, and the benefit to be

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<sup>13</sup> See Jones Rebuttal, p. 8, lines 13-15.

<sup>14</sup> See Bourassa Rebuttal, p. 10, line 5.

1 derived by ratepayers from a rebalanced QCW capital structure in the Company's next rate  
2 case will be proportionately diminished.

3  
4 **Q. In Rebuttal (pp. 5-6, lines 5:3), Mr. Bourassa stated that Staff relied solely on the DCF**  
5 **model, pointing out that Staff did not incorporate estimates derived from the CAPM**  
6 **into its analysis "because current market conditions have led to unusually low results**  
7 **from its CAPM." In view of this, assuming Staff had elected to incorporate estimates**  
8 **derived from the CAPM into its cost of equity analysis, on a pro forma basis what**  
9 **would Staff's updated recommended cost of equity estimate have been for QCW?**

10 **A.** As presented in Surrebuttal Exhibit JAC-A, Staff prepared a pro forma restatement of  
11 Surrebuttal Schedule JAC-3 showing what Staff's updated cost of equity recommendation for  
12 the Company would have been had Staff incorporated estimates derived from the CAPM into  
13 its analysis. As shown, Staff's average CAPM cost of equity estimate is 7.6 percent, based on  
14 estimates derived from Staff's historical market risk premium ("MRP") CAPM (7.3 percent)  
15 and Staff's current MRP CAPM (7.9 percent) models. As can be seen, this 7.6 percent  
16 average CAPM estimate is 120 basis points *lower* than Staff's average 8.8 percent DCF cost of  
17 equity estimate and, on a pro forma basis, results in a Staff estimated cost of equity of 8.2  
18 percent  $((.088 + .076)/2 = .082)$ . As can further be seen, after adoption of Staff's upward 60  
19 basis point (0.6 percent) economic assessment adjustment, Staff's recommended cost of  
20 equity for QCW would be 8.8 percent  $(.082 + .006 = .088)$ , on a pro forma basis.<sup>15</sup>

21  

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<sup>15</sup> In keeping with the Efficient Market Hypothesis, the risk-free ( $R_f$ ) rates used in Staff's historical- and current MRP CAPM models reflect the yields on U.S Treasury debt instruments (5-, 7- and 10-year intermediate Treasury rates for Staff's historical MRP CAPM; 30-year long-term Treasury bond yield in Staff's current MRP CAPM) were obtained as of the close of market trading on May 27, 2015, the same date Staff obtained closing spot market share prices for each of its seven sample companies for purposes of computing the expected dividend ( $D_1/P_0$ ) yield in Staff's constant growth DCF model.

1 **Q. Does Staff believe an authorized return on equity of 8.8 percent is reasonable for rate**  
2 **making purposes in this docket?**

3 A. Staff believes that a return on equity of 8.8 percent would be on the low side of  
4 reasonableness, which is why Staff elected not to incorporate cost of equity estimates  
5 obtained from the CAPM into its analysis.

6  
7 **Q. What is the MRP ( $R_p$ ) component employed by Staff in its historical- and current**  
8 **MRP CAPM analyses?**

9 A. As shown in Column [D] of Surrebuttal Exhibit JAC-A, the MRP employed by Staff in its  
10 historical MRP CAPM is 7.5 percent, and the MRP employed by Staff in its current MRP  
11 CAPM is 6.9 percent.

12  
13 **Q. What is the MRP ( $RP_M$ ) component employed by Mr. Bourassa in his historical- and**  
14 **current MRP CAPM analyses?**

15 A. As shown in Bourassa Rebuttal Schedule D-4.11, the MRP component employed by Mr.  
16 Bourassa in his historical MRP CAPM model is 7.00 percent, and the MRP employed in his  
17 current MRP CAPM model is 9.25 percent.

18  
19 **Q. In Rebuttal (p. 10, lines 19-22), Mr. Bourassa makes reference to a recent *Wall Street***  
20 ***Journal* article,<sup>16</sup> noting that, as of the end of April 2015, the equity risk premium for**  
21 **the S&P 500 was “one of the highest estimates going back to 1960.” Did Staff access**  
22 **the article cited by Mr. Bourassa and, if so, what was the equity risk premium on the**  
23 **S&P 500 as of the end of April 2015?**

24 A. Yes, Staff accessed the article on the internet,<sup>17</sup> and in so doing determined that the equity  
25 risk premium on the S&P 500 as of the end of April 2015 was 5.8 percent.<sup>18</sup>

<sup>16</sup> Lahart, Justin, “Lower Yields May Be Stocks’ Real Threat,” *The Wall Street Journal (WSJ.com)*, (May 17, 2015).

<sup>17</sup> <http://www.wsj.com/articles/lower-yields-may-be-stocks-real-threat-1431885420>

1 **Q. Would an equity risk premium on the S&P 500 of 5.8 percent, measured as of the end**  
2 **of April 2015, be considered an indication of the “current” MRP?**

3 A. Yes, because the S&P 500 is a broad based market index of 500 publicly-traded companies,  
4 and the performance of the S&P 500 is often used as a proxy for that of the market as a  
5 whole.

6  
7 **Q. In light of the above, if the current 5.8 percent equity risk premium is one of the**  
8 **highest since 1960, does Staff believe this to be further evidence that the 9.25 percent**  
9 **MRP component in Mr. Bourassa’s current MRP CAPM has been significantly**  
10 **overstated?**

11 A. Yes. In absolute terms, Mr. Bourassa’s 9.25 percent current MRP exceeds by 345 basis points  
12 this 5.8 percent current MRP value ( $.0925 - .058 = .0345$ ), which in relative terms equates to  
13 an overstatement of 59.48 percent ( $((.0925/.058)-1 = .5948)$ ).

14  
15 **Q. Please quantify the degree to which Mr. Bourassa’s 9.25 percent current MRP exceeds**  
16 **the 6.9 percent current MRP employed by Staff in its current MRP CAPM.**

17 A. In absolute terms, Mr. Bourassa’s 9.25 percent current MRP exceeds by 235 basis points  
18 Staff’s 6.9 percent current MRP ( $.0925 - .069 = .0235$ ), which in relative terms equates to an  
19 overstatement of 34.06 percent ( $((.0925/.069)-1 = .3406)$ ).

20

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<sup>18</sup> The 5.8 percent equity risk premium value cited to is based upon the research findings of Dr. Aswath Damodaran, Professor of Finance at the Stern School of Business at New York University.

1 **Q. In direct testimony,<sup>19</sup> Staff states that Mr. Bourassa's use of EPS and DPS growth**  
2 **inputs in the computation of the MRP component in his current MRP CAPM results**  
3 **in a MRP component that is not reflective of current market conditions. Do the above**  
4 **overstatement quantifications support Staff's position in this regard?**

5 A. Yes.

6  
7 **Q. As presented in Rebuttal Schedule D-4.11, Mr. Bourassa's current MRP CAPM**  
8 **estimated cost of equity (k) is 11.0 percent. Among Mr. Bourassa's cost of equity**  
9 **estimates, is the 11.0 percent estimate derived from his current MRP CAPM the**  
10 **highest expected cost estimate?**

11 A. Yes, it is. As shown in Rebuttal Schedule D-4.1, among the indicated cost of equity estimates  
12 shown for Mr. Bourassa's water sample group, the single highest expected cost estimate is  
13 11.0 percent, obtained from his current MRP CAPM. As further shown in Rebuttal Schedule  
14 D-4.1 (See footnote 1), for purposes of arriving at the indicated cost of equity for QCW, Mr.  
15 Bourassa makes an additional upward 100 basis point adjustment to the equity risk premium,  
16 the highest value being 12.0 percent to reflect an additional 100 basis points added to his 11.0  
17 percent current MRP CAPM estimate.

18  
19 **Q. In Rebuttal, does Mr. Bourassa continue to employ a forecasted risk-free ( $R_f$ ) rate in**  
20 **the computation of both his historical- and current MRP CAPM cost of equity (k)**  
21 **estimates?**

22 A. Yes, he does. As shown in Rebuttal Schedule D-4.11, Mr. Bourassa employs a 4.2 percent  
23 forecasted risk-free rate in the computation of both his historical- and current MRP CAPM  
24 cost of equity estimates.<sup>20</sup>

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<sup>19</sup> See Cassidy Direct, p. 37, lines 4-13.

<sup>20</sup> In direct testimony, Mr. Bourassa employed a forecasted risk-free rate of 4.6 percent in both his CAPM and Risk Premium cost of equity estimation models, a figure 40 basis points higher than the 4.2 percent forecasted rate he employs in rebuttal testimony (See Bourassa Direct, Schedule D-4.11).

1 Q. And does use of a forecasted risk-free rate serve to overstate the market cost (k) of  
2 equity in the CAPM?

3 A. Yes, which suggests that Mr. Bourassa's historical- and current MRP CAPM cost of equity  
4 estimates have both been overstated.

5  
6 Q. Moreover, in Rebuttal (p. 13, lines 13-18) Mr. Bourassa cites to Dr. Morin<sup>21</sup> who,  
7 apparently, affirms the propriety of using forecasted rates in the CAPM. In reviewing  
8 Dr. Morin's book, was Staff able to find contradictory evidence suggesting that use of  
9 a forecasted risk-free rate in the CAPM is inappropriate?

10 A. Yes, Staff found two such occasions where Dr. Morin appears to contradict himself on this  
11 point. First, in regard to the appropriate risk-free rate to be used in the CAPM, Dr. Morin  
12 writes as follows:

13 "At the conceptual level, because common stock is a long-term investment  
14 and because the cash flows to investors in the form of dividends last  
15 indefinitely, the yield on very long-term government bonds, namely, the yield  
16 on 30-year Treasury bonds, is the best measure of the risk-free rate for use in  
17 the CAPM and Risk-Premium methods."<sup>22</sup>

18 Second, as authority for his current MRP CAPM methodology, Mr. Bourassa cites to a case  
19 study appearing on pp. 165-166 of Dr. Morin's book.<sup>23</sup> However, a review of the referenced  
20 case study presented clearly indicates that the **current yield** on the 30-year U.S. Treasury  
21 Bond was used as a proxy for the risk-free rate, and not a forecasted yield. Moreover, in the  
22 case study presented by Morin to which Mr. Bourassa cites, the current yield on the 30-year  
23 U.S. Treasury Bond was used as the risk-free rate in the computation of both (i) the current  
24 MRP component, and (ii) the current MRP CAPM estimated cost (k) of equity. As noted in  
25 Staff's direct testimony,<sup>24</sup> Mr. Bourassa used two different risk-free rates in his current MRP  
26 CAPM analysis -- one a current measure, the other a forecasted measure of the yield on the

<sup>21</sup> Morin, Roger A., *New Regulatory Finance*, Public Utility Reports, Inc. (2006).

<sup>22</sup> Morin, Roger A., *New Regulatory Finance*, Public Utility Reports, Inc. (2006), p. 151.

<sup>23</sup> See Bourassa Rebuttal, p. 13, lines 2-4.

<sup>24</sup> See Cassidy Direct, p. 38, lines 5-14.

1           30-year U.S. Treasury Bond – and in so doing maximized both the current MRP component  
2           as well as the current MRP CAPM estimated cost of equity.

3  
4           **Q. For purposes of updating his current MRP CAPM in Rebuttal, did Mr. Bourassa**  
5           **again elect to utilize two different risk-free ( $R_f$ ) rates in his analysis?**

6           A. Yes, he did. As shown in Rebuttal Schedule D-4.10, Mr. Bourassa employed a 2.60 percent  
7           current 30-year Treasury rate when computing the current MRP component. For purposes  
8           of the computation of his updated 11.0 percent current MRP CAPM estimated cost of equity  
9           (k), however, he used a 4.2 percent forecasted measure of the 30-year Treasury rate as the  
10          risk-free rate, as shown in Rebuttal Schedule D-4.11.

11  
12          **Q. In reviewing Rebuttal Schedule D-4.11, does Staff have reason to believe that Mr.**  
13          **Bourassa has overstated the beta coefficient in both his historical- and current MRP**  
14          **CAPM analyses?**

15          A. Yes. As shown in Rebuttal Schedule D-4.11, Mr. Bourassa employs a sample average beta  
16          coefficient of 0.74 in both his historical- and current MRP CAPM models. Both Mr.  
17          Bourassa and Staff utilize the same proxy group of seven sample companies, and as shown in  
18          Staff's Surrebuttal Schedule JAC-7 the sample average beta coefficient for Staff's proxy group  
19          of companies is currently 0.72. Staff's sample average 0.72 beta is based upon information  
20          provided by *Value Line* in its most recent quarterly update (dated April 17, 2015) of publicly-  
21          traded water utility stocks, which suggests that Mr. Bourassa has overstated the beta  
22          coefficient in both his historical- and current MRP CAPM analyses.

23

1 **Q. Does an overstatement to the beta coefficient in the CAPM result in an overstatement**  
2 **to the estimated cost (k) of equity derived from that model?**

3 A. Yes, which suggests that Mr. Bourassa's historical- and current MRP CAPM cost of equity  
4 estimates have both been fractionally overstated.

5  
6 **Q. For the reasons noted above, therefore, Mr. Bourassa's 11.0 percent current MRP**  
7 **CAPM cost of equity (k) estimate has been overstated in three different ways; namely,**  
8 **by use of (i) an inflated MRP component which is not reflective of current market**  
9 **conditions, (ii) a forecasted risk-free rate, and (iii) an inflated beta coefficient, true?**

10 A. Yes. Furthermore, it should be noted that had Mr. Bourassa utilized market-based inputs in  
11 his current MRP CAPM (i.e., a MRP component reflective of current market conditions, a  
12 current measure of the long-term U.S. Treasury bond rate, and the current sample average  
13 beta) then he, like Staff, might well have elected not to rely on cost of equity estimates  
14 obtained from the CAPM by virtue of their being excessively low at the present time.<sup>25</sup>

15  
16 **Q. In Rebuttal (p. 11, lines 2-6) Mr. Bourassa states that "Staff has previously used share**  
17 **price growth in a DCF model" to estimate the MRP component in its current MRP**  
18 **CAPM, and cites to Staff cost of capital testimony filed in other rate dockets for**  
19 **support. How does Staff respond?**

20 A. First, Mr. Bourassa's characterization of Staff's methodology as being one which utilizes  
21 "share price growth in a DCF model" to estimate the MRP component in Staff's current  
22 MRP model is not accurate. In the constant growth DCF model, the cost of equity  
23 represents the sum of (i) a dividend yield component added to (ii) a dividend growth rate.  
24 Staff's current MRP CAPM methodology is, "DCF derived," only in the sense that it similarly  
25 involves the utilization of a dividend yield component and a growth component, both of

---

<sup>25</sup> It should be noted that Mr. Bourassa's 9.4 percent historical MRP CAPM cost of equity estimate is overstated by use of (i) a forecasted risk-free rate and (ii) an inflated beta, as shown in Rebuttal Schedule D-4.11.

1           which Staff obtains from *Value Line*.<sup>26</sup> Second, the growth component utilized in the  
2           computation of the MRP is a measure of future 3-5 year stock price appreciation. As noted  
3           in Staff's direct testimony,<sup>27</sup> the CAPM is a single-holding period model, thus rendering *Value*  
4           *Line's* 3-5 year price appreciation potential estimate to be an ideal metric with which to  
5           compute the current MRP component in the CAPM. Third, like Staff, Mr. Bourassa formerly  
6           utilized this same methodology to compute the MRP component in his current MRP CAPM.  
7           Although he states in Rebuttal (p. 2, lines 21-22) that there has been no change to his  
8           methods, Mr. Bourassa only recently made a change to his current MRP CAPM  
9           methodology.<sup>28</sup>

10  
11       **Q. As noted earlier, Mr. Bourassa employed a forecasted risk-free rate in both his**  
12       **historical- and current MRP CAPM analyses. Did he similarly employ a forecasted**  
13       **risk-free rate in the computation of his 10.6 percent estimated cost of equity (k)**  
14       **obtained from his Risk Premium Model?**

15       **A.** Yes, he did. As shown in Rebuttal Schedule D-4.9, in obtaining a 10.6 percent estimated cost  
16       of equity from his Risk Premium Model, Mr. Bourassa employed the same 4.2 percent  
17       forecasted risk-free rate used in each of his two CAPM analyses.

18

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<sup>26</sup> For purposes of the computation of the market risk premium component in Staff's current MRP CAPM, the inputs utilized by Staff are (i) *Value Line's* median estimated dividend yield (next 12 months) on all dividend paying stocks under review (i.e., the dividend yield component), and (ii) *Value Line's* estimated median price appreciation potential of all 1700 stocks in the hypothesized economic environment 3 to 5 years hence (i.e., the growth component).

<sup>27</sup> See Cassidy Direct, p. 37, lines 4-13.

