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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE JOINT  
APPLICATION OF WILLOW VALLEY  
WATER CO., INC. AND EPCOR WATER  
ARIZONA, INC. FOR APPROVAL OF THE  
SALE OF ASSETS AND TRANSFER OF  
CERTIFICATE OF CONVENIENCE AND  
NECESSITY.

Docket No. W-01732A-15-0131  
Docket No. W-01303A-15-0131

RUCO'S NOTICE OF FILING

The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing  
the Direct Testimony of Jeffrey M. Michlik, in the above-referenced matter.

RESPECTFULLY SUBMITTED this 9<sup>th</sup> day of October, 2015

Daniel W. Pozefsky  
Chief Counsel

AN ORIGINAL AND THIRTEEN COPIES  
of the foregoing filed this 9<sup>th</sup> day  
of October, 2015 with:

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Arizona Corporation Commission  
1200 West Washington  
Phoenix, Arizona 85007

1 COPIES of the foregoing hand delivered/  
mailed this 9th day of October, 2015 to:

2  
3 Scott Hesla  
4 Hearing Division  
5 Arizona Corporation Commission  
6 1200 W. Washington  
7 Phoenix, Arizona 85007

8  
9 Robin Mitchell  
10 Legal Division  
11 Arizona Corporation Commission  
12 1200 West Washington  
13 Phoenix, Arizona 85007

14  
15 Thomas Broderick  
16 Utilities Division  
17 Arizona Corporation Commission  
18 1200 W. Washington  
19 Phoenix, Arizona 85007

20  
21 Thomas Campbell  
22 Stanley B. Lutz  
23 Lewis Roca Rothgerber, LLP  
24 201 E. Washington Street  
Phoenix, Arizona 85004  
Attorneys for EPCOR Water Arizona, Inc.

1 Timothy Sabo  
2 Snell & Wilmer  
3 One Arizona Center  
4 400 E. Van Buren, Suite 1900  
5 Phoenix, Arizona 85004  
6 Attorneys for Willow Valley Water Co.,  
7 Inc.

8  
9  
10 By Cheryl Frouloub

11  
12  
13  
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EPCOR WATER ARIZONA, INC.  
DOCKET NOS. W-01732A-15-0131 and W-01303A-15-0131

DIRECT TESTIMONY  
OF  
JEFFREY M. MICHLIK

ON BEHALF OF THE  
RESIDENTIAL UTILITY CONSUMER OFFICE

OCTOBER 9, 2015

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## EXECUTIVE SUMMARY

On April 22, 2015 Willow Valley Water Co., Inc. ("Willow Valley") and EPCOR Water Arizona Inc. ("EWAZ") filed an application with the Arizona Corporation Commission ("Commission") requesting the sale of Willow Valley's utility system and transfer of its Certificate of Convenience and Necessity ("CC&N") to EWAZ.

On June 1, 2015 EWAZ made a supplemental filing seeking approval of recovery of price paid in excess of rate base, in other words an acquisition premium to be paid by ratepayers in the future.

The direct testimony of Jeffrey M. Michlik is limited to the Acquisition Premium and the Accumulated Deferred Income Tax ("ADIT").

RUCO recommends that no acquisition premium be authorized by the Commission in this case, simply because there are no benefit(s) to ratepayers in this case.

The acquisition premium methodology as proposed in this case is similar to a SIB and may be illegal. (i.e. An increase in rates between rate cases without a fair value determination)

RUCO recommends that ratepayers be held harmless and that the ADIT balance of \$260,224 also be transferred to EWAZ, and reclassified as a regulatory liability for ratemaking purposes, which is just good public policy.

1 **I. INTRODUCTION**

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

3 A. My name is Jeffrey M. Michlik. I am a Public Utilities Analyst V employed  
4 by the Arizona Residential Utility Consumer Office ("RUCO"). My business  
5 address is 1110 West Washington Street, Suite 220, Phoenix, Arizona  
6 85007.

7

8 **Q. Briefly describe your responsibilities as a Public Utilities Analyst V.**

9 A. In my capacity as a Public Utilities Analyst V, I analyze and examine  
10 accounting, financial, statistical and other information and prepare reports  
11 based on my analyses that present RUCO's recommendations to the  
12 Arizona Corporation Commission ("Commission") on utility revenue  
13 requirements, rate design and other matters. I also provide expert  
14 testimony on these same issues.

15

16 **Q. Please describe your educational background and professional  
17 experience.**

18 A. In 2000, I graduated from Idaho State University, receiving a Bachelor of  
19 Business Administration Degree in Accounting and Finance, and I am a  
20 Certified Public Accountant with the Arizona State Board of Accountancy. I  
21 have attended the National Association of Regulatory Utility  
22 Commissioners' ("NARUC") Utility Rate School, which presents for study

1 and review general regulatory and business issues. I have also attended  
2 various other NARUC sponsored events.

3

4 I joined RUCO as a Public Utilities Analyst V in September of 2013. Prior to  
5 my employment with RUCO, I worked for the Arizona Corporation  
6 Commission in the Utilities Division as a Public Utilities Analyst for a little  
7 over seven years. Prior to employment with the Commission, I worked one  
8 year in public accounting as a Senior Auditor, and four years for the Arizona  
9 Office of the Auditor General as a Staff Auditor.

10

11 **Q. What is the scope of your testimony in this case?**

12 A. I am presenting RUCO's analysis of EWAZ's proposed acquisition premium  
13 and the Accumulated Deferred Income Tax ("ADIT") issue, and not the sale  
14 of Willow Valley's assets or the transfer of the CC&N to EWAZ.

15

16 **II. BACKGROUND**

17 **Q. Please review the background of this application.**

18 A. EPCOR Water Arizona Inc. ("EWAZ" or "Company") is an Arizona "C"  
19 Corporation.<sup>1</sup> EPCOR is a for profit, certificated Arizona public service  
20 corporation that provides water and wastewater utility service to various  
21 communities throughout the State of Arizona. Global Water Resources Inc.

---

<sup>1</sup> On February 1, 2012, EPCOR Water (USA) Inc. ("EWUS") acquired all of Arizona American Water Company's District in Arizona and in New Mexico.

1 (“Global”) is also an Arizona “C” Corporation, and is also a for profit, Arizona  
2 public service corporation that provides water and wastewater utility  
3 services to various communities throughout Arizona. On April 22, 2015,  
4 EWAZ and Global filed a joint application requesting Commission  
5 authorization for the sale and transfer of its Certificate of Convenience and  
6 Necessity (“CC&N”) from Global to EWAZ. In the initial application EWAZ  
7 also asked for an acquisition adjustment, and on June 1, 2015 filed a  
8 supplemental application describing how the acquisition adjustment  
9 mechanism would work. EWAZ’s corporate business office is located at  
10 2355 W. Pinnacle Peak Road, Suite 300 Phoenix, Arizona 85027. Global’s  
11 corporate business office is located at 21410 North 14<sup>th</sup> Avenue Suite 201,  
12 Phoenix, Arizona 85027. Both companies are classified as class A utility  
13 companies.

14  
15 Willow Valley is an Arizona Corporation that provides water utility service to  
16 approximately 1,620 customers in portions of Mohave County. Willow  
17 Valley received its CC&N pursuant to Decision No. 32436 (August 23,  
18 1960). Willow Valley is a subsidiary of Global.

19  
20 **III. EWAZ’S AND GLOBAL’S CORPORATE STRUCTURE**

21 **Q. Can you provide additional background on EWAZ’s corporate**  
22 **structure?**

23 **A. Yes.**

1           EWAZ

2           EWAZ is a subsidiary of the ultimate parent company EPCOR Utilities Inc.

3           The City of Edmonton, Canada is EPCOR Utilities Inc.'s sole shareholder.

4

5           Since the Company took over operations from Arizona American Water

6           Company in February 2012, the following dividend payments have been

7           made:

8                   December 2012                   \$ 10,378,122

9                   March 2014                           3,691,533

10                  June 2014                           9,892,890

11                  Total                               \$ 23,962,545

12

13           Further, EWAZ states it targets 75 percent of its net income to dividend to

14           its parent Company in Canada which ultimately benefits the citizens of

15           Edmonton Canada.<sup>2</sup> EWAZ refused to update its dividend payout

16           information (a copy of all relevant data requests have been included in

17           Attachment B).

18

19           Global

20           Global Water Resources Corp was incorporated in British Columbia to

21           acquire shares of U.S. based Global Water and to actively participate in the

22           management, business and operations of Global Water through its

---

<sup>2</sup> See Direct Testimony of RUCO Witness Jeffrey M. Michlik in Docket No. WS-01303A-14-0010, page 7.

1 representation on the board of directors of Global Water and its shared  
2 management of Global Water. GWRC owns an approximate 48.1% interest  
3 in Global Water.

4  
5 Global refused to provide dividend payout information on its other operating  
6 systems, but stated Willow Valley has not distributed earnings to its parent  
7 company.<sup>3</sup> Subsequently, RUCO was able to review the Company's audited  
8 financial statement via its website and determined the following liabilities  
9 were incurred at the end of December:

10 2014 Dividends Payable approximately \$212,000

11 2013 Dividends Payable approximately \$10,000

12  
13  
14 **Q. Why is dividend payout information important and relevant to this**  
15 **proceeding?**

16 A. Commissioners need to identify financial viability concerns that may arise,  
17 as a result of Companies paying excessive dividends to shareholders  
18 instead of reinvesting accumulated earnings in deteriorating Arizona water  
19 and wastewater plant. Dividends are paid out of retained earnings which  
20 is a consideration in assessing the viability of the transaction as well as the  
21 merits of a proposed acquisition premium. It is also noteworthy that EWAZ  
22 objected to RUCO's review of their board minutes (see RUCO data request

---

<sup>3</sup> See RUCO data request 4.03.

1 1.04). The board minutes might have contained information that reflected  
2 any concerns the board might have had over the acquisition.

3  
4 **IV. EWAZ'S REQUEST FOR AN ACQUISITION PREMIUM**

5 **Q. Please provide background details on the Company's proposed sale,**  
6 **transfer of its Certificate of Convenience and Necessity ("CC&N"), and**  
7 **acquisition premium.**

8 **A.** On April 22, 2015, EWAZ and Global filed a joint application, requesting the  
9 Commission approve the sale of Global's Willow Valley Utility System and  
10 the transfer of its Certificate of Convenience and Necessity ("CC&N") to  
11 EWAZ. The Company also asked for an acquisition premium the details of  
12 which would be forthcoming in a supplemental filing. The Company filed a  
13 supplement to its application seeking approval and recovery of its price paid  
14 in excess of rate base on June 1, 2015. EWAZ is asking for recovery of  
15 approximately \$226,803 (i.e. purchase price of \$2,494,834 less \$2,268,031)  
16 through a surcharge mechanism as shown below:

17	Net Utility Plant in Service	\$2,796,377
18	Less: Advances and Contributions	<u>(\$ 528,346)</u>
19		\$2,268,031
20		
21	Purchase Price	\$2,494,834
22	Less:	<u>(\$2,268,031)</u>
23	Acquisition Premium	\$ 226,803
24		

1 **Q. Please further explain the Company's proposed acquisition**  
2 **adjustment mechanism?**

3 A. The Company has proposed to invest \$1,000,000 in utility plant over a  
4 period of five years. Although confusing, the Company would let the  
5 Commission decide how much of an incentive the Company should receive  
6 - a 10 percent, 15 percent, or 20 percent premium incentive that will  
7 eventually be passed on to its ratepayers as an annual surcharge  
8 mechanism.

9  
10 **Q. Does RUCO have any legal concern with the Company's acquisition**  
11 **premium adjustment mechanism?**

12 A. Yes. The Company's proposed acquisition adjustment seems very similar  
13 to a System Improvement Benefits ("SIB") Mechanism in which utility plant  
14 is built between rate cases. The Arizona Court of Appeals subsequently  
15 determined that the SIB was illegal (see Attachment A). This is basically the  
16 same situation in this case as the acquisition premium as proposed will  
17 create rate increases between rate cases without a fair value  
18 determination.<sup>4</sup>

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<sup>4</sup> This is based on RUCO's interpretation of the Company's supplement to application seeking approval of recovery of price paid in excess of rate base, page 6 which states "If approved by the Commission, EWAZ would work with Commission Staff to create standard reporting procedures to monitor annual progress of the additional capital projects, and to phase in the surcharge as projects are completed. In addition, EWAZ would provide a report to Commission Staff annually, summarizing total surcharge revenues collected and provide for early termination of the surcharge should full recovery of the Acquisition Premium occur prior to the authorized term of recovery. EWAZ would not expect the surcharge to continue further than the originally-authorized term, and would accept the risk of non-recovery of the full Acquisition Premium upon expiration of the authorized surcharge period."

1 RUCO also has prudence concerns. The ratemaking principle of prudence,  
2 addresses the issue of whether a Company's investment was reasonable,  
3 dishonest or wasteful. In this case, EWAZ is asking the Commission to  
4 predetermine the prudence of the plant. The determination of prudence is  
5 traditionally made when the plant is in the ground and is used and useful.  
6 In other words the plant is in service and servicing ratepayers. Here the  
7 Company will be asking the Commission to make a determination before  
8 the plant is in service and useful to the ratepayers.

9

10 **Q. Did Global Water pay a premium when the Willow Valley Company was**  
11 **purchased?**

12 A. Yes.

13

14 **Q. Did the Arizona Corporation Commission approve an acquisition**  
15 **adjustment when Global purchased Willow Valley?**

16 A. No.

17

18 **Q. Can you briefly describe the acquisition of the Willow Valley Company**  
19 **when purchased by Global Water Company?**

20 A. Yes. The Willow Valley acquisition was part of the West Maricopa Combine  
21 that was purchased by Global in 2006. Global paid approximately \$55.4  
22 million for the West Maricopa Combine and approximately \$45.8 was  
23 recorded as Goodwill. As of December 31, 2011, the Goodwill balance

1 (acquisition premium) on Global's Audited Financial Statements related to  
2 the purchase of the West Maricopa Combine was \$13,081,831 of which  
3 \$398,499 was attributable to Willow Valley.<sup>5</sup>  
4

5 **Q. Has there been an "impairment" adjustment recorded on the books of**  
6 **Willow Valley since that time and if there has been why that is**  
7 **important?**

8 **A.** Yes. An impairment adjustment of \$175,837<sup>6</sup> was recorded in June 2015.  
9 An impairment adjustment is recorded when the fair value of the assets that  
10 were purchased is less than the book value of the assets. In other words  
11 Global overpaid for the assets and now the excess purchase price is being  
12 written off to expense. Obviously, RUCO is concerned that EPCOR will be  
13 following in the same footsteps as Global did when it originally purchased  
14 the Willow Valley System. Over-paying for the assets involved in the  
15 purchase and at some future date the excess payment could be impaired  
16 and ultimately written off to expense. This type of ratemaking incentivizes  
17 overpayment by the large utility companies which is bad public policy and  
18 perhaps explains the purchase here.  
19  
20  
21

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<sup>5</sup> See Company response to RUCO DR No. 3.04

<sup>6</sup> See Company response to RUCO DR No. 3.06

1 **V. DUE DILIGENCE**

2 **Q. Did RUCO examine EWAZ's due diligence work papers related to the**  
3 **sale price of Willow Valley?**

4 A. Yes. Both myself and Mr. Mease visited EWAZ's corporate headquarters in  
5 Arizona on August 28, 2015.

6

7 **Q. Did the Company do any type of Net Present Value Analysis ("NPV")**  
8 **or revenue/cash stream projection analysis?**

9 A. RUCO is not sure. The Company stated it did in response to RUCO data  
10 request number 4.04, however, during our visit on August 28<sup>th</sup>, we were  
11 informed that no such analysis was performed. RUCO asked the Company  
12 to explain the discrepancy, but RUCO has not received a response at the  
13 time of this filing.

14

15 **Q. Should acquiring utility companies do a NPV analysis?**

16 A. Yes. Companies will typically perform a NPV analysis of future revenue  
17 streams to determine if the acquisition will be profitable and if the investment  
18 will provide the expected returns over a defined period of time. Companies  
19 can put themselves in a difficult financial situations if such analyses are not  
20 performed. When earnings suffer in a regulated environment it's the  
21 ratepayers who end up paying for these deficiencies.

22

1 **Q. How did the Company determine that a ten percent acquisition**  
2 **premium was warranted in this case?**

3 A. In response to RUCO 3.02, EWAZ stated "The fair market value was  
4 determined through negotiation of an arms-length transaction between  
5 unrelated parties. A value based on a multiple applied to the calculation of  
6 rate base was the result of protracted negotiations and represented the  
7 lowest multiple the seller was willing to accept to sell their assets and forego  
8 their reasonable expectation of returns on the capital investments their  
9 investors have made in the provision of service to the system's customers."

10  
11 RUCO's interpretation is that this is the lowest price that Global was willing  
12 to accept. In this case, it does not make sense to invest almost \$2.5 million  
13 in a water system that EWAZ may not earn a return on its investment or  
14 worse recovery of its investment. Unless of course, the Company can pass  
15 the costs on to ratepayers in the form of an acquisition premium.

16

17 **VI. GENERIC DOCKET NO. WS-00000A-14-0198**

18 **Q. Was there a generic Commission docket opened recently to discuss**  
19 **Acquisitions and Consolidations in Arizona's Water & Wastewater**  
20 **Industry?**

21 A. Yes, generic docket WS-00000A-14-0198, was opened "In the matter of the  
22 Commission's inquiry into the possible development of regulatory policies

1 and strategies to evaluate and potentially encourage consolidation  
2 concerning Arizona's water and wastewater utilities industry.”

3

4 **Q. Did RUCO co-author a white paper on the issue along with Paul Walker**  
5 **chairman, Arizonans for Responsible Water a trade group for the water**  
6 **industry in Arizona?**

7 A. Yes, this was docketed on June 20, 2014.

8

9 **Q. Did RUCO withdraw its support of the paper?**

10 A. Yes. On June 23, 2014 RUCO withdrew its support. Unfortunately, RUCO  
11 could no longer support the White Paper it co-authored in good faith  
12 because it was unsure that its underlying principles will be adhered to by  
13 the Commission. However, a few of the excerpts from that paper are  
14 illustrative.