<sup>28</sup> When filing direct testimony in the recent Utility Source, LLC case (Docket No. W-04235A-13-0331), Mr. Bourassa utilized the same current MRP CAPM methodology as Staff; however, when filing rebuttal testimony in that same docket, Mr. Bourassa utilized a new methodology to compute the market risk premium component, one utilizing projected 3-5 year DPS and EPS growth forecasts, as described in the case study appearing on pp. 165-166 of Dr. Morin's book.

1 Q. Is it correct to state that among the cost of equity estimates obtained from Mr.  
2 Bourassa's cost of equity estimation models in Rebuttal, the 10.6 percent estimate  
3 obtained from his Risk Premium Model was exceeded only by the 11.0 percent cost of  
4 equity estimate obtained from his current MRP CAPM?

5 A. Yes. As shown in Rebuttal Schedule D-4.1, the 10.6 percent estimate obtained from Mr.  
6 Bourassa's Risk Premium Model was second (highest) only to the 11.0 percent cost of equity  
7 estimate obtained from his current MRP CAPM.<sup>29</sup>

8  
9 Q. As shown in Rebuttal Schedule D-4.9, the 10.6 percent cost of equity estimate  
10 obtained from Mr. Bourassa's Risk Premium Model represents the sum of a 6.4  
11 percent 16-year average annual market risk premium plus a 4.2 percent risk-free rate  
12 (6.4 + 4.2 = 10.6). Without commenting on the methodology employed by Mr.  
13 Bourassa in arriving at his 6.4 percent market risk premium, what would Mr.  
14 Bourassa's estimated Risk Premium Model cost of equity have been had he used the  
15 same current risk-free rate (i.e., 2.6 percent) employed in the computation of the MRP  
16 component in his current MRP CAPM rather than a 4.2 percent forecasted rate?

17 A. Had Mr. Bourassa employed a 2.6 percent risk-free rate in the computation, his Risk  
18 Premium Model cost of equity estimate would have been reduced to 9.0 percent ( $.064 + .026$   
19  $= .09$ ).

20

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<sup>29</sup> As can be seen in Rebuttal Schedule D-4.1, Mr. Bourassa's 10.6 percent Risk Premium Model estimate is the indicated cost of equity for his sample companies. For purposes of his indicated cost of equity for QCW, Mr. Bourassa adds an additional 100 basis point risk component to this 10.6 percent cost, resulting in an indicated cost of equity of 11.6 percent.

1 **Q. How would a 9.0 percent cost of equity estimate obtained from Mr. Bourassa's Risk**  
2 **Premium Model compare with the cost of equity estimates obtained by Mr. Bourassa**  
3 **from his two constant growth DCF models?**

4 A. As detailed in Rebuttal Schedules D-4.7 (pages 1 and 2), Mr. Bourassa obtained constant  
5 growth DCF cost of equity estimates of 9.71 percent and 9.41 percent.<sup>30</sup> Thus, a 9.0 percent  
6 estimated cost of equity obtained from Mr. Bourassa's Risk Premium Model when using a  
7 current risk-free rate (i.e., 2.6 percent) would fall *below* the 9.41 – 9.71 percent range of  
8 estimates obtained from his two constant growth DCF models.

9  
10 **Q. In Rebuttal (pp. 5-9) Mr. Bourassa appears to be critical of both the DCF model,**  
11 **generally, and, in particular, Staff's sole reliance on the DCF as a cost of equity**  
12 **estimation model. To begin, does Staff agree with Mr. Bourassa's assertion that Staff**  
13 **has relied on only one model in its analysis?**

14 A. No. While it is true that Staff's cost of equity recommendations are based upon estimates  
15 derived from the DCF (both constant growth- and multi-stage DCF) as shown in Surrebuttal  
16 Schedule JAC-A, Staff also obtained estimates from both its historical-and current MRP  
17 CAPM. For the reasons noted earlier, however, Staff elected not to incorporate those  
18 estimates into its analysis for purposes of setting rates in this docket. That Staff made such  
19 an election should not be construed to suggest that Staff either ignored or otherwise  
20 disregarded the results obtained from its CAPM models.

21

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<sup>30</sup> As presented in his summary of results (Rebuttal Schedule D-4.1), these constant growth DCF indicated costs of equity are shown to be 9.4 percent and 9.7 percent for Mr. Bourassa's sample water companies. He then adds a 100 basis point equity risk premium to each estimate for purposes of arriving at DCF indicated costs of equity of 10.4 percent and 10.7 percent for QCW.

1 **Q. In Rebuttal, Mr. Bourassa quotes from a passage in Dr. Morin's book, stating that he**  
2 **agrees with Dr. Morin that the DCF is not a "superior methodology" relative to other**  
3 **cost of equity estimation models.<sup>31</sup> How does Staff respond?**

4 A. Staff would point out that in the same passage, Dr. Morin goes on to say that the same is true  
5 of the Risk Premium and CAPM models; namely, that they, similarly, are not superior  
6 methodologies.<sup>32</sup> Staff would further point out that the results obtained from any given  
7 model should be evaluated in terms of the inputs utilized to obtain cost of equity estimates  
8 from the model. As discussed earlier, Staff believes the cost of equity estimates obtained by  
9 Mr. Bourassa from his CAPM and Risk Premium models are inflated due to the inputs he has  
10 elected to employ.

11  
12 **Q. And among the cost of equity estimates obtained from Mr. Bourassa's models, are the**  
13 **estimates from his DCF models lower than those obtained from either his CAPM or**  
14 **Risk Premium models?**

15 A. Yes, they are, as can be seen in Bourassa Rebuttal Schedule D-4.1. This, perhaps, explains  
16 why Mr. Bourassa appears critical of Staff's reliance on cost of equity estimates obtained from  
17 the DCF.

18  
19 **Q. Why does Staff believe it is important that the cost of equity estimates obtained from**  
20 **the DCF model should be given appropriate consideration for purposes of setting**  
21 **rates in this docket?**

22 A. Unlike other cost of equity estimation models, the DCF model intrinsically links the price  
23 investors are willing to pay for a security to the return yielded on that investment. While it is  
24 true that equity valuations have risen in the capital markets over the last several years resulting  
25 in a consequential decline in dividend yields, this circumstance is reflective of the market cost

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<sup>31</sup> See Bourassa Rebuttal, p. 6, lines 5-14 (quotation from *Morin*, p. 431).

<sup>32</sup> See Bourassa Rebuttal p. 6 line 13 (quotation from *Morin* p. 431).

1 of equity having fallen. Thus, to disregard cost of equity estimates derived from the DCF at  
2 this time would be to ignore the reality that in today's marketplace investors must pay more  
3 for a given unit of return.  
4

5 **IV. STAFF RECOMMENDATIONS**

6 **Q. What are Staff's recommendations for QCW's cost of capital?**

7 A. Staff makes the following recommendations for QCW's cost of capital:

- 8 1. Staff recommends a capital structure comprised of 0.0 percent debt and 100.0 percent  
9 equity.
- 10 2. Staff recommends a cost of debt of 0.0 percent.
- 11 3. Staff recommends an updated cost of equity of 9.4 percent, based upon Staff's 8.8  
12 percent average DCF cost of equity estimate, and Staff's 60 basis point (0.60 percent)  
13 upward economic assessment adjustment.
- 14 4. Staff recommends an updated overall rate of return ("ROR") of 9.4 percent.  
15

16 **Q. Does Staff's silence on a particular issue raised by the Company in rebuttal testimony**  
17 **infer or otherwise imply that Staff agrees with the Company's stated Rebuttal**  
18 **position?**

19 A. No, it does not.  
20

21 **Q. Does this conclude your cost of capital surrebuttal testimony?**

22 A. Yes, it does.

Quail Creek Water Company, Inc. Cost of Capital Calculation  
 Capital Structure  
 And Weighted Average Cost of Capital  
 Staff Recommended and Company Proposed

[A]	[B]	[C]	[D]
<u>Description</u>	<u>Weight (%)</u>	<u>Cost</u>	<u>Weighted Cost</u>
<b>Staff Recommended Capital Structure</b>			
Debt	0.0%	0.0%	0.0%
Common Equity	100.0%	9.4%	<u>9.4%</u>
Weighted Average Cost of Capital			<b>9.4%</b>
<b>Company Proposed Capital Structure</b>			
Debt	0.00%	0.00%	0.00%
Common Equity	100.00%	10.00%	<u>10.00%</u>
Weighted Average Cost of Capital			<b>10.00%</b>
<b>[D] : [B] x [C]</b>			
<b>Supporting Schedules: JAC-3 and JAC-4.</b>			



Quail Creek Water Company, Inc. Cost of Capital Calculation  
Average Capital Structure of Sample Water Utilities

[A]	[B]	[C]	[D]
<u>Company</u>	<u>Debt</u>	<u>Common Equity</u>	<u>Total</u>
American States Water	38.7%	61.3%	100.0%
California Water	45.9%	54.1%	100.0%
Aqua America	50.3%	49.7%	100.0%
Connecticut Water	45.6%	54.4%	100.0%
Middlesex Water	44.3%	55.7%	100.0%
SJW Corp	54.7%	45.3%	100.0%
York Water	<u>43.4%</u>	<u>56.6%</u>	<u>100.0%</u>
 Average Sample Water Utilities	 <b>46.1%</b>	 <b>53.9%</b>	 <b>100.0%</b>
 Quail Creek Water Company	 <b>0.00%</b>	 <b>100.00%</b>	 <b>100.0%</b>

Source:  
Sample Water Companies from Value Line

Quail Creek Water Company, Inc. Cost of Capital Calculation  
 Growth in Earnings and Dividends  
 Sample Water Utilities

[A]	[B]	[C]	[D]	[E]
	Dividends Per Share 2005 to 2014	Dividends Per Share Projected	Earnings Per Share 2005 to 2014	Earnings Per Share Projected
<u>Company</u>	<u>DPS<sup>1</sup></u>	<u>DPS<sup>1</sup></u>	<u>EPS<sup>1</sup></u>	<u>EPS<sup>1</sup></u>
American States Water	6.4%	6.2%	11.6%	6.5%
California Water	1.4%	8.3%	5.0%	5.4%
Aqua America	7.8%	9.2%	8.9%	6.6%
Connecticut Water	1.9%	5.2%	5.2%	3.2%
Middlesex Water	1.4%	2.3%	4.5%	3.6%
SJW Corp	3.9%	7.0%	8.5%	NA
York Water	<u>3.9%</u>	<u>6.7%</u>	<u>6.1%</u>	<u>5.3%</u>
Average Sample Water Utilities	<b>3.8%</b>	<b>6.4%</b>	<b>7.1%</b>	<b>5.1%</b>

1 Value Line

Quail Creek Water Company, Inc. Cost of Capital Calculation  
Sustainable Growth  
Sample Water Utilities

[A]	[B]	[C]	[D]	[E]	[F]
<u>Company</u>	Retention Growth 2005 to 2014 <u>br</u>	Retention Growth Projected <u>br</u>	Stock Financing Growth <u>vs</u>	Sustainable Growth 2005 to 2014 <u>br + vs</u>	Sustainable Growth Projected <u>br + vs</u>
American States Water	4.6%	6.4%	1.6%	6.2%	8.0%
California Water	2.9%	3.6%	1.3%	4.2%	4.9%
Aqua America	4.3%	6.1%	1.1%	5.5%	7.2%
Connecticut Water	2.3%	4.1%	2.9%	5.1%	6.9%
Middlesex Water	1.6%	3.6%	1.5%	3.1%	5.1%
SJW Corp	4.0%	3.3%	0.9%	4.9%	4.1%
York Water	<u>2.4%</u>	<u>3.8%</u>	<u>2.6%</u>	<u>5.0%</u>	<u>6.4%</u>
Average Sample Water Utilities	<b>3.1%</b>	<b>4.4%</b>	<b>1.7%</b>	<b>4.8%</b>	<b>6.1%</b>

[B]: Value Line

[C]: Value Line

[D]: Value Line, MSN Money, and Form 10-Ks filed with the Securities and Exchange Commission (<http://www.sec.gov/>)

[E]: [B]+[D]

[F]: [C]+[D]

Quail Creek Water Company, Inc. Cost of Capital Calculation  
 Selected Financial Data of Sample Water Utilities

[A] [B] [C] [D] [E] [F] [G]

[A]	[B]	[C]	[D]	[E]	[F]	[G]
<u>Company</u>	<u>Symbol</u>	<u>Spot Price</u> 5/27/2015	<u>Book Value</u>	<u>Mkt To</u> <u>Book</u>	<i>Value Line</i> <u>Beta</u> <i>b</i>	<u>Raw</u> <u>Beta</u> <i>braw</i>
American States Water	AWR	38.78	13.42	2.9	0.70	0.52
California Water	CWT	23.82	13.04	1.8	0.75	0.60
Aqua America	WTR	26.64	9.18	2.9	0.70	0.52
Connecticut Water	CTWS	35.34	20.30	1.7	0.65	0.45
Middlesex Water	MSEX	22.06	12.34	1.8	0.75	0.60
SJW Corp	SJW	29.94	16.80	1.8	0.80	0.67
York Water	YORW	22.40	8.45	2.7	0.70	0.52
Average				2.2	0.72	0.55

- [C]: Msn Money
- [D]: Value Line
- [E]: [C] / [D]
- [F]: Value Line
- [G]: (-0.35 + [F]) / 0.67

Quail Creek Water Company, Inc. Cost of Capital Calculation  
 Calculation of Expected Infinite Annual Growth in Dividends  
 Sample Water Utilities

[A]	[B]
<u>Description</u>	g
DPS Growth - Historical <sup>1</sup>	3.8%
DPS Growth - Projected <sup>1</sup>	6.4%
EPS Growth - Historical <sup>1</sup>	7.1%
EPS Growth - Projected <sup>1</sup>	5.1%
Sustainable Growth - Historical <sup>2</sup>	4.8%
<u>Sustainable Growth - Projected<sup>2</sup></u>	<u>6.1%</u>
Average	<b>5.6%</b>

1 Schedule JAC-5

2 Schedule JAC-6

Quail Creek Water Company, Inc. Cost of Capital Calculation  
 Multi-Stage DCF Estimates  
 Sample Water Utilities

[A]	[B]	[C]	[D]	[E]	[F]	[G]	[H]
Company	Current Mkt. Price ( $P_0$ ) <sup>1</sup> 5/27/2015	Projected Dividends <sup>2</sup> (Stage 1 growth) ( $D_t$ )				Stage 2 growth <sup>3</sup> ( $g_n$ )	Equity Cost Estimate ( $K$ ) <sup>4</sup>
		$d_1$	$d_2$	$d_3$	$d_4$		
American States Water	38.8	0.85	0.90	0.95	1.00	6.4%	8.6%
California Water	23.8	0.68	0.72	0.76	0.80	6.4%	9.2%
Aqua America	26.6	0.66	0.69	0.73	0.77	6.4%	8.8%
Connecticut Water	35.3	1.03	1.09	1.15	1.22	6.4%	9.3%
Middlesex Water	22.1	0.79	0.83	0.88	0.92	6.4%	9.9%
SJW Corp	29.9	0.79	0.83	0.88	0.93	6.4%	9.0%
York Water	22.4	0.60	0.63	0.67	0.71	6.4%	9.1%
						Average	9.1%

$$P_0 = \sum_{t=1}^n \frac{D_t}{(1+K)^t} + \frac{D_n(1+g_n)}{K-g_n} \left[ \frac{1}{(1+K)} \right]^n$$

- Where :
- $P_0$  = current stock price
  - $D_t$  = dividends expected during stage 1
  - $K$  = cost of equity
  - $n$  = years of non - constant growth
  - $D_n$  = dividend expected in year n
  - $g_n$  = constant rate of growth expected after year n

1 [B] see Schedule JAC-7

2 Derived from Value Line Information

3 Average annual growth in GDP 1929 - 2012 in current dollars.

4 Internal Rate of Return of Projected Dividends

Quail Creek Water Company, Inc. Cost of Capital Calculation  
 Final Cost of Equity Estimates  
 Sample Water Utilities

**Pro Forma Restatement of Surrebuttal Schedule JAC-3**  
 As if Staff's Cost of Equity Estimate were based on the Average of  
 Staff's DCF and CAPM Cost of Equity Estimation Models

[A]	[B]	[C]	[D]	[E]			
<u>DCF Method</u>		$D_1/P_0^1$	+	$g^2$	=	<b>k</b>	
Constant Growth DCF Estimate		2.8%	+	5.6%	=	8.4%	
Multi-Stage DCF Estimate					=	9.1%	
Average DCF Estimate					=	8.8%	
<u>CAPM Method</u>	<b>Rf</b>	+	$b^5$	x	<b>(Rp)</b>	=	<b>k</b>
Historical Market Risk Premium <sup>3</sup>	1.9%	+	0.72	x	7.5% <sup>6</sup>	=	7.3%
Current Market Risk Premium <sup>4</sup>	2.9%	+	0.72	x	6.9% <sup>7</sup>	=	7.9%
Average CAPM Estimate						=	7.6%
					Staff's Estimated Cost of Equity		8.2%
					Economic Assessment Adjustment		0.6%
					Sub-Total		8.8%
					Financial Risk Adjustment		0.0%
					<b>Total</b>		<b>8.8%</b>

1 MSN Money and Value Line

2 Schedule JAC-8

3 Risk-free rate (Rf) for 5, 7, and 10 year Treasury rates from the U.S. Treasury Department at [www.ustreas.gov](http://www.ustreas.gov)

4 Risk-free rate (Rf) for 30 Year Treasury bond rate from the U.S. Treasury Department at [www.ustreas.gov](http://www.ustreas.gov)

5 Value Line

6 Historical Market Risk Premium (Rp) calculated from 2014 Ibbotson S&P Classic Yearbook data

7 Testimony

BEFORE THE ARIZONA CORPORATION COMMISSION

SUSAN BITTER SMITH  
Chairman  
BOB STUMP  
Commissioner  
BOB BURNS  
Commissioner  
DOUG LITTLE  
Commissioner  
TOM FORESE  
Commissioner

IN THE MATTER OF THE APPLICATION OF )  
QUAIL CREEK WATER COMPANY, INC., AN )  
ARIZONA CORPORATION, FOR A )  
DETERMINATION OF THE FAIR VALUE OF )  
ITS UTILITY PLANTS AND PROPERTY AND )  
FOR INCREASES IN ITS WATER RATES AND )  
CHARGES FOR UTILITY SERVICE BASED )  
THEREON.)