15

16 The authors' reference : Judge Learned Hand, one of America's greatest  
17 jurists, in the 1943 *Niagara Falls Power Co.* decision, and Professor James  
18 Bonbright, who wrote "Principles of Public utility Rates". These scholars  
19 noted that there are two sources that must be considered when determining  
20 the justness of an acquisition adjustment. If the rate base were to be set at  
21 the price paid by the new purchaser, then "the [company] who does not sell  
22 is confined for [its rate] base to [its] original cost; [the company who sells  
23 can assure the buyer that [it] may use as a base whatever [the buyer] pays

1 in good faith. If the [seller] can persuade the buyer to pay more than the  
2 original cost the difference becomes a part of the [rate] base and the public  
3 must pay rates computed upon the excess. Surely this is a most undesirable  
4 conclusion. - *Niagara Falls Power Co. v. Federal Power Commission*, 137  
5 F (24 787,793 (1943)

6  
7 Judge Hand went on to further note that if the regulator simply allows any  
8 cost above original cost to be included in rate base, the seller will “assure  
9 the buyer that [it] may use as a base whatever [the buyer] pays in good  
10 faith.” This will increase sales, but it will do so by changing the economics  
11 so that buyers become more indifferent to the purchase price, and sellers  
12 realize that the regulatory price constraint no longer exerts a downward  
13 force on the price they ask.”<sup>7</sup>

14  
15 “Therefore the Commission should not do what Judge Hand warned about,  
16 it should not simply allow any cost above original cost to be included in rate  
17 base.”<sup>8</sup>

18  
19 Likewise, Professor Bonbright in “Principles of Public Utility Rates,” stated  
20 that “Investors are not compensated for buying utility enterprises from their

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<sup>7</sup> Please see *The Challenges of Consolidating an Industry* by Pat Quinn, BS, MS, Mathematics and Paul Walker, BS, MBA, Business Administration. Page 17.

<sup>8</sup> Ibid at 18.

1 previous owners... Instead, they are compensated for devoting capital to the  
2 public service.”<sup>9</sup>

3

4 **Q. Interestingly enough was EWAZ mentioned in the white paper?**

5 A. Yes. “Sometimes, that sunk cost is adequately compensated by the  
6 opportunity to grow the acquired entity or simply through the revenue  
7 stream from the acquired company. An example of that sort of acquisition  
8 is EPCOR’s acquisition of Chaparral Water in Fountain Hills. EPCOR paid  
9 an acquisition cost approximately 30% higher than Chaparral’s book value,  
10 but the economics didn’t necessitate an acquisition adjustment.

11

12 That example comes with a huge caveat - Chaparral Water was, by all  
13 accounts, a successful, capable, well-managed company with more than  
14 adequate financial, managerial, and technical ability. ***What Acquisition  
15 Adjustments and a Consolidation policy must address are companies  
16 that aren’t viable, or are in danger of falling into crisis because they  
17 lack the financial, managerial, and technical ability to deal with current  
18 and looming issues*** (such as, e.g., Arizona’s drought.)”<sup>10</sup>

19

20

21

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<sup>9</sup> Ibid at 17.

<sup>10</sup> Ibid. at 17

1 **VII. PRIOR STAFF AND COMMISSION POLICY**

2 **Q. Has Staff proposed a policy for class D and E water system**  
3 **Acquisitions?**

4 A. Yes (see Attachment C).

5  
6 **Q. Did Staff layout six general conditions that a water company must**  
7 **meet in order to qualify for an acquisition adjustment?**

8 A. Yes. Staff stated that the following six conditions must be proven by a  
9 preponderance of the evidence in order to obtain an acquisition adjustment:

- 10 1. The acquired Company is a Class D or E.
- 11 2. The acquisition will not negatively affect the viability of the  
12 acquirer.
- 13 3. The acquired system's customers will receive improved  
14 service in a reasonable timeframe.
- 15 4. The purchase price is fair and reasonable (even though that  
16 price may be more than the original cost less depreciation  
17 book value) and conducted through an arm's length  
18 negotiation.
- 19 5. The recovery period for the acquisition adjustment should be  
20 for a specific minimum time.
- 21 6. The Acquisition is in the public interest.

22  
23

1 **Q. Did Staff update its acquisition policy?**

2 A. Yes (see Attachment C). On March 19, 2012, Staff filed a memorandum  
3 discussing acquisition premiums again.

4  
5 **Q. Has the Commission ever granted an acquisition premium?**

6 A. Based on Staff's analysis the answer is no, based on the definition of a true  
7 acquisition premium.

8  
9 **VIII. RUCO'S ANALYSIS**

10 **Q. What is RUCO's analysis of Staff's acquisition premium conditions as**  
11 **they pertain to the present acquisition?**

12 A. Condition number one – Willow Valley is owned by Global a class A utility,  
13 and as such does not qualify under Staff's first condition.

14  
15 Condition number two – EWAZ claims they are financially viable, however,  
16 in their last rate case just recently completed they claim they were not  
17 unless they received a higher Return on Equity ("ROE"). Further, RUCO  
18 also noted several legal disputes that may or may not have been settled  
19 which could affect the Company's financial viability (see Attachment D).

20  
21 Condition number three – There is no evidence of improved service in a  
22 reasonable timeframe. There are no ADEQ violations or ADWR violations.

1           There is a reliable source of water, capacity, distribution, and customer  
2           service.

3  
4           Condition number four – One can argue whether the purchase is an arm's  
5           length transaction or not, since there may or may not have been an  
6           adequate financial analysis conducted. (i.e. NPV analysis)

7  
8           Condition number five – The Company has offered various payback  
9           periods.

10  
11          Condition number six – RUCO does not believe this acquisition is in the  
12          public interest. The water company is not insolvent. The company is able to  
13          serve water that meets the quality standards as set forth in the Safe Drinking  
14          Water Act. Global is a class A utility and has access to financial markets.  
15          EWAZ could not provide any efficiencies and/or economies of scale above  
16          what Global is providing. There are no clear quantifiable and substantial  
17          benefits to ratepayers that will result.

18  
19          Simply transferring ownership of a utility from one class A utility to another  
20          class A utility does not warrant an acquisition adjustment.

21  
22          Likewise, in Staff's updated policy memo, the Company fails to meet any of  
23          following conditions:

- 1                   1.     Demonstrating clear, quantifiable and substantial benefits
- 2                             realized by ratepayers that are unlikely to have been realized
- 3                             had the transaction not occurred.
- 4                   2.     Balancing the value of the realized benefits against the rate
- 5                             impact.
- 6                   3.     Granting any recovery of an acquisition premium over an
- 7                             extended time and requiring continued recovery to be re-
- 8                             justified in subsequent rate proceedings to encourage
- 9                             continuous delivery of improved, quality service.

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**Q.     Are there any other resources that RUCO used in its analysis?**

A.     Yes (see Attachment E and Attachment F). Again, reasons for allowing an acquisition adjustment seem to be similar in nature, as shown in (Attachment E).

1.     When acquisitions represent an essential or desirable part of an integration of facilities program devoted to better serving the public,
2.     When acquisitions are clearly in the public interest, because operating efficiencies offset the excess price over net original cost; and
3.     When acquisitions are determined to involve arm's-length bargaining.

1 Similarly RUCO reviewed other Public Utility Commissioners' policies on  
2 Acquisition Adjustments (see Attachment F). Again ***the results are the***  
3 ***same, they are very limited and when an acquisition was granted it***  
4 ***must benefit the ratepayers.***

5

6 **IX. RUCO'S RECOMMENDATION**

7 **Q. What is RUCO's recommendation?**

8 A. RUCO recommends that no acquisition premium be authorized by the  
9 Commission in this case, simply because there are no benefit(s) to  
10 ratepayers in this case.

11

12 **X. ACCUMULATED DEFERRED INCOME TAX ("ADIT") ISSUE**

13 **Q. Please explain the term Accumulated Deferred Income Tax.**

14 A. In its simplest form, ADIT is a timing difference between what is recorded  
15 on the Company's books and what the Company records for tax purposes.  
16 Generally the difference arises based on the use of straight line depreciation  
17 for book purposes which the National Association of Regulatory  
18 Commissioners ("NARUC") mandates and the use of accelerated  
19 depreciation for Federal and State tax reporting purposes. This causes  
20 higher depreciation expense for tax purposes than for regulatory book  
21 purposes in the earlier years and then this timing difference reverses in later  
22 years. The difference is a source of interest-free funds, provided by  
23 ratepayers and not investors. This accumulated balance of interest-free

1 funds (ADIT) is available to the utility to further invest until it is then needed  
2 to fund the taxes due and payable in the later years.

3

4 **Q. Does the Company intend to carry forward Global's ADIT balance on**  
5 **its books?**

6 A. Based on Staff data request 4.6, EWAZ does not give any recognition of  
7 Global's ADIT credit of \$293,862 offset by a \$33,638 ADIT debit for a net  
8 ADIT credit of \$260,224.

9

10 **Q. Please elaborate?**

11 A. Generally, the ADIT balance serves as a reduction to rate base in rate  
12 proceedings, and benefits ratepayers. However, in an asset sale as is the  
13 case here, the deferred income tax balances remain with the seller. So as  
14 a result of this accounting transaction, ratepayers in Willow Valley will lose  
15 the benefit of \$260,224, which would have provided rate relief in future rate  
16 case proceedings. This is another reason why EWAZ's acquisition premium  
17 should be denied.

18

19 **Q. Can something be done to ameliorate this inequity?**

20 A. Yes. Commissions across the country have approved ratepayer protection  
21 mechanisms (hold harmless provisions). In this case the Commission could  
22 as part of the sale of assets and transfer of the CC&N, order EWAZ to

1           transfer the ADIT balance and reclassify it as a regulatory liability for  
2           regulatory ratemaking purposes.

3

4   **Q.    What is RUCO's recommendation?**

5   A.    RUCO recommends that ratepayers be held harmless and that the ADIT  
6           balance of \$260,224 also be transferred to EWAZ, and reclassified as a  
7           regulatory liability for ratemaking purposes, which is just good public policy.

8

9   **Q.    Does this conclude your direct testimony?**

10  A.    Yes.

11

# ATTACHMENT A

IN THE  
**ARIZONA COURT OF APPEALS**  
DIVISION ONE

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RESIDENTIAL UTILITY CONSUMER OFFICE, an agency of the State  
of Arizona, *Appellant*,

*v.*

THE ARIZONA CORPORATION COMMISSION, *Appellee*.

ARIZONA WATER COMPANY, *Intervenor*.

No. 1 CA-CC 13-0002  
1 CA-CC 14-0001  
(Consolidated)  
FILED 8-18-2015

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Arizona Corporation Commission  
No. W-01445A-11-0310  
W-01445A-12-0348

**AFFIRMED IN PART; VACATED IN PART**

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COUNSEL

Ridenour Hienton, P.L.L.C., Phoenix  
By Scott S. Wakefield  
*Co-Counsel for Appellant*

Residential Utility Consumer Office, Phoenix  
By Daniel W. Pozefsky  
*Co-Counsel for Appellant*

Arizona Corporation Commission, Legal Division, Phoenix  
By Janice M. Alward, Wesley C. Van Cleve, Charles H. Hains, Bridget A.  
Humphrey  
*Counsel for Appellee Arizona Corporation Commission*

Bryan Cave, L.L.P., Phoenix  
By Steven A. Hirsch, Rodney W. Ott  
*Counsel for Intervenor Arizona Water Company*

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## OPINION

Presiding Judge Margaret H. Downie delivered the Opinion of the Court,  
in which Judge Kenton D. Jones and Judge Jon W. Thompson joined.

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**D O W N I E**, Judge:

¶1 The Residential Utility Consumer Office (“RUCO”) appeals two decisions by the Arizona Corporation Commission (“Commission”) that adopted a system improvement benefits (“SIB”) mechanism permitting Arizona Water Company (“AWC”) to collect surcharges from utility customers in between rate cases for defined capital expenditures. Because we conclude the SIB mechanism does not comply with the Arizona Constitution’s mandate that the Commission determine a public service corporation’s fair value when setting rates, we vacate the approval of that rate-making device. However, we affirm the Commission’s determination of the appropriate return on equity.

## FACTS AND PROCEDURAL HISTORY

### I. The Parties

¶2 The Commission is a constitutionally created entity that, among other things, regulates the rates charged by public service corporations. *See* Ariz. Const. art. 15, §§ 2-3. AWC – a privately held for-profit corporation – is a monopoly water utility whose rates are set by the Commission; AWC provides water service to nineteen separate systems in Arizona. RUCO is a state agency established to represent the interests of residential utility consumers in Commission proceedings. *See* A.R.S. § 40-462.

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**II. Eastern Group Case**

¶3 In August 2011, AWC filed an application with the Commission to increase rates for its eastern group water systems (“Eastern Group Case”). As relevant here, AWC requested: (1) a return on equity (“ROE”) of 12.5%<sup>1</sup> and (2) a distribution system improvements charge (“DSIC”) that would permit AWC to recover, in between rate cases, certain capital costs for improvement projects related to its distribution system and aging infrastructure. RUCO intervened in the Commission proceedings.

¶4 An administrative law judge (“ALJ”) held a multi-day hearing on AWC’s application. Commission staff (“Staff”) and RUCO both opposed the proposed DSIC. Staff expressed concern that it would alter “the balance of ratemaking lag by reducing lag time for recovery of depreciation and return on plant investments, to the benefit of AWC and the detriment of its ratepayers,” and Staff also argued “that allowing recovery of capital improvement costs between regular rate cases results in less scrutiny of plant investments both as to prudence and the used and usefulness of the plant.” In the alternative, Staff recommended several conditions that should apply to any DSIC-type mechanism the Commission might ultimately approve.

¶5 The ALJ recommended that the Commission set the ROE at 10.55% and that it deny the requested DSIC. After considering the ALJ’s written opinion and recommendations, the Commission approved a rate increase for AWC, setting the ROE at 10.55%. The Commission remanded the DSIC issue “to allow the parties the opportunity to enter into discussions regarding AWC’s DSIC proposal and other DSIC like proposals.”

¶6 All parties except RUCO subsequently entered into a settlement agreement in the Eastern Group Case (“Eastern Group Settlement Agreement”). That agreement included a modified version of the DSIC, now called a SIB.

¶7 An ALJ conducted a hearing regarding the Eastern Group Settlement Agreement, with RUCO opposing its approval. With some

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<sup>1</sup> As we discuss *infra*, ¶ 53, the ROE is intended to provide AWC with a fair rate of return on the value of property it employs for public service.

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suggested modifications, the ALJ recommended that the Commission approve the Eastern Group Settlement Agreement, including the SIB mechanism, but also recommended that the ROE be reduced from 10.55% to 10.00%.

¶8 The Commission adopted most of the ALJ's recommendations regarding the Eastern Group Settlement Agreement, but, by majority vote, maintained the ROE at the previously approved level of 10.55%.<sup>2</sup> The Commission also required AWC to provide more documentation with its surcharge applications than the settlement agreement contemplated. RUCO filed an application for rehearing. After further evidentiary proceedings, the ALJ again concluded the SIB was appropriate and again recommended the Commission reduce the ROE to 10.00%.

¶9 In its final decision, by a 3-2 vote, the Commission approved the SIB mechanism and maintained the ROE at 10.55%. RUCO filed a timely notice of appeal.

### III. Northern Group Case

¶10 In August 2012, AWC filed an application with the Commission seeking rate increases for its northern group water systems ("Northern Group Case"). AWC's application included a DSIC proposal similar to that requested in the Eastern Group Case. RUCO intervened in the Northern Group Case as well.

¶11 All parties except RUCO entered into a settlement agreement in April 2013 ("Northern Group Settlement Agreement"). The agreement incorporated the SIB determination from the Eastern Group Case. After an evidentiary hearing, an ALJ recommended that the Commission approve the Northern Group Settlement Agreement.

¶12 The Commission adopted the ALJ's proposed order. However, it made the agreed-upon SIB mechanism "subject to additional modifications that may be made by the Commission" in the Eastern Group Case. RUCO filed an application for rehearing, but its request was denied by operation of law pursuant to A.R.S. § 40-253(A) ("If the

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<sup>2</sup> Commissioner Brenda Burns dissented, stating that "AWC ratepayers should not be asked to pay for an elevated ROE while also being the test case for a newly approved SIB."

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commission does not grant the application [for rehearing] within twenty days, it is deemed denied.”).

¶13 RUCO filed a timely notice of appeal. By stipulation of the parties, we consolidated the Eastern Group and Northern Group cases for purposes of appeal. We also granted AWC’s motion to intervene. This Court has jurisdiction over the consolidated appeals pursuant to A.R.S. § 40-254.01(A).

**IV. The SIB Mechanism<sup>3</sup>**

¶14 The SIB at issue in both the Eastern Group and Northern Group cases is a form of tariff that permits AWC, with Commission approval, to add surcharges to customers’ water bills for up to five years to recoup certain capital costs (depreciation expenses and pre-tax return on investment) of defined infrastructure replacement projects that AWC completes prior to its next rate case. Capital expenditures subject to SIB-based surcharges include:

- Transmission and Distribution Mains
- Fire Mains
- Services, including service connections
- Valves and valve structures
- Meters and meter installations
- Hydrants

¶15 AWC may request surcharges only for completed projects that are “actually serving customers.” Before imposing a surcharge, AWC must apply to the Commission and submit specified documentation. The Commission is required to approve or disapprove each surcharge application, and Staff and RUCO have 30 days from each application’s filing to dispute a surcharge request. Each surcharge is “capped annually at five percent of the revenue requirement authorized” in Commission Decision No. 73736. AWC customers receive an “Efficiency Credit” of

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<sup>3</sup> The SIB mechanism is a type of DSIC. At times, we discuss evidence and testimony regarding a DSIC that also applies to the SIB. However, the SIB mechanism that the Commission ultimately approved differs in some material respects from the DSIC that AWC initially proposed. Our legal analysis is based on the SIB’s terms and methodology.

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“five percent of the SIB revenue requirement.”<sup>4</sup> The SIB mechanism contemplates an annual “true-up,” or reconciliation, pursuant to which any “under- or over-collected SIB revenues shall be recovered or refunded” to customers “by means of a fixed monthly true-up surcharge or credit.”

**DISCUSSION**

**I. Constitutionality of SIB Mechanism**

¶16 RUCO contends the SIB mechanism violates the Arizona Constitution’s mandate that the Commission determine the fair value of a public service corporation’s property when setting rates. According to RUCO, allowing the SIB-based surcharges in between rate cases circumvents this constitutional requirement.

¶17 Whether the SIB mechanism runs afoul of the constitution is a question of law that we review *de novo*. See *Sierra Club – Grand Canyon Chapter v. Ariz. Corp. Comm’n*, \_\_\_ Ariz. \_\_\_, ¶ 15, \_\_\_ P.3d \_\_\_ (App. July 23, 2015) (appellate courts are not bound by Commission’s legal conclusions and must “determine independently whether the Commission erred in its interpretation of the law”); *Ariz. Water Co. v. Ariz. Corp. Comm’n*, 217 Ariz. 652, 656, ¶ 10, 177 P.3d 1224, 1228 (App. 2008) (in reviewing Commission decisions, appellate courts review questions of law *de novo*). RUCO bears the burden of persuasion. See A.R.S. § 40-254.01(E) (litigant challenging Commission decision “must make a clear and satisfactory showing that the order is unlawful”).