DOCKET NO. W-02514A-14-0343

(REVENUE REQUIREMENT AND RATE DESIGN)

SURREBUTTAL TESTIMONY

OF

JOHN A. CASSIDY

PUBLIC UTILITIES ANALYST III

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

JULY 1, 2015

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## SURREBUTTAL SCHEDULES

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**EXECUTIVE SUMMARY  
QUAIL CREEK WATER COMPANY  
DOCKET NO. W-02514A-14-0343**

Staff's updated revenue requirement recommendations reflect a 10 basis-point drop to Staff's recommended cost of equity, from 9.5 percent in direct testimony to 9.4 percent in surrebuttal testimony..

Staff's surrebuttal testimony responds to Quail Creek Water Company ("QCW" or "Company") rebuttal testimony on the issue of revenue requirement and rate design.

Staff has revised its rate design to reflect adoption of the Company's proposed break-over points for all customer classes and meter sizes, and to allow for recovery to Staff's updated revenue requirement.

Staff's revised recommended rates would increase the monthly bill for a typical 5/8 x 3/4-inch meter residential customer, with a median usage of 4,500 gallons, by \$4.53 or 16.41 percent, from \$27.60 to \$32.13.

1 **INTRODUCTION**

2 **Q. Please state your name, occupation, and business address.**

3 A. My name is John A. Cassidy. I am a Public Utilities Analyst III employed by the Arizona  
4 Corporation Commission ("Commission") in the Utilities Division ("Staff"). My business  
5 address is 1200 West Washington Street, Phoenix, Arizona 85007.

6  
7 **Q. Are you the same John A. Cassidy who filed direct testimony in this case?**

8 A. Yes, I am. On behalf of Staff, I filed direct testimony addressing the issues of revenue  
9 requirement, rate design and cost of capital.

10  
11 **PURPOSE OF SURREBUTTAL TESTIMONY**

12 **Q. What is the purpose of your surrebuttal testimony in this proceeding?**

13 A. The purpose of my surrebuttal testimony in this proceeding is to respond, on behalf of Staff,  
14 to the rebuttal testimony of Mr. Ray L. Jones and Mr. Thomas J. Bourassa, witnesses for  
15 Quail Creek Water Company ("QCW" or "Company").

16  
17 **Q. What issues will you address?**

18 A. In this filing, my surrebuttal testimony will address the issues of revenue requirement and rate  
19 design. Under separate cover, I will also be filing surrebuttal testimony addressing the issue  
20 of cost of capital.

21  
22 **Q. Did the change in Staff's recommended required rate of return for QCW, from 9.5  
23 percent in direct testimony to 9.4 percent in surrebuttal testimony, result in a change  
24 to Staff's required revenue requirement for the Company?**

25 A. Yes. As shown in Surrebuttal Schedule JAC-1 (Revenue Requirement), Staff's updated  
26 required revenue increase is \$283,295, a figure \$5,159 lower than the \$288,454 revenue

1 increase reported in Schedule JAC-1 filed in Staff's direct testimony (\$288,454 - \$283,295  
2 =\$5,159). This change resulted in a reduction to Staff's required revenue increase from 34.15  
3 percent in direct testimony, to 33.54 percent in surrebuttal testimony.

4  
5 **Q. Was the reduction to Staff's recommended rate of return, from 9.5 percent in direct**  
6 **testimony to 9.4 percent in surrebuttal testimony, the only factor which contributed to**  
7 **the change in Staff's recommended revenue requirement for QCW?**

8 **A. Yes, it was.**

9  
10 **STAFF RESPONSE TO COMPANY REVENUE REQUIREMENT WITNESS RAY**  
11 **JONES**

12 **Q. In direct testimony, did Staff acknowledge the existence of the NARUC accounting**  
13 **guidance (i.e., NARUC Uniform System of Accounts) to which Mr. Jones cites as**  
14 **authority for allowing the drilling costs associated with a non-productive well (i.e.,**  
15 **Well 16) to be included in the cost of the final production well (i.e., Well 12)?**

16 **A. Yes.<sup>1</sup>**

17  
18 **Q. Mr. Cassidy, upon further review regarding Company witness Mr. Jones continuing**  
19 **discussion regarding the applicability of the NARUC USofA Account No. 307**  
20 **accounting guidelines to the very short "in-service life" of Well 16. Does Staff believe**  
21 **that NARUC Account 307 should have even been used in the accounting for Well 16?**

22 **A. No. The Company has acknowledged that Well 16 was only "marginally operationally useful"**  
23 **at any point in time and QWC has also acknowledged that Well 16 was only connected to its**  
24 **system for "on-going testing." Staff believes that Well 16 should have been accounted for as**  
25 **Construction Work in Progress ("CWIP"), which is NARUC Account 105. Based upon the**

---

<sup>1</sup> See Cassidy Direct, p. 14, lines 13-16.

1 evidence noted in the rebuttal testimony of Mr. Jones, any Well 16 investment would never  
2 have even showed up on Account 307. This fact also supports Staff's conclusion that Well  
3 16 was not really in-service even during September of 2009, which is the single month that  
4 the Company claims Well 16 was in-service. I have included an excerpt from the NARUC  
5 Account 105 description as Attachment 1 to my surrebuttal testimony. Clearly, as  
6 acknowledged by the testimony of the Company's witness<sup>2</sup> that this Well was still being tested  
7 in September of 2009, the facility was, at best, still in the process of being constructed and  
8 rightly accounted for in Account 105.

9  
10 Staff also notes that the well was not in-service, or used and useful during the test year.

11  
12 **Q. In rebuttal testimony, however, Mr. Jones makes the following statement: "Mr.**  
13 **Cassidy does not challenge the Company's interpretation of the NARUC [Uniform]**  
14 **System of Accounts."<sup>3</sup> Does Staff believe this to be an accurate statement, and if not,**  
15 **why not?**

16 **A.** No, this is not an accurate statement. As noted, Staff acknowledged the existence of the  
17 NARUC Uniform System of Accounts ("USoA") cited to as authority by Mr. Jones; however,  
18 given the circumstances of the case, Staff determined *application* of this NARUC accounting  
19 guidance in the instant docket to be improper. For the reasons noted in Staff's direct  
20 testimony,<sup>4</sup> Staff determined (i) the USoA not to be controlling because they apply only to  
21 regulated utilities, and not to their non-regulated affiliates, and (ii) the NARUC Guidelines for  
22 Cost Allocations and Affiliate Transactions ("NARUC Guidelines") to be controlling.

23  

---

<sup>2</sup> Refer to the rebuttal testimony of Mr. Jones, page 11, lines 11 through 23.

<sup>3</sup> See Jones Rebuttal, p. 6, lines 23-24.

<sup>4</sup> See Cassidy Direct, pp. 14-15, lines 20:10. For obvious reasons, had Staff not challenged the Company's interpretation of the NARUC System of Accounts in regard to the treatment of Well 16 drilling costs, Staff would not have made an adjustment disallowing those costs.

1 Q. In direct testimony,<sup>5</sup> Staff identified the two reasons noted above as support for its  
2 adjustment disallowing the net \$249,432 of Well 16 drilling costs transferred by QCW  
3 to the Well 12 project account. When addressing the reasoning behind Staff's  
4 disallowance in Rebuttal (pp. 6-7, lines 26:5), does Mr. Jones properly characterize the  
5 first reason given for Staff's disallowance?

6 A. No, he does not. Staff's direct testimony clearly indicates that the first reason given for the  
7 disallowance has to do with the fact that the USoA to which Mr. Jones cites "has relevance  
8 only to regulated utilities, and *not to their non-regulated developer affiliates*" (emphasis added). Mr.  
9 Jones' Rebuttal knows this substantive point and, by implication, attempts to suggest that the  
10 guidance provided by the USoA applies equally to both regulated utilities and their non-  
11 regulated affiliates, alike. Again, this is contrary to Staff's stated position.

12  
13 Q. In Rebuttal (p. 7, lines 8-21), Mr. Jones then goes on to assert that Staff's reliance on  
14 the NARUC Guidelines for Cost Allocations and Affiliate Transactions ("NARUC  
15 Guidelines") for support is improper. In doing so, Mr. Jones argues that the NARUC  
16 Guidelines do not apply in this instance, as "[t]he Guidelines are not rules and do not  
17 contain rules," and as such "should not be used to override accounting treatment  
18 called for in specific provisions of the NARUC [Uniform] System of Accounts." How  
19 does Staff respond?

20 A. Staff would agree with the first point Mr. Jones makes; namely, that the NARUC Guidelines  
21 are not rules and do not contain rules. However, Staff strongly disagrees with the second  
22 point he attempts to make on grounds that the USoA apply *only to regulated utilities*. In the  
23 absence of any written type of contract between QCW and its non-regulated developer  
24 affiliate regarding Well 16, all available evidence suggests that the risks associated with the  
25 drilling/rehabilitation of Well 16 were borne by the non-regulated affiliate, RRQC. Implicit

---

<sup>5</sup> See Cassidy Direct, pp. 14-15, lines 20:10.

1 in the arguments put forth by Mr. Jones in Rebuttal that the NARUC Guidelines do not  
2 apply is the notion that the USoA applies to both QCW and its non-regulated affiliate. That  
3 Mr. Jones is mistaken on this point renders moot his assertion that the NARUC Guidelines  
4 do not apply in this instance.

5  
6 **Q. In rebuttal testimony, does Mr. Jones acknowledge that affiliate transactions should  
7 receive heightened scrutiny by regulators?**

8 A. Yes.<sup>6</sup>

9  
10 **Q. In direct testimony,<sup>7</sup> Staff recommended that on a going-forward basis QCW be  
11 required to seek competitive bids and enter into written contracts for all capital  
12 projects in excess of \$100,000. In Rebuttal (pp. 12-13, lines23:4), Mr. Jones states that  
13 Staff's recommendation is "unnecessary" asserting that "[t]here is simply too much  
14 coordination required between the various Robson affiliates involved in the  
15 development of the various subdivisions and projects to allow a third-party to  
16 effectively oversee the projects without burdening QCW and its ratepayers with  
17 increased costs and risk." How does Staff respond?**

18 A. Staff respectively disagrees, for as evidenced by the Company's responses to Staff data  
19 requests JAC 2-2(d)(i)<sup>8</sup> and JAC 4-1<sup>9</sup>, there appears to be a distinct lack of any written record  
20 of contractual agreements and/or coordination between the various Robson affiliates as they  
21 relate to the capital projects associated with QCW. It should be noted that QCW, unlike its  
22 non-regulated Robson affiliates, is a public utility subject to regulation by the Commission.  
23 For this reason, Staff believes its recommendation to be appropriate, as ratepayers will benefit  
24 from QCW being required to obtain independent bids on capital projects in excess of

---

<sup>6</sup> See Jones Rebuttal, p. 7, line 24.

<sup>7</sup> See Cassidy Direct, p. 13, lines 7-9.

<sup>8</sup> See Cassidy Direct Attachment F

<sup>9</sup> See Cassidy Direct Attachment E

1           \$100,000, and the Company will be assured of having a documentary record of contractual  
2           agreements available when coming before the ACC seeking rate relief.

3  
4           **STAFF RESPONSE TO COMPANY RATE BASE WITNESS THOMAS J. BOURASSA**

5           **Q.     In Rebuttal (p. 10, lines 13-21), Mr. Bourassa suggests that because Decision No.**  
6           **61611 (dated April 1, 1999) issued in the Company's prior rate case authorized a**  
7           **composite depreciation rate of 4.08 percent, Staff's use of a 5.0 percent composite rate**  
8           **during the 15-month interim between QCW's prior test year end (i.e., December 31,**  
9           **1997) and the issuance of Decision No. 61611 was improper. How does Staff respond?**

10          **A.     For the reasons noted in Staff's direct testimony,<sup>8</sup> Staff's use of a 5.0 percent composite rate**  
11          **over the 15-month interim period between the December 31, 1997 test-year end of the**  
12          **Company's prior rate filing and the April 1, 1999 effective date of Decision No. 61611 was**  
13          **proper.**

14  
15          **Q.     In Rebuttal (pp. 12-13, lines 17:8), Mr. Bourassa stated that Staff did not make an**  
16          **adjustment for Accumulated Deferred Income Taxes ("ADIT"). Specifically, he**  
17          **argues that Staff should have made an adjustment to ADIT of approximately \$92,000,<sup>9</sup>**  
18          **and that in failing to do so, Staff's rate base is understated by over \$92,000. How does**  
19          **Staff respond?**

20          **A.     Staff made no adjustment to ADIT because the Company did not provide the necessary**  
21          **documentation needed to make such adjustment. That said, Staff would agree that an**  
22          **adjustment to ADIT is appropriate, for as shown in Surrebuttal Schedule JAC-3 Staff adopted**  
23          **the Company's \$1,071,554 deferred income tax credit account balance, but subsequently**  
24          **made adjustments to plant without also making an adjustment to ADIT.**

---

<sup>8</sup> See Cassidy Direct, pp. 18-19, lines 20:3; and Footnote 17.

<sup>9</sup> As presented in Rebuttal Exhibit TJB-RB1, Mr. Bourassa computes Staff's ADIT adjustment to be \$92,419, based upon Staff's recommendations.

1 **STAFF RESPONSE TO COMPANY RATE DESIGN WITNESS THOMAS J. BOURASSA**

2 **Q. In Rebuttal (pp. 15-17, lines 24:23) Mr. Bourassa is critical of Staff's proposed break-**  
3 **over points in direct testimony. For purposes of Staff's updated surrebuttal testimony,**  
4 **did Staff adopt (i) QCW's proposed 1<sup>st</sup> and 2<sup>nd</sup> tier break-over points for ¾-inch and**  
5 **smaller metered residential customers, and (ii) the Company's proposed break-over**  
6 **points for all 1-inch and larger meter sizes utilizing a scaling approach based upon**  
7 **relative flows from a ¾-inch meter?**

8 **A. Yes. Please refer to JAC-1**

9  
10 **Q. Having made the above noted changes to its recommended break-over points, did**  
11 **Staff make other revisions to its recommended rate design in Surrebuttal?**

12 **A. Yes. Staff increased its recommended commodity rates for its second-tier (4,001 to 10,000**  
13 **gallons) and third-tier (over 10,000 gallons) break-over points for all ¾-inch and smaller**  
14 **metered residential customers to \$4.25 and \$5.36 per thousand gallons, respectively.<sup>10</sup>**  
15 **Additionally, Staff increased the recommended commodity rates used in Staff's two-tier**  
16 **inverted-block rate for larger residential and commercial classes with break-over points which**  
17 **vary by meter size; Staff's first-tier commodity rate was increased to \$4.25 per thousand**  
18 **gallons, and Staff's commodity rate for any consumption over the first tier was reduced to**  
19 **\$5.36 per thousand gallons.<sup>11</sup> These revisions to Staff's rate design in Surrebuttal were made**  
20 **to generate Staff's recommended revenue requirement.**

21  

---

<sup>10</sup> In Direct testimony, Staff had previously recommended 2<sup>nd</sup> and 3<sup>rd</sup> tier commodity rates of \$4.00 and \$5.42 per thousand gallons, respectively.

<sup>11</sup> In Direct testimony, Staff had previously recommended commodity rates of \$4.00 and \$5.42 per thousand gallons, respectively, for use in Staff's two-tier inverted-block rate for larger residential and commercial classes with break-over points which vary by meter size.