**A. Fair Value Determination Requirement**

¶18 “The Arizona Corporation Commission, unlike such bodies in most states, is not a creature of the legislature, but is a constitutional body which owes its existence to provisions in the organic law of this state.” *Ethington v. Wright*, 66 Ariz. 382, 389, 189 P.2d 209 (1948). Under the Arizona Constitution, the Commission has plenary power to set “just and reasonable rates and charges” for public service corporations. Ariz. Const. art. 15, § 3. Article 15, Section 3 provides, in pertinent part:

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<sup>4</sup> The two five-percent figures apply to different amounts. The cap on each surcharge is five percent of the revenue requirement authorized by the Commission in AWC’s most recent rate case, whereas the efficiency credit is five percent of the SIB revenue requirement, as defined in the settlement agreements.

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The corporation commission shall have full power to, and shall, prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected, by public service corporations within the state for service rendered therein . . . .

*Id.*

¶19 The Commission's plenary power over rate-making, though, is not unfettered. Among other things, our constitution requires the Commission to "ascertain the fair value of property" when it sets rates. Ariz. Const. art. 15, § 14. Section 14's mandate "is an imperative. The commission is charged with an affirmative duty to act." *US West Commc'ns, Inc. v. Ariz. Corp. Comm'n*, 201 Ariz. 242, 245, ¶ 11, 34 P.3d 351, 354 (2001) ("*US West*"). "[A]scertaining the fair value of property of public service corporations is a necessary step in prescribing just and reasonable classifications, rates, and charges." *Ethington*, 66 Ariz. at 392, 189 P.2d at 216; *see also Ariz. Corp. Comm'n v. Ariz. Pub. Serv. Co.*, 113 Ariz. 368, 370, 555 P.2d 326, 328 (1976) ("[T]he Commission is required to find the fair value of the company's property and use such finding as a rate base for the purpose of determining what are just and reasonable rates.").

¶20 Surcharges trigger the constitutional requirement for a fair value determination. *See Residential Util. Consumer Office v. Ariz. Corp. Comm'n*, 199 Ariz. 588, 589, ¶ 1, 20 P.3d 1169, 1170 (App. 2001) ("*RUCO*"). Indeed, the parties here acknowledge that "[t]he SIB mechanism is a ratemaking device."

**B. Exceptions to Fair Value Determination Requirement**

¶21 Arizona's appellate courts have recognized two relatively narrow exceptions to the constitutional requirement that the Commission determine the fair value of a utility's property when setting rates: automatic adjustor clauses and interim rates. *See id.* at 591, ¶ 11, 20 P.3d at 1172. As we discuss *infra*, the SIB mechanism fits within neither exception.

**1. Automatic Adjustor Clauses**

¶22 In approving the SIB mechanism, the Commission labeled it an adjustor mechanism. We disagree. *Cf. id.* at 593, ¶ 21, 20 P.3d at 1174 ("If ever there was a situation 'fraught with potential abuse,' it occurs

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when the Commission of its own volition has the ability to declare any rate increase an 'automatic adjustment.'").

¶23 An automatic adjustor mechanism permits "rates to adjust automatically, either up or down, in relation to fluctuations in certain, narrowly defined, operating expenses." *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616 (App. 1978). Adjustor mechanisms "usually embody a formula established during a rate hearing to permit adjustment of rates in the future to reflect changes in specific operating costs, such as the wholesale of gas or electricity." *Id.* The purpose of an automatic adjustor mechanism is to pass on to customers certain naturally fluctuating costs so that the utility neither benefits nor suffers a diminished return from those costs. *Id.*

¶24 William Rigsby, Chief of Accounting and Rates for RUCO, described the characteristics of a typical automatic adjustor clause as follows:

When I think of an adjuster mechanism, I think of something along the lines of like a purchased gas adjuster mechanism, where the company has to . . . buy natural gas on the open market, or an electric company . . . has to buy power . . . on the grid in the wholesale market and so forth. And so the cost of that either natural gas or electricity is passed on to the ratepayer at no profit to the company, and that's the reason that it's implemented, is because of the price fluctuations of the commodity in the marketplace. It's a two-way street. If the prices go down, then consumers see a credit on the bill. If prices go up, then, of course, they go ahead and they pay that. Whereas in the case of . . . a DSIC, it's not a two-way street.

¶25 Rigsby's testimony is consistent with our own jurisprudence regarding automatic adjustor clauses. *See, e.g., Mountain States Tel. & Tel. Co. v. Ariz. Corp. Comm'n*, 137 Ariz. 566, 569, 672 P.2d 495, 498 (App. 1983) (An automatic adjustment clause is "a device that allows a rate to adjust automatically, either up or down in relation to fluctuations in certain, narrowly defined, operating expenses."). RUCO's view is also aligned with the position Staff took at the outset of the Eastern Group Case. In Phase I of that proceeding, Staff stated that adjustor mechanisms are used to "allow utilities to pass on to customers changes in certain specific volatile costs outside of the utility's control, such as purchased power costs." Staff also correctly noted that "rate adjustors outside of a rate case

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are the exception rather than the rule and [are] very limited in what they can do."

¶26 Under the SIB mechanism, surcharges will not fluctuate in amount within an annual cycle, and they will never decrease. Moreover, AWC is being allowed to recoup *capital expenditures*, rather than "narrowly defined operating expenses" that naturally fluctuate. As such, the SIB mechanism lacks essential attributes of an automatic adjustor clause and does not fall within that exception to the constitutional fair value determination requirement.

**2. Interim Rate**

¶27 Interim rates assessed on a temporary basis in between rate cases may also be exempt from the constitutional fair value determination requirement. The interim rate exception, though, "is limited to circumstances in which: (1) an emergency exists; (2) a bond is posted by the utility guaranteeing a refund to customers if interim rates paid are higher than the final rates determined by the Commission; and (3) the Commission undertakes to determine final rates after a valuation of the utility's property." *RUCO*, 199 Ariz. at 591, ¶ 12, 20 P.3d at 1172.

¶28 During the Commission proceedings, AWC did not assert that emergency circumstances exist. It instead described its infrastructure replacement needs as "extraordinary," and on appeal, it characterizes them as "exceptional." AWC estimates the cost of needed improvements in the Eastern Group systems alone at \$67 million over a ten-year period.

¶29 In the first phase of the Eastern Group Case, Staff did not quarrel with AWC's cost estimates or dispute the notion that infrastructure at the end of its useful life must be replaced. Staff, however, did not consider AWC's situation an emergency or even an "extraordinary circumstance." Jeffrey Michlik, Public Utilities Analyst for the Commission, testified:

Q. Do you consider infrastructure replacement to be an extraordinary circumstance?

A. No. . . . That's something we expect of all the water companies that are public service companies here. They should . . . supply customers with safe and reliable drinking water, with or without a DSIC.

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Q. Does the dollar amount of [the repairs] et cetera, drive the determination of whether something is extraordinary or not?

A. It could, I mean if it's a huge amount.

Q. . . . In this case [AWC] has talked about a \$67 million expense that they anticipate in infrastructure replacement. . . . Does Staff consider that . . . significantly high to . . . deem that circumstance extraordinary?

A. No.

Staff contended AWC was proposing a DSIC-type mechanism "for routine expenditures" that was "unjustified." In a brief filed during Phase I of the Eastern Group Case, Staff wrote:

[O]ther cost recovery mechanisms in use in Arizona all address extraordinary circumstances outside the utility's control, such as the fluctuating cost of natural gas or a federal mandate requiring the addition of massive amounts of plant. This case seeks to recover the cost of replacing aging infrastructure. The most basic laws of science and nature are that materials have a limited life-span. They deteriorate and must be replaced. [AWC] knew from the time it entered the market that someday the infrastructure would require replacement. [AWC] could and should have anticipated this event and prepared for the same, but failed to do so. [AWC] has some control over the rate of deterioration, by performing routine repairs and maintenance. By their own admission, they cut maintenance expenses "to the bone" in 2008. Staff has expressed concern that this has caused a more rapid deterioration of plant. To a significant extent, the circumstances in which AWC now finds itself are of its own making. The customer should not be required to bear the burden of the Company's decisions.

¶30 The ALJ's Opinion and Order noted "plentiful evidence" that certain AWC systems have degraded and that leaks and breaks are "occurring at excessive rates," requiring replacement of infrastructure "at a much faster rate than [AWC] has historically done." But the ALJ concluded the situation was not "exceptional," so as to warrant "the creation of and authorization to use a nontraditional ratemaking device such as the DSIC." See *RUCO*, 199 Ariz. at 592, ¶ 18, 20 P.3d at 1173

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("Nothing in the record indicates that the increase in CAP water expense rose to the level of an emergency situation, thereby making [the utility] eligible for an interim rate.").

¶31 In considering the ALJ's findings and recommendations, the Commission similarly found no emergency and cited AWC's acknowledgement it had not been "'ambushed' by the need to replace its aging infrastructure." The Commission further noted that, "[i]n spite of AWC's decision to cut operating costs, AWC has consistently continued to pay its shareholders dividends, paying \$4,287,600 in 2008, 2009, and 2010. . . . AWC increased the amount of dividends in 2011, after having held dividends steady for three years."

¶32 The settlement agreements that were later negotiated also do not state that an emergency exists or describe circumstances that would ordinarily be considered an emergency. *See, e.g., Garvey v. Trew*, 64 Ariz. 342, 354, 170 P.2d 845, 853 (1946) ("The word 'emergency' has a well understood meaning. It is defined and understood as: 'An unforeseen combination of circumstances which calls for immediate action.'"); *see also Hunt v. Norton*, 68 Ariz. 1, 11, 198 P.2d 124, 130 (1948) ("'Emergency' does not mean expediency, convenience, or best interests."). Instead, the Eastern Group Settlement Agreement provides, in pertinent part:

It is necessary for AWC to undertake a variety of system improvements in order to maintain adequate and reliable service to existing customers. AWC is also required to complete certain system improvements in order to comply with requirements imposed by law. The Signatory Parties acknowledge that these projects are necessary to provide proper, adequate and reliable service to existing customers . . . .

In its final approval of the settlement agreements, the Commission again made no finding of emergency circumstances and noted AWC's concession "that its infrastructure replacement needs have been developing for a long time."

¶33 Because AWC neither claimed nor established the requisite emergency circumstances, the interim rate exception to the constitutional fair value determination requirement does not apply.

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C. Compliance with Fair Value Determination Requirement

¶34 Absent a valid automatic adjustor mechanism or interim rate, the Commission “cannot impose a rate surcharge based on a specific cost increase without first determining a utility’s fair value rate base.” *RUCO*, 199 Ariz. at 589, ¶ 1, 20 P.3d at 1170. The question thus becomes whether the SIB mechanism satisfies this constitutional mandate.

¶35 Arizona is a regulated monopoly state. *Ariz. Corp. Comm’n v. Ariz. Water Co.*, 111 Ariz. 74, 76, 523 P.2d 505, 507 (1974). “The monopoly is tolerated only because it is to be subject to vigilant and continuous regulation by the Corporation Commission.” *Davis v. Corp. Comm’n*, 96 Ariz. 215, 218, 393 P.2d 909, 911 (1964). One important component of the Commission’s “vigilant and continuous” regulatory role is determining and using fair value when setting a monopolistic utility’s rates. In discussing the fair value determination requirement more than a century ago, our supreme court stated:

In order that the Corporation Commission might act intelligently, justly, and fairly between the public service corporations doing business in the state and the general public, section 14 was written into the Constitution . . . . The “fair value of the property” of public service corporations is the recognized basis upon which rates and charges for services rendered should be made, and it is made the duty of the Commission to ascertain such value, not for legislative use, but for its own use, in arriving at just and reasonable rates and charges . . . .

*State v. Tucson Gas, Elec., Light & Power Co.*, 15 Ariz. 294, 303, 138 P. 781, 784-85 (1914); see also *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956) (“It is clear . . . that under our constitution as interpreted by this court, the commission is required to find the fair value of the company’s property and use such finding as a rate base for the purpose of calculating what are just and reasonable rates.”).

¶36 A fundamental underpinning of the fair value determination requirement is the principle that the public has “the right to demand” that a public utility operate “with reasonable efficiency and under proper charges.” *City of Phx. v. Kasun*, 54 Ariz. 470, 475, 97 P.2d 210, 212 (1939); see also *Ariz. Corp. Comm’n v. State ex rel. Woods*, 171 Ariz. 286, 292, 830 P.2d 807, 813 (1992) (The Commission must use its “powers to regulate public service corporations in the public interest.”). Although our constitution

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“does not establish a formula for arriving at fair value, it does require such value to be found and used as the base in fixing rates.” *Simms*, 80 Ariz. at 151, 294 P.2d at 382; see also *Ariz. Corp. Comm’n v. Ariz. Water Co.*, 85 Ariz. 198, 202, 335 P.2d 412, 414 (1959) (“No formula is given for determining fair value . . . but the Commission must establish the rate base on the basis of fair value and that alone.”). The fair value determination is intended to avoid “the harsh extremes of the rate spectrum” and to ensure that both consumers and public service corporations are treated fairly. *US West*, 201 Ariz. at 246, ¶ 21, 34 P.3d at 355.

¶37 The Commission suggests the SIB mechanism is constitutionally permissible because it is akin to step rate increases the Arizona Supreme Court discussed in *Arizona Community Action Ass’n v. Arizona Corp. Commission*, 123 Ariz. 228, 230, 599 P.2d 184, 186 (1979) (“ACAA”). We conclude otherwise.

¶38 ACAA includes *dicta* stating that, in the context of a rate case, the Commission may consider construction work in progress (“CWIP”) in calculating a utility’s fair value and may approve prospective percentage rate increases based on that fair value for a “limited period of time.” *Id.* at 230-31, 599 P.2d at 186-87. The court observed that “[t]he adjustments ordered by the Commission in adding the CWIP to [the] determination of fair value were adequate to maintain a reasonable compliance with the constitutional requirements *if used only for a limited period of time.*” *Id.* at 231, 599 P.2d at 187 (emphasis added). But even accepting this language as persuasive authority, as the Commission urges, the SIB mechanism at issue here differs materially from the step rate increases discussed in ACAA.

¶39 ACAA suggests that, with Commission authorization, a utility may charge stepped-up rates for a limited period of time to account for CWIP that was reviewed and approved by the Commission during a rate case. Here, however, much of the work that will be subject to SIB-based surcharges was not in progress when AWC’s rate case was adjudicated. Under the settlement agreements, AWC may add improvement projects that will be subject to the SIB mechanism. Cf. *Consol. Water Utils., Ltd. v. Ariz. Corp. Comm’n*, 178 Ariz. 478, 482-83, 875 P.2d 137, 141-42 (App. 1993) (affirming non-inclusion of anticipated CWIP in establishing fair value rate base because, among other things, “[t]he amount of actual construction to be undertaken is not known and measureable”). And even if the Commission’s review of new projects were to approximate the evaluation occurring during a rate case, unlike the two-year step increases in ACAA, the Commission here has authorized

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AWC to seek surcharges for five years – the entire time span between rate cases.

¶40 Turning next to the question of whether the SIB mechanism's methodology satisfies the constitutional fair value determination requirement, we note that the documentation AWC must submit to obtain approval of surcharges is substantially less than what is required in a rate case. See A.A.C. R14-2-103(A)(1) (delineating financial and statistical information "required to be filed with a request by a public service corporation doing business in Arizona for a determination of the value of the property of the corporation and of the rate of return to be earned thereon, with regard to proposed increased rates or charges"). Moreover, it is undisputed that the Commission will not conduct a full fair value determination when it evaluates AWC's surcharge requests.

¶41 Rigsby testified that RUCO's primary concern with a DSIC-type mechanism is that the Commission will not "take into consideration all of the various ratemaking elements that would be looked at and scrutinized in a general rate case proceeding. That would include such things as revenues, expenses, and, of course, capital expenditures and the prudence considerations for each one of those ratemaking elements." The record supports this concern. As Rigsby observed, the Commission will only be "looking at the capital costs and depreciation expense associated with the plant additions under the SIB, as opposed to an actual test year, where we're looking at all of the ratemaking elements that would . . . include not only plant and accumulated depreciation and such, but other rate base items like accumulated deferred income taxes, customer deposits, working capital." In other words, the SIB mechanism focuses on the marginal effect of the SIB on fair value – an important, but quite limited assessment of fair value. Steve Olea, former Director of the Utilities Division for the Commission, confirmed that "[t]he only thing being considered in the SIB is the plant," not current operating and maintenance expenses, and he acknowledged that "the SIB application doesn't look at all the rate case elements that you would normally look at in a rate case proceeding."

¶42 To be sure, AWC must submit substantial information to the Commission when it requests a surcharge, including project details, "a calculation of the SIB revenue requirement and SIB efficiency credit," a true-up calculation for the prior surcharge period, an analysis of the impact of the SIB Plant on the fair value rate base, revenue, and the fair value rate of return, current balance sheets and income statements, and an earnings test schedule. But although infrastructure costs will be current

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when the Commission considers surcharge requests, other critical valuation factors will be premised on a past rate case that, at the outer reaches of the SIB cycle, will be five years old. Such a process is inconsistent with the mandate that the Commission perform a fair value determination "at the time of inquiry." See *Ariz. Corp. Comm'n*, 85 Ariz. at 201-02, 335 P.2d at 414-15 ("A reasonable judgment concerning all relevant factors is required in determining the fair value of the properties at the time of inquiry. If the Commission abuses its discretion in considering these factors or if it refuses to consider all the relevant factors, the fair value of the properties cannot have been determined under our Constitution."); *Simms*, 80 Ariz. at 151, 294 P.2d at 382 ("Fair value means the value of properties at the time of inquiry.").

¶43 The abbreviated review under the SIB mechanism is particularly problematic given the five-year duration of the surcharges and the compounding effect those surcharges will have on ratepayers over that relatively lengthy period of time. Additionally, the Commission will not be assessing savings or other efficiencies attributable to capital improvements when it approves surcharges. See *Kasun*, 54 Ariz. at 475, 97 P.2d at 212 (public has right to demand that utilities operate with reasonable efficiency); *Scates*, 118 Ariz. at 534, 578 P.2d at 615 (A noted peril of a "piecemeal approach" to rate-making via tariff is that it serves "both as an incentive for utilities to seek rate increases each time costs in a particular area rise, and as a disincentive for achieving countervailing economies in the same or other areas of their operations.").

¶44 In defending its decisions, the Commission cites cases that confirm its broad discretion in setting rates. See, e.g., *Ariz. Corp. Comm'n v. Ariz. Pub. Serv. Co.*, 113 Ariz. at 371, 555 P.2d at 329. The Commission, however, lacks discretion to disregard or dilute state constitutional requirements, including the mandate that it determine fair value in setting rates.