1 **Q. As noted in Mr. Bourassa's Rebuttal (pp. 17-18, lines 26:9), the Company's proposed**  
2 **rate design allows for revenue recovery of 44.73 percent from the monthly minimum**  
3 **charges. Based upon Staff's recommended rate design in Surrebuttal, what**  
4 **percentage of revenue recovery is provided from Staff's proposed monthly minimum**  
5 **charges?**

6 A. In Surrebuttal, Staff's proposed rate design provides for revenue recovery of 45.12 percent  
7 from the monthly minimum charges.

8  
9 **Q. As recommended by the Company in Rebuttal, what is the rate impact on a typical**  
10 **5/8 x 3/4 inch meter residential customer?**

11 A. As shown in Rebuttal Schedule H-2 (Page 2), the Company's recommended rates would  
12 increase the typical 5/8 x 3/4 inch meter residential bill with a median usage of 4,500 gallons  
13 from \$27.60 to \$37.66, for an increase of \$10.06 or 36.44 percent.

14  
15 **Q. As recommended by Staff in Surrebuttal, what is the rate impact on a typical 5/8 x 3/4**  
16 **inch meter residential customer?**

17 A. As shown in Surrebuttal Schedule JAC-2, Staff's recommended rates would increase the  
18 typical 5/8 x 3/4 inch meter residential bill with a median usage of 4,500 gallons from \$27.60  
19 to \$32.13, for an increase of \$4.53 or 16.41 percent.

20  
21 **Q. Does this conclude your surrebuttal testimony?**

22 A. Yes, it does.

**REVENUE REQUIREMENT**

LINE NO.	DESCRIPTION	[A]	[B]	[C]	[D]
		COMPANY ORIGINAL COST	COMPANY FAIR VALUE	STAFF ORIGINAL COST	STAFF FAIR VALUE
1	Adjusted Rate Base	\$ 3,678,863	\$ 3,678,863	\$ 3,196,580	\$ 3,196,580
2	Adjusted Operating Income (Loss)	\$ 118,963	\$ 118,963	\$ 132,242	\$ 132,242
3	Current Rate of Return (L2 / L1)	3.23%	3.23%	4.14%	4.14%
4	Required Rate of Return	10.00%	10.00%	9.40%	9.40%
5	Required Operating Income (L4 * L1)	\$ 367,886	\$ 367,886	\$ 300,479	\$ 300,479
6	Operating Income Deficiency (L5 - L2)	\$ 248,923	\$ 248,923	\$ 168,237	\$ 168,237
7	Gross Revenue Conversion Factor	1.6543	1.6543	1.6839	1.6839
8	Required Revenue Increase (L7 * L6)	\$ 411,785	\$ 411,785	\$ 283,295	\$ 283,295
9	Adjusted Test Year Revenue	\$ 844,719	\$ 844,719	\$ 844,719	\$ 844,719
10	Proposed Annual Revenue (L8 + L9)	\$ 1,256,504	\$ 1,256,504	\$ 1,128,014	\$ 1,128,014
11	Required Increase in Revenue (%)	48.75%	48.75%	33.54%	33.54%

References:

Column (A): Company Schedule B-1

Column (B): Company Schedule B-1

Column (C): Staff Schedules OCRB, GRCF, TYOI & COC

Column (D): Staff Schedules OCRB, GRCF, TYOI & COC

**GROSS REVENUE CONVERSION FACTOR**

LINE NO.	DESCRIPTION	(A)	(B)	(C)	(D)
<u>Calculation of Gross Revenue Conversion Factor:</u>					
1	Revenue	100.0000%			
2	Uncollectible Factor (Line 11)	0.0000%			
3	Revenues (L1 - L2)	100.0000%			
4	Combined Federal and State Tax Rate (Line 17) + Property Tax Factor (Line 22)	40.6143%			
5	Subtotal (L3 - L4)	59.3857%			
6	<b>Revenue Conversion Factor (L1 / L5)</b>	<b>1.6839</b>			
<u>Calculation of Uncollectible Factor:</u>					
7	Unity	100.0000%			
8	Combined Federal and State Tax Rate (Line 17)	39.8386%			
9	One Minus Combined Income Tax Rate (L7 - L8)	60.1614%			
10	Uncollectible Rate	0.0000%			
11	Uncollectible Factor (L9 * L10)	0			
<u>Calculation of Effective Tax Rate:</u>					
12	Operating Income Before Taxes (Arizona Taxable Income)	100.0000%			
13	Arizona State Income Tax Rate	4.9000%			
14	Federal Taxable Income (L12 - L13)	95.1000%			
15	Applicable Federal Income Tax Rate (Line 44)	36.7388%			
16	Effective Federal Income Tax Rate (L14 x L15)	34.9386%			
17	Combined Federal and State Income Tax Rate (L13 +L16)	39.8386%			
<u>Calculation of Effective Property Tax Factor</u>					
18	Unity	100.0000%			
19	Combined Federal and State Tax Rate (Line 17)	39.8386%			
20	One Minus Combined Income Tax Rate (L18 - L19)	60.1614%			
21	Property Tax Factor (XXX-18, L24)	1.2893%			
22	Effective Property Tax Factor (L 21 * L 22)	0.007756854			
23	Combined Federal and State Tax and Property Tax Rate (L17+L22)		40.6143%		
24	Required Operating Income (Schedule XXX-1, Line 5)	\$ 300,479			
25	Adjusted Test Year Operating Income (Loss) (Schedule XXX-10, Line 40)	\$ 132,242			
26	Required Increase in Operating Income (L24 - L25)		\$ 168,237		
27	Income Taxes on Recommended Revenue (Col. (D), L52)	\$ 178,250			
28	Income Taxes on Test Year Revenue (Col. (B), L52)	\$ 66,844			
29	Required Increase in Revenue to Provide for Income Taxes (L27 - L28)		\$ 111,405		
30	Recommended Revenue Requirement (Schedule XXX-1, Line 10)	\$ 1,128,014			
31	Uncollectible Rate (Line 10)	0.0000%			
32	Uncollectible Expense on Recommended Revenue (L24 * L25)	\$ -			
33	Adjusted Test Year Uncollectible Expense	\$ -			
34	Required Increase in Revenue to Provide for Uncollectible Exp. (L32 - L33)		\$ -		
35	Property Tax with Recommended Revenue (XXX-18, L19)	\$ 36,327			\$ -
36	Property Tax on Test Year Revenue (XXX-18, L 16)	\$ 32,674			
37	Increase in Property Tax Due to Increase in Revenue (XXX-18, L22)		\$ 3,653		
38	<b>Total Required Increase in Revenue (L26 + L30 + L34+L37)</b>		<b>\$ 283,295</b>		
<u>Calculation of Income Tax:</u>					
39	Revenue (Schedule XXX-10, Col.(C), Line 5 & Sch. XXX-1, Col. (B), Line 10)	\$ 844,719	\$ 283,295	\$ 1,128,014	
40	Operating Expenses Excluding Income Taxes	645,633	\$ 3,653	649,286	
41	Synchronized Interest (L47)	-		-	
42	Arizona Taxable Income (L36 - L37- L38)	\$ 199,086		\$ 478,728	
43	Arizona State Income Tax Rate	4.9000%		4.9000%	
44	Arizona Income Tax (L39 x L40)		\$ 9,755		\$ 23,458
45	Federal Taxable Income (L33 - L35)	\$ 189,331		\$ 455,271	
46	Federal Tax on First Income Bracket (\$1 - \$50,000) @ 15%	7,500		7,500	
47	Federal Tax on Second Income Bracket (\$50,001 - \$75,000) @ 25%	6,250		6,250	
48	Federal Tax on Third Income Bracket (\$75,001 - \$100,000) @ 34%	8,500		8,500	
49	Federal Tax on Fourth Income Bracket (\$100,001 - \$335,000) @ 39%	34,839		91,650	
50	Federal Tax on Fifth Income Bracket (\$335,001 - \$10,000,000) @ 34%	-		40,892	
51	Total Federal Income Tax		\$ 57,089		\$ 154,792
52	Combined Federal and State Income Tax (L35 + L42)		\$ 66,844		\$ 178,250
53	Applicable Federal Income Tax Rate [Col. (D), L42 - Col. (B), L42] / [Col. (C), L36 - Col. (A), L36]				36.74%
<u>Calculation of Interest Synchronization:</u>					
54	Rate Base (Schedule XXX-3, Col. (C), Line (17))	\$ 3,196,580			
55	Weighted Average Cost of Debt (Schedule XXX-1)	0.00%			
56	Synchronized Interest (L45 X L46)	\$ -			

RATE BASE - ORIGINAL COST/FAIR VALUE

LINE NO.	DESCRIPTION	[A]	[B]	REF	[C]
		COMPANY AS FILED	STAFF ADJUSTMENTS		STAFF AS ADJUSTED
1	Plant in Service	\$ 7,819,192	\$ (248,170)	1, 2, 3	\$ 7,571,022
2	Less: Accumulated Depreciation	2,352,796	234,113	4	2,586,909
3	Net Plant in Service	<u>\$ 5,466,396</u>	<u>\$ (482,283)</u>		<u>\$ 4,984,113</u>
<u>LESS:</u>					
4	Net Contribution in Aid-of Construction (CIAC)	\$ 535,758	\$ -		\$ 535,758
5	Advances in Aid of Construction (AIAC)	-	-		-
8	Customer Deposits	180,221	-		180,221
9	Deferred Income Tax Credits	1,071,554	-		1,071,554
	Total Deductions	<u>\$ 1,787,533</u>	<u>\$ -</u>		<u>\$ 1,787,533</u>
<u>ADD:</u>					
10	Unamortized Finance Charges	\$ -	\$ -		\$ -
11	Deferred Tax Assets	-	-		-
12	Allowance for Working Capital	-	-		-
13	Intentional Left Blank	-	-		-
	Total Additions	<u>\$ -</u>	<u>\$ -</u>		<u>\$ -</u>
14	<b>Original Cost Rate Base</b>	<u><b>\$ 3,678,863</b></u>	<u><b>\$ (482,283)</b></u>		<u><b>\$ 3,196,580</b></u>

References:  
Column (A), Company Schedule B-1  
Column (B): Schedules JAC-5a, JAC-5b, JAC-5c, and JAC-6  
Column (C): Column (A) + Column (B)

SUMMARY OF ORIGINAL COST RATE BASE ADJUSTMENTS

5

LINE NO.	ACCT. NO.	DESCRIPTION	[A]	[B]	[C]	[D]	[E]	[F]
			COMPANY AS FILED	Well 16 Disallowance ADJ #1	Capitalized Interest ADJ #2	Capitalization of Well 12 test costs ADJ #3	Accumulated Depreciation ADJ #4	STAFF ADJUSTED
<b><u>PLANT IN SERVICE:</u></b>								
1	301	Organization Costs	\$ 37,295	\$ -	\$ -	\$ -	\$ -	\$ 37,295
2	302	Franchise Costs	-	-	-	-	-	-
3	303	Land & Land Rights	92,895	-	-	-	-	92,895
4	304	Structures & Improvements	75,442	-	(18)	-	-	75,424
5	307	Wells & Springs	834,248	(249,432)	(2,561)	4,013	-	586,268
6	310	Power Generation Equipment	37,618	-	-	-	-	37,618
7	311	Electric Pumping Equipment	1,137,275	-	(173)	-	-	1,137,102
8	320	Water Treatment Equipment	-	-	-	-	-	-
9	320.2	Solutions & Feeders	-	-	-	-	-	-
	320.3	Arsenic Remediation Plant	-	-	-	-	-	-
10	330	Distribution Reservoirs & Standpipes	-	-	-	-	-	-
11	330.1	Storage Tanks	856,574	-	-	-	-	856,574
12	330.2	Pressure Tanks	32,236	-	-	-	-	32,236
13	331	Transmission & Distribution Mains	3,194,161	-	-	-	-	3,194,161
14	333	Services	891,232	-	-	-	-	891,232
15	334	Meters & Meter Installations	90,315	-	-	-	-	90,315
16	335	Hydrants	477,182	-	-	-	-	477,182
17	336	Backflow Prevention Devices	-	-	-	-	-	-
18	339	Other Plant & Misc. Equip.	-	-	-	-	-	-
19	340	Office Furniture & Fixtures	2,071	-	-	-	-	2,071
20	340.1	Computer & Software	-	-	-	-	-	-
21	341	Transportation Equipment	-	-	-	-	-	-
22	342	Store Equipment	-	-	-	-	-	-
23	343	Tools & Work Equipment	2,399	-	-	-	-	2,399
24	344	Laboratory Equipment	-	-	-	-	-	-
25	345	Power Operated Equipment	-	-	-	-	-	-
26	346	Communications Equipment	57,194	-	-	-	-	57,194
27	347	Miscellaneous Equipment	-	-	-	-	-	-
28	348	Other Tangible Plant	1,056	-	-	-	-	1,056
29		Gross Utility Plant in Service	\$ 7,819,192	\$ (249,432)	\$ (2,752)	\$ 4,013	\$ -	\$ 7,571,022
30		Less: Accumulated Depreciation	2,352,796	-	-	-	234,113	2,586,909
31		Net Utility Plant in Service (L29 - L30)	\$ 5,466,396	\$ (249,432)	\$ (2,752)	\$ 4,013	\$ (234,113)	\$ 4,984,113
<b><u>DEDUCTIONS</u></b>								
32		Contributions in Aid of Construction (CIAC)	\$ 820,205	\$ -	\$ -	\$ -	\$ -	\$ 820,205
33		Less: Accumulated Amortization	284,447	-	-	-	-	284,447
34		Net CIAC (L32 - L33)	\$ 535,758	\$ -	\$ -	\$ -	\$ -	\$ 535,758
35		Advances in Aid of Construction (AIAC)	-	-	-	-	-	-
36		Customer Meter Deposits	180,221	-	-	-	-	180,221
37		Deferred Income Tax Credits	1,071,554	-	-	-	-	1,071,554
38		Total Deductions	\$ 1,787,533	\$ -	\$ -	\$ -	\$ -	\$ 1,787,533
<b><u>ADDITIONS:</u></b>								
39		Unamortized Finance Charges	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
40		Deferred Tax Assets	-	-	-	-	-	-
41		Allowance for Working Capital	-	-	-	-	-	-
42		Intentional Left Blank	-	-	-	-	-	-
43		Total Additions	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
44		<b>ORIGINAL COST RATE BASE</b>	\$ 3,678,863	\$ (249,432)	\$ (2,752)	\$ 4,013	\$ (234,113)	\$ 3,196,580

ADJ #	Description	Reference Schedule
1	Well 16 Disallowance	JAC - 5a
2	Capitalized Interest	JAC - 5b
3	Capitalization of Well 12 New Source Testing Costs	JAC - 5c
4	Accumulated Depreciation	JAC - 6

**RATE BASE ADJUSTMENT NO. 1 - Disallowance of Well 16 Drilling Costs**

LINE NO.	DESCRIPTION	[A] COMPANY AS FILED	[B] ADJUSTMENT	[C] STAFF ADJUSTED
1	Wells and Springs (Acct. No. 307)	\$ 249,432	\$ (249,432)	\$ -
	Well 16 Drilling Costs recored in NARUC Acct. 307		\$ 251,984	
	Less: Capitalized Interest		2,552	
	Net Well 16 Drilling Costs to be Disallowed		\$ 249,432	

REFERENCES:

Column [A]: Company Schedule B-2; Company response to Staff DR JAC 1-12  
 Column [B]: Testimony, Schedule JAC-5b  
 Column [C]: Column [A] + Column [B]

**RATE BASE ADJUSTMENT NO. 2 - CAPITALIZED INTEREST**

LINE NO.	ACCT. NO.	DESCRIPTION	[A] COMPANY AS FILED	[B] ADJUSTMENT	Year	[C] STAFF ADJUSTED
	301	Organization Costs	\$ 37,295			\$ 37,295
	302	Franchise Costs	-			-
	303	Land & Land Rights	92,895			92,895
	304	Structures & Improvements	75,442	\$ (18)	2002	75,424
	307	Wells & Springs	834,248	\$ (2,561)	2002; 2009	831,687
	310	Power Generation Equipment	37,618			37,618
	311	Electric Pumping Equipment	1,137,275	(173)	2002	1,137,102
	320	Water Treatment Equipment	-			-
	320.2	Solutions & Feeders	-			-
	320.3	Arsenic Remediation Plant	-			-
	330	Distribution Reservoirs & Standpipes	-			-
	330.1	Storage Tanks	856,574			856,574
	330.2	Pressure Tanks	32,236			32,236
	331	Transmission & Distribution Mains	3,194,161			3,194,161
	333	Services	891,232			891,232
	334	Meters & Meter Installations	90,315			90,315
	335	Hydrants	477,182			477,182
	336	Backflow Prevention Devices	-			-
	339	Other Plant & Misc. Equip.	-			-
	340	Office Furniture & Fixtures	2,071			2,071
	340.1	Computer & Software	-			-
	341	Transportation Equipment	-			-
	342	Store Equipment	-			-
	343	Tools & Work Equipment	2,399			2,399
	344	Laboratory Equipment	-			-
	345	Power Operated Equipment	-			-
	346	Communications Equipment	57,194			57,194
	347	Miscellaneous Equipment	-			-
	348	Other Tangible Plant	1,056			1,056
			<u>\$ 7,819,193</u>	<u>\$ (2,752)</u>		<u>\$ 7,816,441</u>

REFERENCES:

- Column [A]: Company Schedule B-2
- Column [B]: Testimony, JAC; Data Request JAC 1-3 and JAC 3-1
- Column [C]: Column [A] + Column [B]

**RATE BASE ADJUSTMENT NO. 3 - Capitalization of Well 12 New Source Water Testing Costs**

LINE NO.	DESCRIPTION	[A] COMPANY AS FILED	[B] ADJUSTMENT	[C] STAFF ADJUSTED
1	Wells and Springs (Acct. No. 307)	\$ -	\$ 4,013	\$ 4,013

REFERENCES:

Column [A]: Company Schedule B-2  
Column [B]: Testimony, Company response to Staff DR JAC 1-22  
Column [C]: Column [A] + Column [B]

Docket No. W-02514A-14-0343

Test Year Ended December 31, 2013

**RATE BASE ADJUSTMENT NO. 4 - ACCUMULATED DEPRECIATION**

LINE NO.	ACCT. NO.	DESCRIPTION	[A] COMPANY AS FILED	[B] ADJUSTMENT	[C] STAFF ADJUSTED
1	301	Organization Costs	\$ 36,273	\$ (36,273)	\$ -
2	302	Franchise Costs	-	-	-
3	303	Land & Land Rights	-	-	-
4	304	Structures & Improvements	16,734	(8)	16,726
5	307	Wells & Springs	258,516	(42,119)	216,397
6	310	Power Generation Equipment	13,537	-	13,537
7	311	Electric Pumping Equipment	(39,241)	259,531	220,290
8	320	Water Treatment Equipment	-	-	-
9	320.2	Solutions & Feeders	-	-	-
10	320.3	Arsenic Remediation Plant	-	-	-
11	330	Distribution Reservoirs & Standpipes	-	-	-
12	330.1	Storage Tanks	377,367	42,091	419,458
13	330.2	Pressure Tanks	12,495	-	12,495
14	331	Transmission & Distribution Mains	1,244,095	11,195	1,255,289
15	333	Services	237,169	80	237,249
16	334	Meters & Meter Installations	30,053	(969)	29,084
17	335	Hydrants	150,082	585	150,668
18	336	Backflow Prevention Devices	-	-	-
19	339	Other Plant & Misc. Equip.	-	-	-
20	340	Office Furniture & Fixtures	416	-	416
21	340.1	Computer & Software	-	-	-
22	341	Transportation Equipment	-	-	-
23	342	Store Equipment	-	-	-
24	343	Tools & Work Equipment	399	-	399
25	344	Laboratory Equipment	-	-	-
26	345	Power Operated Equipment	-	-	-
27	346	Communications Equipment	13,876	-	13,876
28	347	Miscellaneous Equipment	-	-	-
29	348	Other Tangible Plant	1,027	-	1,027
Accumulated Depreciation			\$ 2,352,796	\$ 234,113	\$ 2,586,909

REFERENCES:

Column [A]: Company Schedule B-2

Column [B]: Testimony

Column [C]: Column [A] + Column [B]

OPERATING INCOME STATEMENT - ADJUSTED TEST YEAR AND STAFF RECOMMENDED

LINE NO.	DESCRIPTION	[A] COMPANY ADJUSTED TEST YEAR AS FILED	[B] STAFF TEST YEAR ADJUSTMENTS	[C] STAFF TEST YEAR AS ADJUSTED	[D] STAFF PROPOSED CHANGES	[E] STAFF RECOMMENDED
1	<b>REVENUES:</b>					
2	Metered Water Sales	\$ 837,366	\$ -	\$ 837,366	\$ 283,295	\$ 1,120,661
3	Water Sales - Unmetered	-	-	-	-	-
4	Other Operating Revenue	7,353	-	7,353	-	7,353
5	<b>Total Operating Revenues</b>	<u>\$ 844,719</u>	<u>\$ -</u>	<u>\$ 844,719</u>	<u>\$ 283,295</u>	<u>\$ 1,128,014</u>
6	<b>OPERATING EXPENSES:</b>					
7	Salaries & Wages	\$ 85,321	\$ -	\$ 85,321	\$ -	\$ 85,321
		21,254	-	21,254	-	21,254
8	Purchased Water	-	-	-	-	-
9	Purchased Power	72,800	-	72,800	-	72,800
10	Chemicals	6,454	-	6,454	-	6,454
11	Repairs & Maintenance	23,693	-	23,693	-	23,693
12	Office Supplies & Expense	20,818	-	20,818	-	20,818
13	Contractual Services - Engineering	-	-	-	-	-
	Contractual Services - Accounting	380	-	380	-	380
	Contractual Services - Legal	468	-	468	-	468
	Contractual Services - Other	17,777	-	17,777	-	17,777
	Contractual Services - Testing	12,864	(5,256) 1	7,608	-	7,608
14	Water Testing	-	-	-	-	-
15	Rents	566	-	566	-	566
16	Transportation Expense	13,067	(2,136) 2	10,931	-	10,931
17	Insurance - General Liability	524	-	524	-	524
18	Insurance - Health & Life	9,483	-	9,483	-	9,483
19	Regulatory Commission Expense	425	-	425	-	425
	Reg. Comm. Exp. - Rate Case	40,000	-	40,000	-	40,000
	Bad Debt Expense	442	-	442	-	442
20	Miscellaneous Expense	12,741	(4,787) 3	7,954	-	7,954
21	Depreciation Expense	294,340	(8,279) 4	286,061	-	286,061
22	Taxes Other than Income	-	-	-	-	-
23	Property Taxes	35,106	(2,432) 5	32,674	3,653	36,327
24	Income Tax	57,233	9,611 6	66,844	111,405	178,250
25	<b>Total Operating Expenses</b>	<u>\$ 725,756</u>	<u>\$ (13,279)</u>	<u>\$ 712,477</u>	<u>\$ 115,058</u>	<u>\$ 827,535</u>
26	<b>Operating Income (Loss)</b>	<u>\$ 118,963</u>	<u>\$ 13,279</u>	<u>\$ 132,242</u>	<u>\$ 168,237</u>	<u>\$ 300,479</u>

References:

- Column (A): Company Schedule C-1
- Column (B): Schedule JAC-8
- Column (C): Column (A) + Column (B)
- Column (D): Schedules JAC-13 and JAC-14
- Column (E): Column (C) + Column (D)

SUMMARY OF OPERATING INCOME STATEMENT ADJUSTMENTS - TEST YEAR

LINE NO.	DESCRIPTION	[A] COMPANY AS FILED	[B] Water Testing ADJ #1	[C] Transportation Exp. ADJ #2	[D] Misc. Exp. ADJ #3	[E] Depreciation Exp. ADJ #4	[F] Property Tax ADJ #5	[G] Income Tax ADJ #6	[H] STAFF ADJUSTED
1	<b>REVENUES:</b>								
2	461 Metered Water Sales	\$ 837,366							\$ 837,366
3	460 Water Sales - Unmetered								
4	474 Other Operating Revenue	7,353							7,353
5	<b>Total Operating Revenues</b>	<b>\$ 844,719</b>							<b>\$ 844,719</b>
6	<b>OPERATING EXPENSES:</b>								
7	601 Salaries & Wages	\$ 85,321							\$ 85,321
8	Employee Pensions and Benefits	21,254							21,254
9	610 Purchased Water								
10	615 Purchased Power	72,800							72,800
11	618 Chemicals	6,454							6,454
12	620 Materials and Supplies	23,693							23,693
13	621 Office Supplies & Expense	20,818							20,818
14	630 Contractual Services - Engineering								
15	Contractual Services - Accounting	380							380
16	Contractual Services - Legal	468							468
17	Contractual Services - Other	17,777							17,777
18	Contractual Services - Testing	12,864	(5,256)						7,608
19	635 Water Testing								
20	641 Rents	566							566
21	650 Transportation Expense	13,067		(2,136)					10,931
22	Insurance - Vehicle	524							524
23	657 Insurance - General Liability	9,483							9,483
24	666 Regulatory Commission Expense	425							425
25	Reg. Comm. Exp. - Rate Case	40,000							40,000
26	Bad Debt Expense	442							442
27	675 Miscellaneous Expense	12,741			(4,787)				7,954
28	403 Depreciation Expense	294,340							286,061
29	408 Taxes Other than Income								
30	408.11 Property Taxes	35,106							32,674
31	409 Income Tax	57,233							66,844
32	<b>Total Operating Expenses</b>	<b>\$ 725,756</b>	<b>\$ (5,256)</b>	<b>\$ (2,136)</b>	<b>\$ (4,787)</b>	<b>\$ (8,279)</b>	<b>\$ (2,432)</b>	<b>\$ 9,611</b>	<b>\$ 712,477</b>
33	<b>Operating Income (Loss)</b>	<b>\$ 118,963</b>	<b>\$ 5,256</b>	<b>\$ 2,136</b>	<b>\$ 4,787</b>	<b>\$ 8,279</b>	<b>\$ 2,432</b>	<b>\$ (9,611)</b>	<b>\$ 132,242</b>

ADJ #	Description	Reference Schedule
1	Contractual Services - Water Testing Expense	JAC - 9
2	Miscellaneous Expense	JAC - 10
3	Transportation Expense	JAC - 11
4	Depreciation Expense	JAC - 12
5	Property Tax Expense	JAC - 13
6	Income Tax Expense	JAC - 14
7		

**OPERATING INCOME ADJUSTMENT NO. 1 - Contractual Services - Water Testing**

LINE NO.	DESCRIPTION	[A] COMPANY PROPOSED	[B] STAFF ADJUSTMENT	[C] STAFF RECOMMENDED
1	Water Testing Expense	\$ 12,864	\$ (5,256)	\$ 7,608
2	Water Testing Cost reclassified from Misc. Exp.	-	-	-
3	Total	\$ 12,864	\$ (5,256)	\$ 7,608

Contractual Services - Water Testing - per Company	\$	12,864
Less: Robson Ranch Water Testing Costs - per Staff Engineering		(6,825)
New source testing - reclassified as a capital expenditure		(4,013)
Sub-Total	\$	2,026
Add: Known and measureable increase to annual water testing expenses		241
Known and measureable increase in MAP water testing expenses		554
MAP water testing costs - reclassified from Miscellaneous Expense		4,787
Contractual Services - Water Testing - per Staff	\$	7,608

Water testing expenses (going forward) -- As per Staff Engineering	\$	2,267
Less: Annual test-year water testing expenses accounted for		2,026
Known and measureable increase to annual water testing expenses	\$	241

MAP testing expenses (going forward) -- As per Staff Engineering	\$	5,341
Less: Test-year MAP Costs accounted for as Miscellaneous expenses		4,787
Known and measureable increase in MAP water testing expenses	\$	554

References:

Column (A), Company Schedule C-2 & Workpapers

Column (B): Testimony JAC; Schedule JAC-8

Column (C): Column (A) + Column (B)

**OPERATING INCOME ADJUSTMENT NO. 2 - Transportation Expense**

LINE NO.	DESCRIPTION	[A] COMPANY PROPOSED	[B] STAFF ADJUSTMENT	[C] STAFF RECOMMENDED
1	Transportation Expense	\$ 13,067	\$ (2,136)	\$ 10,931
2		-	-	-
3	Total	\$ 13,067	\$ (2,136)	\$ 10,931

Personal Commute Miles of Superintendent	15	miles per day
IRS Standard Mileage Rate for 2013	\$ 0.565	rate per mile
	\$ 8.48	
Number of work days per month	21	
Monthly personal commute expense	\$ 177.98	
Months per year	12	
Annual personal commute expense	\$ 2,135.70	

References:

Column (A), Company Schedule C-2 & Workpapers

Column (B): Testimony JAC; Response to Staff Data Request JAC 1-23

Column (C): Column (A) + Column (B)

**OPERATING INCOME ADJUSTMENT NO. 3 - Miscellaneous Expense**

LINE NO.	DESCRIPTION	[A] COMPANY PROPOSED	[B] STAFF ADJUSTMENT	[C] STAFF RECOMMENDED
1	Miscellaneous Expense	\$ 12,741	\$ (4,787)	\$ 7,954
2		-	-	-
3	Total	<u>\$ 12,741</u>	<u>\$ (4,787)</u>	<u>\$ 7,954</u>

To reclassify MAP water testing expenses from Miscellaneous Expense to Contractual Services - Testing (as per Staff Engineer Michael Thompson)

References:

Column (A), Company Schedule C-2 & Workpapers

Column (B): Testimony JAC

Column (C): Column (A) + Column (B)

OPERATING INCOME ADJUSTMENT No. 4 - DEPRECIATION EXPENSE

Line No.	ACCT NO.	DESCRIPTION	GROSS UTILITY PLANT IN SERVICE	FULLY/NON DEPRECIABLE	DEPRECIABLE PLANT	DEPREC. RATE	EXPENSE
<i>Plant In Service</i>							
1	301	Organization Costs	\$ 37,295	\$ 37,295	\$ -	0.00%	\$ -
2	302	Franchise Costs	-	-	-	0.00%	-
3	303	Land & Land Rights	92,895	92,895	-	0.00%	-
2	304	Structures & Improvements	75,424	-	75,424	3.33%	2,512
3	307	Wells & Springs	586,268	-	586,268	3.33%	19,523
4	310	Power Generation Equipment	37,618	-	37,618	5.00%	1,881
3	311	Electric Pumping Equipment	1,137,102	-	1,137,102	12.50%	142,138
4	320	Water Treatment Equipment	-	-	-	3.33%	-
5	320.2	Solutions & Feeders	-	-	-	20.00%	-
4	320.3	Arsenic Remediation Plant	-	-	-	0.00%	-
5	330	Distribution Reservoirs & Standpipes	-	-	-	0.00%	-
6	330.1	Storage Tanks	856,574	-	856,574	2.22%	19,016
5	330.2	Pressure Tanks	32,236	-	32,236	5.00%	1,612
6	331	Transmission & Distribution Mains	3,194,161	-	3,194,161	2.00%	63,883
7	333	Services	891,232	-	891,232	3.33%	29,678
6	334	Meters & Meter Installations	90,315	-	90,315	8.33%	7,523
7	335	Hydrants	477,182	-	477,182	2.00%	9,544
8	336	Backflow Prevention Devices	-	-	-	6.67%	-
7	339	Other Plant & Misc. Equip.	-	-	-	6.67%	-
8	340	Office Furniture & Fixtures	2,071	-	2,071	6.67%	138
9	340.1	Computer & Software	-	-	-	20.00%	-
8	341	Transportation Equipment	-	-	-	20.00%	-
9	342	Store Equipment	-	-	-	4.00%	-
10	343	Tools & Work Equipment	2,399	-	2,399	5.00%	120
9	344	Laboratory Equipment	-	-	-	10.00%	-
10	345	Power Operated Equipment	-	-	-	5.00%	-
11	346	Communications Equipment	57,194	-	57,194	10.00%	5,719
10	347	Miscellaneous Equipment	-	-	-	10.00%	-
11	348	Other Tangible Plant	1,056	-	1,056	10.00%	106
29		Subtotal General	<u>\$ 7,571,022</u>		<u>\$ 7,440,832</u>		\$ 303,392
30		Less: Amortization of Contributions (Depreciable Plant/Depreciation Exp.)			\$ 820,205	2.1130%	\$ 17,331
31		Staff Recommended Depreciation Expense					\$ 286,061
32		Company Proposed Depreciation Expense					<u>294,340</u>
33		Increase/(Decrease) to Depreciation Expense					<u>\$ (8,279)</u>

**OPERATING INCOME ADJUSTMENT No. 5 - PROPERTY TAXES**

LINE NO.	DESCRIPTION	[A]	[B]
		STAFF AS ADJUSTED	STAFF RECOMMENDED
1	Staff Adjusted Test Year Revenues	\$ 844,719	\$ 844,719
2	Weight Factor	2	2
3	Subtotal (Line 1 * Line 2)	\$ 1,689,438	\$ 1,689,438
4	Staff Recommended Revenue	844,719	1,128,014
5	Subtotal (Line 4 + Line 5)	\$ 2,534,157	\$ 2,817,452
6	Number of Years	3	3
7	Three Year Average (Line 5 / Line 6)	\$ 844,719	\$ 939,151
8	Department of Revenue Multiplier	2	2
9	Revenue Base Value (Line 7 * Line 8)	\$ 1,689,438	\$ 1,878,301
10	Plus: 10% of CWIP		
11	Less: Net Book Value of Licensed Vehicles		
12	Full Cash Value (Line 9 + Line 10 - Line 11)	\$ 1,689,438	\$ 1,878,301
13	Assessment Ratio		
14	Assessment Value (Line 12 * Line 13)	\$ 304,099	\$ 338,094
15	Composite Property Tax Rate - Obtained from ADOR		
16	Staff Test Year Adjusted Property Tax Expense (Line 14 * Line 15)	\$ 32,674	
17	Company Proposed Property Tax	35,106	
18	Staff Test Year Adjustment (Line 16 - Line 17)	\$ (2,432)	
19	Property Tax - Staff Recommended Revenue (Line 14 * Line 15)		\$ 36,327
20	Staff Test Year Adjusted Property Tax Expense (Line 16)		32,674
21	Increase in Property Tax Due to Increase in Revenue Requirement		\$ 3,653
22	Increase in Property Tax Due to Increase in Revenue Requirement (Line 21)		\$ 3,653
23	Increase in Revenue Requirement		\$ 283,295
24	Increase in Property Tax Per Dollar Increase in Revenue (Line 22 / Line 23)		<b>1.289340%</b>