¶45 Nor do we agree that *Scates* authorizes a rate increase without a fair value determination based on "exceptional circumstances," as the Commission and AWC suggest. *Scates* reversed an order approving increased telephone rates because the Commission "failed to make any examination whatsoever of the company's financial condition, and to make any determination of whether the increase would affect the utility's rate of return." 118 Ariz. at 537, 578 P.2d at 618. In language unnecessary to its holding, *Scates* continued:

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There may well be exceptional situations in which the Commission may authorize partial rate increases without requiring entirely new submissions. We do not decide in this case, for example, whether the Commission could have referred to previous submissions without some updating or whether it could have accepted summary financial information. We do hold that the Commission was without authority to increase the rate without any consideration of the overall impact of that rate increase upon the return [of the company], and without, as specifically required by our law, a determination of [the company's] rate base.

*Id.*

¶46 To the extent this *dicta* in *Scates* can be read as suggesting that an "exceptional situation" may excuse the constitutional requirement for a fair value determination, we disagree. No Arizona court has so held, and since *Scates*, we have reaffirmed that, absent a valid interim rate or automatic adjustor mechanism, the Commission may not impose rate surcharges without first determining fair value. See *RUCO*, 199 Ariz. at 589, ¶ 1, 20 P.3d at 1171.

¶47 AWC's reliance on *US West* is similarly unavailing. In a fundamentally different context, our supreme court held in *US West* that although a fair value determination is constitutionally mandated when rates are set, in a *competitive* market, the Commission has "broad discretion" to determine what weight to give that determination. *US West*, 201 Ariz. at 246, ¶¶ 19-21, 34 P.3d at 355. We are not dealing here with a competitive market. Nor is our focus on how the Commission may weigh and apply fair value in approving surcharges. At issue is whether the SIB mechanism provides the functional equivalent of a fair value determination. See *Ariz. Corp. Comm'n*, 85 Ariz. at 202, 335 P.2d at 414 (The Commission abuses its discretion if "it refuses to consider all the relevant factors" in determining fair value.). Moreover, *US West* confirms that in the context of a regulated monopoly, the Commission must both determine and use fair value:

[W]hile the constitution clearly requires the Arizona Corporation Commission to perform a fair value determination, only our jurisprudence dictates that this finding be plugged into a rigid formula as part of the rate-setting process. . . . As we have seen, a line of cases nearly as old as the state itself has sustained the traditional formulaic

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approach. The commission . . . correctly points out, however, that those decisions were rendered during a time of monopolistic utility markets. In such a setting, where rates were determined by giving the utility a reasonable return on its Arizona property, the fair value requirement was essential. *We still believe that when a monopoly exists, the rate-of-return method is proper.*

201 Ariz. at 245-46, ¶¶ 17-19, 34 P.3d at 354-55 (emphasis added); *see also Phelps Dodge Corp. v. Ariz. Elec. Power Coop., Inc.*, 207 Ariz. 95, 105 n.8, ¶ 21, 83 P.3d 573, 583 n.8 (App. 2004) (“Although [*US West*] held that this rate-of-return method for rate setting may be inappropriate in a competitive environment, it affirmed the supreme court’s long-standing view that this method is properly employed in traditional, non-competitive markets.”).

¶48 The Commission and AWC raise colorable policy arguments in support of flexible rate-making tools like the SIB and stress that other jurisdictions have approved similar devices.<sup>5</sup> We recognize the Commission’s legitimate desire to “initiate innovative procedures in an attempt to deal promptly and equitably with increasingly complex regulatory matters,” and its corresponding goal of avoiding “a constant series of extended rate hearings [that] are not necessary to protect the public interest.” *ACAA*, 123 Ariz. at 230-31, 599 P.2d at 186-87. But the question before us is not whether the SIB mechanism represents prudent public policy. Our focus is on the propriety of that mechanism given the unique and express provisions of our state constitution.

¶49 The fair value determination requirement imposed by the Arizona Constitution may be cumbersome, time-consuming, and expensive, as the Commission asserts. The answer, though, is not to

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<sup>5</sup> Also in the record are materials describing potentially negative policy implications of DSIC-type mechanisms, including circumvention of regulatory review of rate base items for prudence and reasonableness, elimination of incentive to control costs between rate cases, and rewarding water companies that “imprudently fall behind in infrastructure improvements.” Additionally, AWC’s reliance on “regulatory lag” as a basis for implementing a DSIC-type mechanism caused Staff to note during Phase I of the Eastern Group Case that “[w]hile utilities tend to decry regulatory lag as causing them to have to wait too long to recover costs, regulatory lag serves a useful purpose in incentivizing a utility to operate efficiently and minimize costs.”

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ignore it or to circumvent the constitutional mandate by judicial fiat. See Ariz. Const. art. 2, § 32 (“The provisions of this Constitution are mandatory, unless by express words they are declared to be otherwise.”). Although the Arizona electorate has refused to amend the constitutional fair value requirement in recent years,<sup>6</sup> “[s]hould they think it wise, our citizens are free to amend the Arizona Constitution to reflect changed circumstances.” *US West*, 201 Ariz. at 245, ¶ 12, 34 P.3d at 354. Meanwhile, under appropriate circumstances, the Commission may employ alternative rate-making devices approved by our appellate courts if it complies with the well-established requirements for those mechanisms.

¶50 Because the SIB mechanism does not comply with the Arizona Constitution’s mandate that the Commission determine and use fair value when setting a monopolistic utility’s rates, we vacate the Commission’s approval of that rate-making device.

## II. Return on Equity

¶51 RUCO also contends the adoption of a 10.55% ROE was arbitrary given the Commission’s corresponding approval of the SIB mechanism. To the extent this argument is not moot by virtue of our disapproval of the SIB mechanism, we disagree.

¶52 “[T]he Commission is constitutionally mandated to set fair rates of return on fair value base of public service utilities.” *Ariz. Corp. Comm’n v. Citizens Utils. Co.*, 120 Ariz. 184, 188, 584 P.2d 1175, 1179 (App. 1978). “This function cannot be performed by the judiciary and the judicial role is limited . . . to determining whether the Commission’s decision was supported by substantial evidence, was not arbitrary and was not otherwise unlawful.” *Id.* The Commission exercises discretion in setting an appropriate rate of return. *Litchfield Park Serv. Co. v. Ariz. Corp. Comm’n*, 178 Ariz. 431, 434, 874 P.2d 988, 991 (App. 1994).

¶53 The Commission considered substantial evidence relevant to the ROE determination. Some of that evidence, including expert opinions, suggested that AWC required both a SIB-type mechanism and a higher

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<sup>6</sup> Arizona voters defeated proposed constitutional amendments to the fair value determination requirement in 1984, 1988, and 2000. *US West*, 201 Ariz. at 245 n.2, ¶ 12, 34 P.3d at 354.

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ROE to complete necessary projects and obtain financing. See *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 693 (1923) ("The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."). Other testimony posited that the efficiency credit included in the settlement agreements effectively reduces the ROE. Opinions about the appropriate ROE ranged from 8.5% to 12.5%. RUCO took the position that the ROE and SIB mechanism are, to some degree, duplicative, and that the SIB reduces AWC's risk "because it improves cash flow and reduces regulatory lag related to cost recovery of qualifying infrastructure investment."

¶54 Faced with a conflict in the evidence, a majority of the Commission opted to authorize the 10.55% ROE, even while approving the SIB mechanism.<sup>7</sup> There is support for that decision in the record, and our role is not to reweigh the evidence to determine whether we would reach the same conclusion. See *DeGroot v. Ariz. Racing Comm'n*, 141 Ariz. 331, 335-36, 686 P.2d 1301, 1305-06 (App. 1984) (appellate court does not reweigh evidence to resolve perceived conflicts). We find no abuse of discretion in setting the ROE at 10.55%.

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<sup>7</sup> Commissioners Brenda Burns and Robert Burns dissented. In his written dissent, Commissioner R. Burns stated that the final decision "allows for both a SIB mechanism and a higher return on equity . . . which leads to duplicative recovery." He concluded that permitting "both a SIB and an elevated ROE is not in the best interest of the ratepayers."

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CONCLUSION

¶55 For the reasons stated, we vacate the Commission's approval and adoption of the SIB mechanism but affirm its determination of the appropriate ROE.



Ruth A. Willingham · Clerk of the Court  
FILED : ama

# **ATTACHMENT B**

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** W-01732A-15-0131

**Response provided by:** Tom Campbell  
**Title:** EWAZ Legal Counsel

**Address:** 2355 W. Pinnacle Peak Road, Suite 300  
Phoenix, AZ 85027

**Company Response Number:** RUCO 1.03

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Q: Work Papers - Please provide a copy of all due diligence work papers created and/or utilized by EPCOR during their analytical review of the Willow Valley Water, Co.

A: EWAZ objects to RUCO 1.03 to the extent that it seeks information that is not reasonably calculated to lead to the discovery of admissible evidence. EWAZ further objects to RUCO 1.03 to the extent that it seeks information protected by the attorney-client privilege, the work-product doctrine or any other privilege recognized under the law. EWAZ also objects to RUCO 1.03 to the extent that it seeks highly confidential business information or trade secrets.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** W-01732A-15-0131

**Response provided by:** Tom Campbell  
**Title:** EWAZ Legal Counsel

**Address:** 2355 W. Pinnacle Peak Road, Suite 300  
Phoenix, AZ 85027

**Company Response Number:** RUCO 1.04

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- Q: Minutes of the Board of the Directors – Please provide copies of the minutes of all meetings of the Board of Directors of EPCOR Water Arizona Inc., approving the purchase of Willow Valley Water Co. Inc.
- A: EWAZ objects to RUCO 1.04 to the extent that it seeks information that is not reasonably calculated to lead to the discovery of admissible evidence. EWAZ further objects to RUCO 1.04 to the extent that it seeks information protected by the attorney-client privilege, the work-product doctrine or any other privilege recognized under the law.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Ron Fleming (Part a.)  
**Title:** CEO, Global Water Resources, Inc.