REFERENCES:

- Line 15: Composite Tax Rate obtained from Arizona Department of Revenue
- Line 17: Company Schedule C-1 Page 2
- Line 21: Line 19 - Line 20
- Line 23: Schedule JAC-1

**OPERATING INCOME ADJUSTMENT NO. 6 - INCOME TAX EXPENSE**

LINE NO.	DESCRIPTION	[A] COMPANY PROPOSED	[B] STAFF ADJUSTMENT	[C] STAFF RECOMMENDED
1	Income Tax Expense	\$ 57,233	\$ 9,611	\$ 66,844
2	Total	<u>\$ 57,233</u>	<u>\$ 9,611</u>	<u>\$ 66,844</u>

References:  
Column (A): Company Schedule C-2  
Column (B): Testimony  
Column (C): Column (A) + Column (B)

**RATE DESIGN**

Monthly Usage Charge	Present Rates	Company Proposed Rates	Staff Recommended Rates
5/8 x 3/4" Meter	\$ 15.00	\$ 21.23	\$ 18.00
3/4" Meter	20.00	28.30	27.00
1" Meter	25.00	35.38	45.00
1½" Meter	50.00	70.75	90.00
2" Meter	80.00	113.20	144.00
3" Meter	150.00	212.25	288.00
4" Meter	250.00	353.75	450.00
6" Meter	500.00	707.50	900.00
<b>Commodity Rates</b>			
All Meters - Flat Commodity Rate	\$ 2.80		
<b>5/8 x 3/4" &amp; 3/4" Meter - Residential</b>			
Gallons Included in Minimum	0	0	0
Excess of Minimum - per 1,000 Gallons			
From 1 to 4,000 Gallons		\$ 3.58	\$ 3.00
From 4,001 to 10,000 Gallons		\$ 4.68	\$ 4.25
Over 10,000 Gallons		\$ 5.78	\$ 5.36
<b>5/8 x 3/4" &amp; 3/4" Meter - Commercial</b>			
Gallons Included in Minimum	0	0	0
Excess of Minimum - per 1,000 Gallons			
From 1 to 10,000 Gallons		\$ 4.68	\$ 4.25
Over 10,000 Gallons		\$ 5.78	\$ 5.36
<b>5/8 x 3/4" &amp; 3/4" Meter - Irrigation</b>			
Gallons Included in Minimum	0	0	0
Excess of Minimum - per 1,000 Gallons			
From 1 to 10,000 Gallons		\$ 4.68	\$ 4.25
Over 10,000 Gallons		\$ 5.78	\$ 5.36
<b>1" - Residential, Commercial &amp; Irrigation</b>			
Gallons Included in Minimum	0	0	0
Excess of Minimum - per 1,000 Gallons			
From 1 to 17,000 Gallons		\$ 4.68	\$ 4.25
Over 17,000 Gallons		\$ 5.78	\$ 5.36
<b>1½" - Residential, Commercial &amp; Irrigation</b>			
Gallons Included in Minimum	0	0	0
Excess of Minimum - per 1,000 Gallons			
From 1 to 33,000 Gallons		\$ 4.68	\$ 4.25
Over 33,000 Gallons		\$ 5.78	\$ 5.36
<b>2" - Residential, Commercial &amp; Industrial</b>			
Gallons Included in Minimum	0	0	0
Excess of Minimum - per 1,000 Gallons			
From 1 to 53,000 Gallons		\$ 4.68	\$ 4.25
Over 53,000 Gallons		\$ 5.78	\$ 5.36
<b>3" - Residential, Commercial &amp; Industrial</b>			
Gallons Included in Minimum	0	0	0
Excess of Minimum - per 1,000 Gallons			
From 1 to 100,000 Gallons		\$ 4.68	\$ 4.25
Over 100,000 Gallons		\$ 5.78	\$ 5.36
<b>4" - Residential, Commercial &amp; Industrial</b>			
Gallons Included in Minimum	0	0	0
Excess of Minimum - per 1,000 Gallons			
From 1 to 167,000 Gallons		\$ 4.68	4.25
Over 167,000 Gallons		\$ 5.78	5.36
<b>6" - Residential, Commercial &amp; Industrial</b>			
Gallons Included in Minimum	0	0	0
Excess of Minimum - per 1,000 Gallons			
From 1 to 334,000 Gallons		\$ 4.68	\$ 4.25
Over 334,000 Gallons		\$ 5.78	\$ 5.36

RATE DESIGN

Service Line and Meter Installation Charges	Company Proposed Rates			Staff Recommended Rates			
	Present Rates	Service Line Charge	Meter Charge	Total Charge	Service Line Charge	Meter Charge	Total Charge
5/8" x 3/4" Meter	\$ 350	\$ 385	\$ 135	\$ 520	\$ 385	\$ 135	\$ 520
3/4" Meter	\$ 400	415	205	620	415	205	620
1" Meter	\$ 470	465	265	730	465	265	730
1 1/2" Meter	\$ 695	520	475	995	520	475	995
2" Turbine Meter	\$ 1,225	800	995	1,795	800	995	1,795
2" Compound Meter	\$ 1,820	800	1,840	2,640	800	1,840	2,640
3" Turbine Meter	\$ 1,735	1,015	1,620	2,635	1,015	1,620	2,635
3" Compound Meter	\$ 2,410	1,135	2,495	3,630	1,135	2,495	3,630
4" Turbine Meter	\$ 2,700	1,430	2,570	4,000	1,430	2,570	4,000
4" Compound Meter	\$ 3,455	1,610	3,545	5,155	1,610	3,545	5,155
6" Turbine Meter	\$ 5,115	2,150	4,925	7,075	2,150	4,925	7,075
6" Compound Meter	\$ 6,650	2,270	6,820	9,090	2,270	6,820	9,090
<b>Service Charges</b>							
Establishment	\$ 25.00			\$ 25.00			\$ 25.00
Establishment (after hours)	45.00			Eliminate			Eliminate
Reestablishment within 12 months	**			**			**
Reconnection/Delinquent	25.00			25.00			\$ 25.00
Meter Test (if correct)	25.00			25.00			\$ 25.00
Meter Re-read (if correct)	15.00			15.00			\$ 15.00
Deposit	*			*			*
Deposit Interest	*			*			*
NSF Check	\$ 15.00			\$ 15.00			\$ 15.00
Deferred Payment, per month	1.5% per month			1.5% per month			1.5% per month
Late Payment Fee (per month)	***			***			***
After-Hours Service Charge	NT			\$ 50.00			\$ 50.00
<b>Monthly Service Charge of Fire Sprinklers</b>							
4" or Smaller	****			****			****
6"	****			****			****
8"	****			****			****
10"	****			****			****
Larger than 10"	****			****			****

\* Per Commission Rule A.A.C. R-14-2-403(b)

\*\* Number of months off the system times the monthly minimum per Commission Rule A.A.C. R-14-2-403(D)

\*\*\* 1.5% per month or a minimum of \$3.50

\*\*\*\* 1% of monthly minimum for a comparable sized meter connection, but no less than \$5.00 per month (requires separate service line)

NT = No Tariff

**Typical Bill Analysis**  
General Service 5/8 x 3/4-Inch Meter

Company Proposed	Gallons	Present Rates	Proposed Rates	Dollar Increase	Percent Increase
Average Usage	5,725	\$ 31.03	\$ 43.62	\$ 12.59	40.58%
Median Usage	4,500	27.60	37.89	\$ 10.29	37.28%
<b>Staff Recommended</b>					
Average Usage	5,725	\$ 31.03	\$ 37.33	\$ 6.30	20.31%
Median Usage	4,500	27.60	32.13	\$ 4.53	16.41%

**Present & Proposed Rates (Without Taxes)**  
General Service 5/8 x 3/4-Inch Meter

Gallons Consumption	Present Rates	Company Proposed Rates	% Increase	Staff Recommended Rates	% Increase
-	\$ 15.00	\$ 21.23	41.53%	\$ 18.00	20.00%
1,000	\$ 17.80	24.81	39.38%	21.00	17.98%
2,000	\$ 20.60	28.39	37.82%	24.00	16.50%
3,000	\$ 23.40	31.97	36.62%	27.00	15.38%
4,000	\$ 26.20	35.55	35.69%	30.00	14.50%
5,000	\$ 29.00	40.23	38.72%	34.25	18.10%
6,000	\$ 31.80	44.91	41.23%	38.50	21.07%
7,000	\$ 34.60	49.59	43.32%	42.75	23.55%
8,000	\$ 37.40	54.27	45.11%	47.00	25.67%
9,000	\$ 40.20	58.95	46.64%	51.25	27.49%
10,000	\$ 43.00	63.63	47.98%	55.50	29.07%
11,000	\$ 45.80	69.41	51.55%	60.86	32.88%
12,000	\$ 48.60	75.19	54.71%	66.22	36.26%
13,000	\$ 51.40	80.97	57.53%	71.58	39.26%
14,000	\$ 54.20	86.75	60.06%	76.94	41.96%
15,000	\$ 57.00	92.53	62.33%	82.30	44.39%
16,000	\$ 59.80	98.31	64.40%	87.66	46.59%
17,000	\$ 62.60	104.09	66.28%	93.02	48.59%
18,000	\$ 65.40	109.87	68.00%	98.38	50.43%
19,000	\$ 68.20	115.65	69.57%	103.74	52.11%
20,000	\$ 71.00	121.43	71.03%	109.10	53.66%
25,000	\$ 85.00	150.33	76.86%	135.90	59.88%
30,000	\$ 99.00	179.23	81.04%	162.70	64.34%
35,000	\$ 113.00	208.13	84.19%	189.50	67.70%
40,000	\$ 127.00	237.03	86.64%	216.30	70.31%
45,000	\$ 141.00	265.93	88.60%	243.10	72.41%
50,000	\$ 155.00	294.83	90.21%	269.90	74.13%
75,000	\$ 225.00	439.33	95.26%	403.90	79.51%
100,000	\$ 295.00	583.83	97.91%	537.90	82.34%

UNIFORM SYSTEM OF ACCOUNTS

FOR

CLASS A

WATER UTILITIES



1996

NATIONAL ASSOCIATION  
OF  
REGULATORY UTILITY COMMISSIONERS

## BALANCE SHEET ACCOUNTS

C. Gains or losses from the sale of land and land rights or other disposition of such property previously recorded in this account and not placed in utility service shall, unless otherwise authorized or required by the Commission, be recorded directly in account 414 - Gains (Losses) from Disposition of Utility Property. However, when determined to be significant by the Commission the gain or loss shall be transferred to account 253 - Other Deferred Credits, or account 186 - Miscellaneous Deferred Debits. Such deferred amounts shall then be amortized to account 414 - Gains (Losses) from Disposition of Utility Property, unless otherwise authorized or required by the Commission.

D. The property included in this account shall be classified according to the detailed accounts prescribed for utility plant in service and the account shall be maintained in such detail as though the property were in service. Separate subaccounts shall be maintained hereunder for each utility department for which plant is held for future use.

Note:--Materials and supplies, and meters held in reserve, and normal spare capacity of plant in service shall not be included in this account.

### 104. Utility Plant Purchased or Sold

A. This account shall be charged with the cost of utility plant acquired as an operating unit or system by purchase, merger, consolidation, liquidation, or otherwise, and shall be credited with the selling price of like property transferred to others pending the distribution to appropriate accounts in accordance with Accounting Instruction 21.

B. Within six months from the date of acquisition or transfer of property recorded herein, the utility shall file with the Commission the proposed journal entries to clear from this account the amounts recorded herein.

C. When an existing water system or operating unit is acquired the utility shall be obligated to obtain, from the party acquired from, all existing records, including records of plant construction dates and costs, and records of accumulated depreciation applicable to such properties.

### 105. Construction Work in Progress

A. This account shall include the total of balances of work orders for utility plant in process of construction but not ready for service at the date of the balance sheet.

## BALANCE SHEET ACCOUNTS

B. Work orders shall be cleared from this account as soon as practicable after completion of the job. Further, if a project, such as pumping station or treatment plant, is designed to consist of two or more units which may be placed in service at different dates, any expenditures which are common to and which will be used in the operation of the project as a whole shall be included in utility plant in service upon the completion and the readiness for service of the first unit. Any expenditures which are identified exclusively with units of property not yet in service shall be included in this account..

C. Expenditures on research and development projects for construction of utility facilities are to be included in a separate subdivision in this account. Records must be maintained to show separately each project along with complete detail of the nature and purpose of the research and development project together with the related costs.

### 106. Completed Construction Not Classified

At the end of the year or such other date as a balance sheet may be required by the Commission, this account shall include the total of the balances of work orders for utility plant which has been completed and placed in service but which work orders have not been classified for transfer to the detailed utility plant accounts.

Note:--For the purpose of reporting to the Commission, the classification of utility plant in service by accounts is required. The utility shall also report the balance in this account tentatively classified as accurately as practicable according to prescribed account classifications. The purpose of this provision is to avoid any significant omissions in reported amounts of utility plant in service.

### 108. Accumulated Depreciation

A. This account shall reflect the depreciation accumulated on plant used in water utility service.

B. The utility shall maintain separate subaccounts corresponding with the depreciable plant accounts, in which the accumulated depreciation total is segregated.

C. The following subaccounts shall be maintained:

#### 108.1 Accumulated Depreciation of Utility Plant in Service

A. This account shall be credited with the following:

BEFORE THE ARIZONA CORPORATION COMMISSION

SUSAN BITTER SMITH  
Chairman  
BOB STUMP  
Commissioner  
BOB BURNS  
Commissioner  
DOUG LITTLE  
Commissioner  
TOM FORESE  
Commissioner

IN THE MATTER OF THE APPLICATION OF ) DOCKET NO. W-02514A-14-0343  
QUAIL CREEK WATER COMPANY, INC., AN )  
ARIZONA CORPORATION, FOR A )  
DETERMINATION OF THE FAIR VALUE OF )  
ITS UTILITY PLANTS AND PROPERTY AND )  
FOR INCREASES IN ITS WATER RATES AND )  
CHARGES FOR UTILITY SERVICE BASED )  
THEREON. )  
\_\_\_\_\_ )

SURREBUTTAL

TESTIMONY

OF

JAMES R. ARMSTRONG

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

JULY 1, 2015

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**EXECUTIVE SUMMARY**  
**QUAIL CREEK WATER COMPANY, INC.**  
**DOCKET NO. W-02514A-14-0343**

Mr. Armstrong identifies and discusses a number of on-going Quail Creek Water Company ("QCW") accounting and financial reporting concerns.

Mr. Armstrong also recommends that the Commission require QCW to:

1. Enter into written contracts with affiliates governing the design and construction of future utility plant and facility additions;
2. Develop and sign a Code of Affiliate Conduct that would be binding upon QCW and all affiliates;
3. Assure that the Company's 2015 Annual Report to the Commission reflect proper accrual accounting for all balance sheet and income statement items; and
4. Isolate the facts and financial implications associated with material future early plant retirements concurrent with the timing of such an early retirement decision so that all issues and considerations related to such decisions can be identified and addressed at the proper time.

1 **INTRODUCTION**

2 **Q. Please state your name, occupation, and business address.**

3 A. My name is James R. Armstrong. I am employed as the Chief Accountant of the Finance &  
4 Regulatory Analysis Section of the Utilities Division ("Staff") of the Arizona Corporation  
5 Commission ("ACC"). My business address is 1200 West Washington, Phoenix, Arizona  
6 85007.

7  
8 **Q. Mr. Armstrong, please provide a brief overview of your education and previous  
9 ratemaking experience.**

10 A. I hold a Bachelor's Degree in Finance and a Master's Degree in Accounting, both from  
11 Kansas State University. I am a Certified Public Accountant. My professional work  
12 background includes serving over 30 years in various ratemaking capacities, including time  
13 serving on the staffs of the Kansas Corporation Commission, the Oklahoma Corporation  
14 Commission, and the Residential Utilities Consumer Office in Arizona. I also spent ten years  
15 as the Manager of Rates for Oklahoma Natural Gas ("ONG") and also two years as ONG's  
16 Manager of Financial Planning. In addition, I worked as a full time regulatory consultant for  
17 Westar Energy for almost two years, immediately before joining the ACC Staff in September  
18 of 2012.

19  
20 **Q. Mr. Armstrong, did you file direct testimony on behalf of Staff in Docket No. 14-0343,  
21 the rate case Application filed by Quail Creek Water Company ("QCW" or  
22 "Company")?**

23 A. No.

24

1 **SCOPE OF TESTIMONY - QCW'S ACCOUNTING AND FINANCIAL REPORTING**

2 **Q. Please identify the issues that will be the focus of your surrebuttal testimony.**

3 A. I will be responding to comments made by Company witnesses Mr. Jones and Mr. Bourassa  
4 regarding QCW's accounting and financial reporting.

5

6 **Q. Mr. Armstrong, why is Staff just now raising these accounting irregularity concerns?**

7 A. Staff felt obligated to formally address the Company's ongoing accounting and financial  
8 reporting deficiencies as a result of the additional fact finding efforts undertaken in response  
9 to comments contained in the testimony of the Company's witnesses.

10

11 **Q. Mr. Armstrong, are ACC-regulated utilities required to follow the NARUC accounting  
12 guidelines contained in the NARUC Uniform System of Accounts ("USoA")?**

13 A. Yes. Such a directive is found in Arizona Administrative Code § R14-2-411 D (2). Further,  
14 R14-2-411 D (1) also contains language requiring utilities to keep records that are "complete  
15 and authentic."

16

17 **Q. Has QCW indicated that it does follow the NARUC USoA guidelines?**

18 A. Yes, QCW specifically stated that it follows NARUC USoA in response to Staff Data Request  
19 No. JAC 1-2. Refer to Staff Surrebuttal-4 attached to my testimony.

20

21 **Q. Mr. Armstrong, do the NARUC USoA Accounting Instructions also contain a  
22 directive requiring the timely and accurate recording of transactions with associated  
23 companies?**

24 A. Yes. General Accounting Instruction No. 15 contains the following language:

25

1 I have included a copy of Accounting Instruction No. 15 as Staff Surrebuttal Exhibit - 1  
2 affixed to my surrebuttal testimony.

3  
4 **Q. Mr. Armstrong, has Company witness Mr. Jones, acknowledged that QWC's books  
5 and records did not account for Well 16 on a timely basis?**

6 A. Yes, I believe so. Mr. Jones sums up QCWs Well 16 accounting as being one of several  
7 "deferred plant purchases" that the Company apparently just chose not to reflect on its books  
8 and records in a timely manner.

9  
10 **Q. Mr. Armstrong, would you agree that on page 7, lines 1 through 5 of Mr. Jones'  
11 rebuttal testimony filed on behalf of QWC, Mr. Jones appears to confirm the fact that  
12 the Company did not pay for Well 16 until two years after the well was known to be  
13 unproductive.**

14 A. Yes.

15  
16 **Q. Mr. Jones then goes on to make reference to Staff's decision to develop its Well 16  
17 recommendations around accounting treatment discussion contained in the NARUC  
18 produced *Guidelines for Cost Allocations and Affiliate Transactions* ("Guidelines").  
19 Is it fair to say that this two year accounting timeframe displacement was a  
20 contributing factor in Staff's decision to broaden its Well 16 focus to include  
21 consideration of these NARUC Guidelines?**

22 A. Yes. Further, Staff and the Company are in agreement that, generally, affiliate transactions  
23 should receive heightened scrutiny, and evidence of untimely or incomplete accounting  
24 involving affiliate transactions certainly enhanced the need for additional scrutiny.

25

1 **Q. In Staff's opinion has QCW, in fact, followed the NARUC accounting guidelines in an**  
2 **acceptable manner?**

3 A. No.

4  
5 **Q. What is the basis for this Staff conclusion?**

6 A. Staff's conclusion is based upon numerous Company witness statements as well as  
7 corresponding accounting deviations found in Annual Reports filed by QCW.

8  
9 **Q. Mr. Armstrong, please begin your discussion of the examples Staff has noted of**  
10 **unacceptable accounting on behalf of QCW.**

11 A. First, beginning at page 6, line 21, through page 13, line 22, of his direct testimony, Mr. Jones  
12 spends a great deal of time identifying and discussing the numerous adjustments he needed to  
13 make in order to "correct" the implications resulting from the Company's past accounting  
14 shortcomings. From this rather extensive list, which is summarized within the table shown  
15 on page 13 of Mr. Jones' direct testimony, Staff can only conclude that this effort must have  
16 taken many hours of Mr. Jones' time.

17  
18 It is also interesting to note that Mr. Jones makes reference to accounting challenges  
19 presented in other rate cases filed by Robson controlled ACC-regulated utilities<sup>1</sup>. Mr. Jones  
20 acknowledges that similar accounting issues have been vetted over an extended period of time  
21 in many such rate cases<sup>2</sup>. These facts beg two valid questions: how long must the parties to  
22 Robson-run utility rate cases continue to deal with such recurring accounting shortcomings,  
23 and, of equal or greater importance, how long are rate payers going to be required to pay for

---

<sup>1</sup> On page 10 of Mr. Jones's rebuttal testimony he discusses a recent rate case filed by affiliate Lago Del Oro where the parties had to work around delayed accounting issues similar to those encountered in the QWC rate case.

<sup>2</sup> Refer to page 8, lines 4 through 6 of Mr. Jones rebuttal testimony.

1 the higher level of rate case expense driven by the many hours of consulting time required to  
2 “reconstruct Robson utility books and records” each time a new rate case is filed?

3  
4 **Q. Does Staff have another reason for bringing this issue to the Commission’s attention?**

5 A. Yes. Company witness Mr. Soriano indicated on page 4, lines 1 and 2 of his direct testimony  
6 that all of the Robson water and wastewater utilities are planning on filing rate cases over the  
7 next few years. Couple this statement with the acknowledgement of QCW’s consultants in  
8 this rate case that this Commission has been faced with similar accounting inadequacies for  
9 many years, and over several rate cases, and you have the foundation for the remainder of my  
10 surrebuttal testimony regarding additional accounting and business practice abnormalities  
11 noted in the rebuttal testimony of Company witnesses Mr. Jones and Mr. Bourassa.

12  
13 **Q. Please identify the other statements found in the rebuttal testimonies of the**  
14 **Company’s two witnesses, Mr. Jones and Mr. Bourassa, that led Staff to evaluate more**  
15 **closely the Company’s accounting.**

16 A. Statements made by these witnesses included the following:

- 17 a. Statements regarding QCW affiliates providing long-term financing to support capital  
18 projects;
- 19 b. Statements regarding “Accounts Receivable” that were allegedly recorded on the  
20 books of the QCW affiliates without a discussion of corresponding “Accounts  
21 Payable”<sup>3</sup> being recorded on the QCW books; and,
- 22 c. Statements regarding QCW’s delay in accounting for plant acquired from affiliates or  
23 constructed for QCW by affiliates.
- 24

---

<sup>3</sup> More accurately, these should be referred to Notes Receivable from Affiliates and Notes Payable to Affiliates.

1 **Q. Where did Staff turn in order to understand the full context and soundness of these**  
2 **statements?**

3 A. Staff turned to the 2004 through 2014 Annual Reports submitted to the ACC by QCW. Each  
4 of these Annual Reports contains sworn statements indicating that the information submitted  
5 is complete and correct. So, Staff initially presumed that the information contained in these  
6 reports could be relied upon as being complete and accurate.

7  
8 **Q. Regarding Staff's review of the referenced QCW Annual Reports, please identify the**  
9 **financial data categories that became Staff's primary focus.**

10 A. The financial data of primary focus included the following items reported on the year end  
11 QCW Balance Sheets:

- 12 • Available Cash;
- 13 • Notes Receivable from Affiliates;
- 14 • Notes Payable to Affiliates;
- 15 • Long-Term Debt; and,
- 16 • Gross Plant Investments

17  
18 **Q. Mr. Armstrong, did Staff prepare an Exhibit that summarizes the significant elements**  
19 **of financial information found in these Balance Sheets<sup>4</sup> that you will be addressing?**

20 A. Yes. The financial element summaries are contained in Staff Surrebuttal Exhibit 2 attached to  
21 my surrebuttal testimony.

22  
23 **Q. Please continue.**

24 A. The columns show the relevant financial data amounts by year, while the line items shown on  
25 the left identify individual items of interest.

---

<sup>4</sup> Staff would also note that Exhibit Staff Surrebuttal 1 also contains some information taken from the QWC Income Statement, but generally Staff focused on information found on the QWC Balance Sheets.

1 **Q. Referring to the three statements (noted as Statements a, b, and c) made by Company**  
2 **witnesses that drew Staff's interest, and beginning with item (a) - statements made**  
3 **about QCW affiliates providing long-term financing to support capital projects, please**  
4 **discuss Staff's findings.**

5 A. Based upon rebuttal testimony statements made by Company witnesses Mr. Jones and Mr.  
6 Bourassa, it appears to Staff that QCW committed to long-term indebtedness and/or "other  
7 evidences of indebtedness" without Commission approval. On page 8, line 23 through page  
8 9, line 6, direct Mr. Jones notes that a QCW affiliate financed the cost of various capital  
9 projects, including Well 16, and that such financing arrangements were allowed to remain in  
10 effect for several years after the projects were completed. Mr. Bourassa makes several similar  
11 statements including on page 5, line 12, of his rebuttal testimony where he refers to the  
12 arrangement as a method of financing plant additions.

13  
14 **Q. Mr. Armstrong, turn now to statement (b) – statements made regarding construction**  
15 **project-related Accounts Receivable<sup>5</sup> that were allegedly recorded on the books of the**  
16 **QCW affiliates without a discussion of corresponding construction project-related**  
17 **Accounts Payable being recorded on the QCW books. Please explain why this is a**  
18 **problem from an accounting perspective?**

19 A. The problem is that such acknowledgments indicate the presence of incomplete and/or  
20 inaccurate accounting on the part of QCW.

21

---

<sup>5</sup> It would be more appropriate to refer to the Accounts Receivable/Accounts Payable involving affiliate transactions as Accounts Payable to Affiliates and/or Accounts Receivable or Payable to Affiliates or Notes Payable to and/or Notes Receivable from affiliates.

1     **Q.     Mr. Armstrong, by turning to Staff Surrebuttal Exhibit 2, can you show us the finding**  
2           **that supports the conclusion that the construction project-related Accounts Payable to**  
3           **Affiliates were not recorded on the regulated water company's books?**

4     A.     Yes. Such Accounts Payable would show up on line 4, and the amount of the Accounts  
5           Payable would correspond (be equal) to the amount of the Accounts Receivable allegedly  
6           recorded on the affiliate's books, to which the Company witnesses do specifically refer.  
7           Further, as I will discuss in more detail later, this Accounts Payable to Affiliate entry should  
8           have been accompanied by a corresponding entry to Plant-In-Service (line 8) in the same  
9           accounting period(s) that these Accounts Payable to Affiliate liabilities were actually incurred.

10  
11           Other than two small Notes Payable to Affiliate balances showing up in the year 2004, and  
12           year 2005 QCW financial statements, there are no additional Accounts Payable to Affiliate  
13           balances shown on any of the Company's Annual Reports submitted between 2004 and 2014.

14  
15     **Q.     Does QCW explain why it did not accrue the capital project-related liabilities the**  
16           **Company had to its affiliate, on its books, as these liabilities actually became**  
17           **obligations of QCW?**

18     A.     No, it does not. This management decision is perplexing since this unrecorded liability  
19           apparently reached \$2.7 million before being recorded (in 2011), while the same management  
20           team found it necessary and reasonable to record much smaller affiliate payables and  
21           receivables on the QCW books.

22

1 **Q. Mr. Armstrong, by viewing Staff Surrebuttal Exhibit 2, is it possible to see where and**  
2 **when these much smaller payables and receivables involving affiliates were recorded**  
3 **on QCW's books?**

4 A. Yes, it is. If we look at lines 3 and 4 we clearly see that QCW's management recorded affiliate  
5 payables and receivables as small as \$8,616 (line 3, column E). Yet the significantly larger  
6 affiliate transactions (ultimately totaling \$2.7 million) were not reported, until years after they  
7 should have been reported.

8  
9 **Q. Mr. Armstrong, please explain the accounting accuracy implications associated with**  
10 **statement (c) regarding delays in recording plant acquisitions.**

11 A. I would first direct the Commission's attention to the Table shown on page 10 of the direct  
12 testimony of Company witness Mr. Jones and to footnote No. 12 at the bottom of page 13 of  
13 the direct testimony of Staff witness, Mr. Cassidy. Within these two references, we find a  
14 summary of the Plant-In-Service additions that **were recorded in the wrong years** by QCW.  
15 By recording these Plant additions in the wrong years, I mean that the investments were  
16 recorded on the QCW books and records in years other than the years the items were placed  
17 into service, which would have been the correct accounting.

18  
19 Turning to line 10 and the various year-by-year columns in Staff Surrebuttal Exhibit 1, we see  
20 the plant additions recorded in 2009, 2010, and 2011 that, according to the Company's own  
21 witnesses, should have been recorded in 2002 through 2009. On line 11 we see the net year-  
22 by-year plant-in-service changes that would have resulted if these plant additions were  
23 recorded accurately. Footnote 1 of this Exhibit also demonstrates this accounting inaccuracy.

24

1 Q. So, to be clear, is it accurate to state that, for example, the positive entries shown on  
2 line 10 represent the plant additions that should have been recorded in the respective  
3 years, while the negative figures represent when these plant additions were actually  
4 recorded on the QCW books?

5 A. Yes. The negative entries also suggest that the recorded plant addition activities for those  
6 respective years are actually over stated by these amounts.

7  
8 Q. Mr. Armstrong, does Staff believe QCW's management should have been aware of the  
9 fact that the financial data presented in its Annual Reports to the ACC was  
10 inaccurate?

11 A. Yes.

12  
13 Q. Which Annual Reports does Staff believe contained inaccurate and/or incomplete  
14 financial information?

15 A. Since the plant additions were inaccurately presented going back to at least 2002, and since  
16 such errors would have rolling implications to the subsequently submitted financial report,  
17 Staff believes that all Annual Reports submitted between 2002 and 2014 could be in error.

18  
19 Q. Is it acceptable for QCW to continue with the accounting practices you have been  
20 discussing?

21 A. No, and Staff will be addressing a number of accounting practices and policy improvements  
22 that it believes the Commission should require QCW and its affiliates to adopt and follow.

23

1 STAFF RECOMMENDATIONS REGARDING QCW'S ACCOUNTING AND  
2 REPORTING PRACTICES

3 Q. Mr. Armstrong, after giving consideration to the evidence showing that QCW has  
4 failed to follow NARUC guidelines and has otherwise engaged in some incomplete  
5 and/or untimely accounting and financial reporting covering many years, which  
6 included instances where transactions with affiliates were not being recorded on the  
7 Company's books in an accurate and expeditious manner as required by NARUC, is  
8 Staff making additional recommendations to the Commission related to the  
9 Company's accounting practices?

10 A. Yes. Staff recommends that the Commission incorporate the following directives in the  
11 Decision rendered in Docket No. 14-0343:

12 1. The Company should commit to entering into written contracts with its affiliates  
13 governing the design and construction of future utility plant and facilities additions.  
14 Such contracts should incorporate all elements that would reasonably be expected to  
15 be included in an agreement with a non-affiliate entity.<sup>6</sup>

16  
17 2. QCW should be directed to develop and agree to sign a Code-of-Affiliate-Conduct  
18 ("Code") that would be binding upon QCW and all affiliates (regulated and non-  
19 regulated).

20  
21 But for the provisions related specifically to Global Water's Infrastructure  
22 Construction and Financing Agreements ("ICFAs"), the QCW Code should include  
23 provisions similar to the provisions contained in the Code-of-Affiliate-Conduct filed  
24 by Global Water on August 15, 2014 in Docket No SW-20445A-12-0310, and the  
25 accompanying consolidated Dockets.

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<sup>6</sup> QWC already committed to this requirement. See rebuttal testimony of Company witness, Mr. Jones, page 13, lines 5 through 8.

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The Company's draft Code would be submitted to Staff within 90 days of the date of the Commission's Decision in this Docket, and Staff will review the Company's proposed Code and work with the Company regarding any needed revisions. The ultimate content of this Code must be acceptable in all respects to Staff.

3. The 2015 QCW Annual Reports submitted by the Company must reflect proper accrual accounting for all balance sheet and income statement items. This 2015 Annual Report must be accompanied by an Attachment identifying and explaining all changes made within this Report to align QCW's ongoing financial accounting and reporting with correction/revisions resulting from the Commission's Decision in Docket No. 14-0343.

4. The Company should be placed on notice that information related to all material future early plant retirements is to be isolated and set up as potential regulatory assets as discussed in more detail later in my surrebuttal testimony. In essence the accounting related to any material early plant retirement should fall under the provisions of paragraph 27 H of the NARUC Utility Plant Accounting Instructions, excerpts of which are attached to my surrebuttal testimony as Staff Surrebuttal Exhibit 3. This accounting for material early plant retirements would be followed as an alternative to automatically charging the debit side of the asset retirement journal entry against the Company's accumulated depreciation reserve for the underlying plant account.

1    **Q.    Mr. Armstrong, please expand upon point 4 in Staff's list of recommendations, i.e.,**  
2           **why does Staff believe this accounting alternative can be an acceptable way of**  
3           **addressing such material early retirements?**

4    A.    First, let me say that material early retirements should be the exception rather than the rule.  
5           Staff believes that early retirements should be isolated on the utility's books and records so  
6           that all issues and considerations that identify and explain why such early retirements  
7           occurred are readily available.  If a utility knows up front that there are going to be early  
8           retirements, it will be easier for the utility to strive to meet this burden of proof at the time  
9           the need for the early retirement surfaces rather than have Staff determine during the course  
10          of a future rate case audit that such early retirements occurred.  In such instances, the utility  
11          would then have to attempt to surface explanations and support related to the need and  
12          reasonableness of management's early retirement decision.

13  
14          Second, more timely isolation of the financial implications associated with early retirement  
15          decisions will allow the Commission to review and ultimately approve a plan that could  
16          ultimately amortize (and thus remove) the impacts associated with the early retirement from  
17          the books of the utility, instead of leaving this early retirement impact stranded forever within  
18          the utility's accumulated depreciation reserve balance.

19  
20          Obviously, with regards to the QCW early retirement issue, we are not able to insist that the  
21          Company follow this alternative accounting since we are now well after the asset retirement  
22          date.  However, requiring the isolation of relevant information in the future should be  
23          required.

24

1 **Q. Would Staff's recommendation to require QCW to isolate the facts related to such**  
2 **early retirements, provide for a full review and assessment of these facts, that could**  
3 **ultimately lead to the establishment of ACC-authorized regulatory assets, and allow**  
4 **the Commission to address cost-recovery issues in a subsequent QCW rate case?**

5 A. Yes. At that time, the Company would need to show that the early retirement decision was  
6 prudent, and it must also identify and give recognition to all early retirement related factors  
7 such as were insurance proceeds received related to this retirement if this was an insurable  
8 loss.

9  
10 **Q. Are there conditions that would need to be met before this accounting approach could**  
11 **be requested in future QCW rate case dockets?**

12 A. Yes. Staff's recommendations in each rate case are always based upon a specific evaluation of  
13 the evidence presented. But, preliminarily, Staff believes that any early plant retirements  
14 would need to be material and occur before the underlying asset reaches 75% of its original  
15 estimated useful life, as defined by the depreciation rate authorized for this particular asset.  
16 Materiality would be a case-specific determination, but generally Staff believes that materiality  
17 would be defined as a retirement that reduces the recorded depreciation reserve for this asset  
18 class by more than 25%.

19  
20 **Q. Mr. Armstrong would Staff be supportive of a Commission decision to apply this**  
21 **regulatory asset treatment to the QCW Well 16 early retirement?**

22 A. No. Staff stands by the Well 16 recommendations presented in the direct testimony of Staff  
23 witness Mr. Cassidy. In addition to the arguments in Mr. Cassidy's direct testimony, Staff  
24 believes that the history behind the development, ownership, and accounting related to Well

1           16, which was never truly used and useful to ratepayers<sup>7</sup>, remains far too questionable for the  
2           Commission to authorize the cost recoveries requested by the Company. The uncertainty  
3           and haziness cast by the result of Staff's review of the history and facts surrounding this well  
4           should be resolved by the Commission in favor of protecting ratepayers.

5  
6           Notwithstanding all of the explanations provided by QCW witnesses Mr. Jones and Mr.  
7           Bourassa regarding why QCW's accounting and financial reporting shortcomings and  
8           missteps should be of no real concern to the Commission, the fact is that having complete  
9           and accurate accounting is necessary to ensure the proper setting of rates. When there is a  
10          significant breakdown in accounting and financial reporting, there is a higher risk of setting  
11          improper rates, the level of trust declines, and system protections (for ratepayers) diminish.  
12          Accurate accounting assures that the rate setting process works.

13  
14       **Q.    Mr. Armstrong, does this conclude your surrebuttal testimony?**

15       **A.    Yes.**

---

<sup>7</sup> QWC witness Mr. Jones refers to Well 16 as being "only marginally operationally useful" to describe the Well's service history which covered at best one month in 2009 when it was used to deliver water containing high levels of sand to be used and paid for by customers.

UNIFORM SYSTEM OF ACCOUNTS  
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## ACCOUNTING INSTRUCTIONS

not relieve the utility from the responsibility of providing a distribution of the costs of labor or from being able to substantiate its labor charged with sufficient source documents.

### 12. General - Operating Reserves

Accretions to operating reserve accounts made by charges to operating expenses shall not exceed a reasonable provision for the expense. Material balances in such reserve accounts shall not be diverted from the purpose for which provided, unless the permission of the Commission is first obtained.

### 13. General - Records for Each Plant

Separate records shall be maintained by utility plant accounts of the book cost of each plant owned including additions by the utility to plant leased from others and of the cost of operating and maintaining each plant owned or operated.

### 14. General - Accounting for Other Departments

If the utility also operates other utility departments, such as electric, wastewater, gas, etc., it shall keep such accounts for the other departments as may be prescribed by proper authority and in the absence of prescribed accounts, it shall keep such accounts as are proper or necessary to reflect the results of operating each other department.

### 15. General - Transactions with Associated Companies

Each utility shall keep its accounts and records so as to be able to furnish accurately and expeditiously statements of all transactions with associated companies. The statements may be required to show the general nature of the transactions, the amounts involved therein and the amounts included in each account prescribed herein with respect to such transactions. Transactions with associated companies shall be recorded in the appropriate accounts for transactions of the same nature. Nothing herein contained, however, shall be construed as restraining the utility from subdividing accounts for the purposes of recording separately transactions with associated companies.

### 16. General - Contingent Assets and Liabilities

Contingent assets represent a possible source of value to the utility contingent upon the fulfillment of conditions regarded as uncertain. Contingent liabilities include items which may under certain conditions become obligations of the utility but which are

Quail Creek Water  
Annual Report Review  
Docket No. 14-0343

Exhibit - Staff Surrebuttal 1

Line	Year	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	<b>Income Statement:</b>													
	Depreciation Expense			47,838	51,787	60,677	65,702	76,663	89,429	102,736	117,504	253,395	266,378	236,826
	Income Tax			244,297	124,199	162,387	188,480	287,976	167,908	224,220	150,679	51,482	65,338	122,389
	Net Income			139,420	186,299	242,863	271,587	342,906	262,624	166,000	216,768	269,956	189,830	205,347
	<b>Approximate Available</b>													
1	Cash	187,258	238,086	187,258	238,086	303,540	337,289	419,569	352,053	268,736	334,272	523,351	456,808	442,173
	<b>Balance Sheet:</b>													
2	Cash	67,604	93,508	67,604	93,508	72,443	26,732	28,404	22,238	54,094	84,746	76,293	80,775	76,040
	Temp. Cash Investments	-	-	-	-	-	-	-	-	-	-	-	-	-
3	Notes Receivable from Affil.	-	-	-	-	8,616	82,606	17,504	64,161	19,939	146,925	828,893	1,172,323	1,208,407
4	Notes Payable to Affiliates	13,294	55,263	13,294	55,263	-	-	-	-	-	-	-	-	-
	Customer Deposits	-	-	-	-	370,189	332,901	303,042	259,043	231,127	195,179	159,806	180,221	151,157
5	Long-Term Notes	-	-	-	-	-	-	-	-	-	-	-	-	-
6	Equity	2,018,816	2,401,795	2,018,816	2,401,795	2,303,490	2,675,984	3,138,763	3,602,574	4,091,008	7,035,078	7,772,171	8,031,573	8,199,705
	Utility Plant in Service:													
	Org. Cost	1,964,506	2,363,550	1,964,506	2,363,550	2,592,620	2,899,547	3,395,897	3,775,218	4,248,102	6,998,586	7,026,791	6,958,696	7,066,415
	Accumulated Depreciation	556,053	607,840	556,053	607,840	668,517	734,218	810,882	900,312	1,003,047	1,120,552	1,373,947	1,054,550	1,291,376
	OCLD	1,408,453	1,755,710	1,408,453	1,755,710	1,924,103	2,165,329	2,585,015	2,874,906	3,245,055	5,878,034	5,652,844	5,904,146	5,775,039
9	Gross Plant Investments	399,044	229,070	399,044	229,070	306,927	306,927	496,350	379,321	472,884	2,750,484	28,205	(68,095)	107,719
	<b>Plant Additions Reflected</b>													
	In Actual Years	-	90,390	-	90,390	221,062	174,844	174,844	510,205	(996,501)	(960,590)			
10		193,816		776,457		184,133			(193,816)	(450,000)				
	<b>Total Indicated Changes to</b>													
11	Gross Plant by Year <sup>1</sup>	193,816	1,226,457	1,226,457	90,390	405,195	174,844	316,389	(450,000)	(1,957,091)				

<sup>1</sup> Staff would note that reported depreciation expense and the resulting depreciation reserve would also change.

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## DEFINITIONS

24. "Premium", as applied to the securities issued or assumed by the utility, means the excess of the cash value of the consideration received from their sale over the sum of their par (stated value of no-par stocks) or face value and interest or dividends accrued at the date of sale.
25. "Property retired", as applied to utility plant, means property which has been removed, sold, abandoned, destroyed, or which for any cause has been permanently withdrawn from service.
26. "Reclaimed water" means water that has received at least secondary treatment and basic disinfection and is reused after flowing out of a wastewater treatment plant.
27. "Regulatory Assets and Liabilities" are assets and liabilities that result from rate actions of regulatory agencies. Regulatory assets and liabilities arise from specific revenues, expenses, gains or losses that would have been included in determination of net income in one period under the general requirements of the Uniform System of Accounts but for it being probable that; 1) such items will be included in a different period(s) for purposes of developing the rates the utility is authorized to charge for its utility services; or 2) in the case of regulatory liabilities, that refunds to customers, not provided for in other accounts, will be required. Regulatory assets and liabilities can also be created in reconciling differences between the requirements of generally accepted accounting principles, regulatory practice and tax laws.
28. "Replacing" or "replacement", when not otherwise indicated in the context, means the construction or installation of utility plant in place of property of retired, together with the removal of the property retired.
29. "Research and development" means expenditures incurred by public utilities which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned.
30. "Retained earnings" means the accumulated net income of the utility less distributions to stockholders and transfers to other capital accounts, and other adjustments (See account 439 - Adjustments to Retained Earnings).
31. "Retirement units" means those items of utility plant which, when retired, with or without replacement, are accounted for by crediting the original costs.

## ACCOUNTING INSTRUCTIONS

or in "stores", shall be charged to the plant account appropriate for their use.

C. The equipment accounts shall include angle irons and similar items which are installed at the base of an item of equipment, but piers and foundations which are designed to be as permanent as the buildings which house the equipment, or which are constructed as a part of the buildings and which cannot be removed without cutting into the walls, ceilings or floors without in some way impairing the building, shall be included in the building accounts.

D. The equipment accounts shall include the necessary costs of testing or running a plant or part thereof during an experimental or test period prior to becoming available for service. The utility shall furnish the Commission with full particulars of and justification for any test or experimental run extending beyond a period of thirty days.

E. The cost of efficiency or other tests made subsequent to the date equipment becomes available for service shall be charged to the appropriate expense accounts, except that tests to determine whether equipment meets the specifications and requirements as to efficiency, performance, etc., guaranteed by manufacturers, made after operations have commenced and within the period specified in the agreement or contract of purchase, may be charged to the appropriate utility plant account.

### 27. Utility Plant - Additions and Retirements

A. For the purpose of avoiding undue refinement in accounting for additions to and retirements and replacements of utility plant, all property shall be considered as consisting of (1) retirement units and (2) minor items of property. Each utility shall use such list of retirement units as is in use by it at the effective date hereof or as may be prescribed by the Commission, with the option, however, of using smaller units, provided the utility's practice in this respect is consistent.

B. The addition and retirement of retirement units shall be accounted for as follows:

- (1) When a retirement unit is added to the utility plant, the cost thereof shall be added to the appropriate utility plant account, except that when units are acquired in the acquisition of any utility plant constituting an operating system, they shall be accounted for as provided in Instruction 21.

## ACCOUNTING INSTRUCTIONS

- (2) When a retirement unit is retired from utility plant, with or without replacement, the book cost thereof shall be credited to the utility plant account in which it is included, determined in the manner set forth in paragraph D, below. If the retirement unit is of a depreciable class, the book cost of the unit retired and credited to utility plant shall be charged to the accumulated depreciation applicable to such property. The cost of removal and the salvage shall be charged or credited, as appropriate, to such depreciation account.

C. The addition and retirement of minor items of property shall be accounted for as follows:

- (1) When a minor item of property which did not previously exist is added to plant and a substantial addition results, the cost thereof shall be accounted for in the same manner as for the addition of a retirement unit, as set forth in paragraph B(1), above, otherwise the charge shall be to the appropriate maintenance expense account.
- (2) When a minor item of property is retired and not replaced, the book cost thereof shall be credited to the utility plant account in which it is included; and, in the event the minor item is a part of a depreciable plant, the account for accumulated depreciation shall be charged with the book cost and cost of removal and credited with the salvage. If, however, the book cost of the minor item retired and not replaced has been or will be accounted for when such unit is retired, no separate credit to the property account is required.
- (3) When a minor item of depreciable property is replaced independently of the retirement unit of which it is a part, the cost of replacement shall be charged to the maintenance expense account appropriate for the item, except that if the replacement effects a substantial betterment (the primary aim of which is to make the property affected more useful, more efficient, of greater durability, or of greater capacity), the excess cost of the replacement over the estimated cost at current prices of replacing without betterment shall be charged to the appropriate utility plant account.

D. The book cost of the utility plant retired shall be the amount at which such property is included in the utility plant accounts, including all components of construction costs. The book cost shall be determined from the utility's records and if this cannot be done, it shall be estimated. When it is impracticable to

## ACCOUNTING INSTRUCTIONS

determine the book cost of each unit, due to the relatively large number or small cost thereof, an appropriate average book cost of the units, with due allowance for any differences in size and character, shall be used as the book cost of the units retired.

E. The book cost of land retired shall be credited to the appropriate land account. If the land is sold, the difference between the book cost and the sale price of the land (less commissions and other expenses of making the sale) shall be included in account 414 - Gains (Losses) from Disposition of Utility Property, unless otherwise authorized or required by the Commission. If the land is not used in utility service but is retained by the utility, the book cost shall be charged to account 103 - Property Held for Future Use, or account 121 - Nonutility Property, as appropriate.

F. The book cost less net salvage of depreciable utility plant retired shall be charged in its entirety to account 108.1 - Accumulated Depreciation of Utility Plant in Service. Any amounts which, by approval or order of the Commission, are charged to account 182 - Extraordinary Property Losses, shall be credited to account 108.1 - Accumulated Depreciated of Utility Plant in Service.

G. The accounting for the retirement of amounts included in account 302 - Franchises and the items of limited term interest in land included in the accounts for land and land rights shall be as provided for in the text of account 110.1 - Accumulated Amortization of Utility Plant in Service, account 407.1 - Amortization of Limited Term Plant and account 407.3 - Amortization of Other Utility Plant.

H. In some instances the unexpected early retirement of a major unit of property, which would eliminate or seriously deplete the existing depreciation reserve, may require accounting treatment which differs from that described in paragraph B above. In such instances the Commission may authorize or order the loss on retirement (less any tax savings) to be charged to income in the current year or transferred to account 186 - Miscellaneous Deferred Debits, and amortized in future periods. Such accounting treatment shall be used only when specifically authorized or directed by the Commission.

QUAIL CREEK WATER COMPANY, INC.  
DOCKET NOS. W-02514A-14-0343  
RESPONSES TO STAFF'S FIRST SET OF DATA REQUESTS

November 21, 2014

Respondent: Thomas J. Bourassa, CPA

Title: Consultant

Address: 139 W. Wood Drive  
Phoenix, AZ 85029

Company Response Number: JAC 1-2

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Q. Cross References For General Ledger – Please provide a cross reference to show the general ledger accounts combined for presentation of each line item in Schedules B-1 and C-1.

RESPONSE: The Company follows the National Association of Regulatory Commissioners (“NARUC”) Uniform System of Accounts. Please see tabs “E-1” and “E-2” in the work paper file “Quail Creek Water Standard Filing Schedules.xlsx” provided herewith for cross-references to GL.