**Address:** 21410 N. 19<sup>th</sup> Ave., Suite 220  
Phoenix, Arizona 85027

**Response provided by:** Sarah Mahler (Part b.)  
**Title:** Manager, Rates

**Address:** 2355 W. Pinnacle Peak Road, Suite 300  
Phoenix, AZ 85027

**Company Response Number:** RUCO 2.02

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**Q:** Customer Benefits – The Company states the following on page 5, line 1. *“Willow Valley’s customers will benefit from the in-house water utility expertise and resources afforded by EWAZ ownership. EWAZ’s size naturally affords it access to broad in-house utility expertise and resources. The proximity of EWAZ’s other systems will provide additional operational resources and personnel. In addition, EWAZ intends to implement or continue various industry best operating practices in the Willow Valley systems. EWAZ uses various sophisticated maintenance and management systems such as maintenance management, environmental and water quality compliance management, hydraulic modeling, and GIS systems. All these support resources will be deployed in support of the Willow Valley systems to provide reliable and high quality service to customers.”*

Please answer the following questions:

- a. Were these customer benefits not provided by Global Water Resources, Inc. (“Global”)?
  - b. What services or customer benefits will EPCOR Water Arizona, Inc. (“EPCOR”) provide over those offered by Global (e.g. hydraulic modeling, and GIS systems)?
- A:**
- a. Global Water provided many of the customer benefits identified, including in-house water utility expertise and resources. Also, Global Water implemented best practices for the Willow Valley utility, including a computerized maintenance management system, hydraulic modeling, and GIS. Further, Global Water provided management and additional support resources from its Phoenix-metro area utility operations. However, because EWAZ is larger and has systems in the same region as Willow Valley, this allows access to greater resources in closer proximity.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Ron Fleming (Part a.)  
**Title:** CEO, Global Water Resources, Inc.

**Address:** 21410 N. 19<sup>th</sup> Ave., Suite 220  
Phoenix, Arizona 85027

**Response provided by:** Sarah Mahler (Part b.)  
**Title:** Manager, Rates

**Address:** 2355 W. Pinnacle Peak Road, Suite 300  
Phoenix, AZ 85027

**Company Response Number:** RUCO 2.02

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- b. EWAZ will bring the Willow Valley service area into its operational management systems, which, in addition to the systems already employed by Global, also includes an environmental and water quality compliance management system.

Also, while EWAZ does not waive its right to start collecting customer security deposits in the future, EWAZ does not currently collect security deposits from its customers. We note that Global does hold security deposits, and will be returning any outstanding security deposit balances to the respective customers after the close of this transaction.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Ron Fleming  
**Title:** CEO, Global Water Resources, Inc.

**Address:** 2355 W. Pinnacle Peak Road, Suite 300  
Phoenix, AZ 85027

**Company Response Number:** RUCO 2.05

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**Q:** Water Quality – Is the Willow Valley Water System currently providing safe and reliable drinking water?

**A:** Yes.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Ron Fleming  
**Title:** CEO, Global Water Resources, Inc.

**Address:** 21410 N. 19<sup>th</sup> Ave., Suite 220  
Phoenix, Arizona 85027

**Company Response Number:** RUCO 2.06

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**Q:** Water Quality – Does the Willow Valley Water System currently have any Notice of Violations outstanding with the Arizona Department of Environmental Quality? If so please explain.

**A:** No.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Sarah Mahler  
**Title:** Manager, Rates and Regulatory

**Address:** 2355 W. Pinnacle Peak Road, Suite 300  
Phoenix, AZ 85027

**Company Response Number:** RUCO 2.07

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Q: Acquisition Premium – Please describe how the Company's acquisition premium was derived?

A: Please see the Company's Response to STF GWB 1.1 and the table below (from STF GWB 1.1)

<u>Descriptions</u>	<u>EPCOR Purchase Price Calculation as of 12/31/2014</u>
Utility Plant in Service	\$5,146,109
CWIP	\$19,767
<b>Total PP&amp;E</b>	<b>\$5,165,876</b>
Accum Depreciation	(\$2,369,499)
<b>Gross Plant</b>	<b>\$2,796,377</b>
AIAC	(\$69,347)
CIAC	(\$458,999)
<b>Net Rate Base</b>	<b>\$2,268,031</b>
With 10% Acquisition Premium	1.10
<b>Purchase Price</b>	<b>\$2,494,834</b>

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Greg Barber  
**Title:** EPCOR Controller

**Address:** 2355 W. Pinnacle Peak Road, Suite 300  
Phoenix, AZ 85027

**Company Response Number:** RUCO 3.01

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**Q:** Please see RUCO DR. No. 2.07 requesting "how the Company's acquisition premium was derived?" The Company's response was as follows:

**A:** Please see the Company's Response to STF GWB 1.1 and the table below (from STF GWB 1.1)

<u>Descriptions</u>	<u>EPCOR Purchase Price Calculation as of 12/31/2014</u>
Utility Plant in Service	\$5,146,109
CWIP	\$19,767
Total PP&E	\$5,165,876
Accum Depreciation	(\$2,369,499)
Gross Plant	\$2,796,377
AIAC	(\$69,347)
CIAC	(\$458,999)
Net Rate Base	\$2,268,031
With 10% Acquisition Premium	1.10%
Purchase Price	\$2,494,834

RUCO can see how the calculation of the purchase price was calculated, however, **please explain how the 10% Acquisition Premium was derived?**

**A.** The 10% acquisition premium was derived through negotiation, and represented the lowest price premium that would have motivated a sale from the current owner. This negotiated premium was the result of protracted negotiations with the seller who initially indicated an expectation of a higher premium. The formulaic method which defined the acquisition price in this instance as a percentage applied to rate base was agreed to by the parties as a means of defining the final purchase price in recognition of the changes to plant and advances/contributions that can occur during the period between signing a purchase agreement and completion of the regulatory approval process.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Shawn Bradford  
**Title:** EPCOR—VP Corporate Services

**Address:** 2355 W. Pinnacle Peak Road, Suite 300  
Phoenix, AZ 85027

**Company Response Number:** RUCO 3.02

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**Q:** On page 2, line 5 of "Supplement to Application" filed on June 1, 2015, it states that the purchase price for the Willow Valley system reflects the fair market value of the assets and operations being purchase." **Can you please explain in detail how the fair market value was determined?**

**A:** The fair market value was determined through negotiation of an arms-length transaction between unrelated parties. A value based on a multiple applied to the calculation of rate base was the result of protracted negotiations and represented the lowest multiple the seller was willing to accept to sell their assets and forego their reasonable expectation of returns on the capital investments their investors have made in the provision of service to the system's customers.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Shawn Bradford  
**Title:** EPCOR—VP Corporate Services

**Address:** 2355 W. Pinnacle Peak Road, Suite 300  
Phoenix, AZ 85027

**Company Response Number:** RUCO 3.03

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**Q:** Also on page 2 on the "Supplement to Application" beginning on line 14 it states, "EWAZ will need to make significant capital investments to increase the reliability and quality of the Willow Valley system, such as replacement of non-operational system valves, installation of a more robust backwash effluent discharge retention system, and necessary maintenance of storage tanks." **If such significant new investments are required to be made by EPCOR, why would a prudent investor pay a ten percent premium?**

**A:** Willow Valley has made investments and improvements to its systems over the years to address numerous areas of concern. While EPCOR recognizes the need for additional investment to improve system reliability and lower water loss, the negotiated sale price was based on the approved rate base plus a 10 percent premium, which is fair market value for the types of assets being acquired. This acquisition also meets the Commission's objective of industry consolidation for the benefit of customers.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Mike Liebman  
**Title:** CFO, Global Water Resources, Inc.

**Address:** 21410 N. 19<sup>th</sup> Ave., Suite 220  
Phoenix, AZ 85027

**Company Response Number:** RUCO 3.04

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**Q:** Global Water, Inc., paid a negotiated purchase price of \$54,369,889 for the West Maricopa Combine in 2006, of which \$45,809,111 was identified as Goodwill in the Company's audited financial statements for the year ending December 31, 2011. Of the total amount of Goodwill how much was recorded on the books of Willow Valley Water Co., Inc.? Please show the calculations for the amount recorded as Goodwill.

**A:** Please see the attached Exhibit 3.04 Goodwill Calculation. For clarification, see page 55 of the Audited Financial Statement for the year ended December 31, 2011 for the Company's Goodwill balance, which was approximately \$13,081,831. The Goodwill recorded at Willow Valley for the year ended December 31, 2011 was \$398,499.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Mike Liebman  
**Title:** CFO, Global Water Resources, Inc.

**Address:** 21410 N. 19<sup>th</sup> Ave., Suite 220  
Phoenix, AZ 85027

**Company Response Number:** RUCO 3.05

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Q: If there was no Goodwill recorded on the books of Willow Valley, please explain why not?

A: See above response to RUCO 3.04 for the Goodwill calculation.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Mike Liebman  
**Title:** CFO, Global Water Resources, Inc.

**Address:** 21410 N. 19<sup>th</sup> Ave., Suite 220  
Phoenix, Arizona 85027

**Company Response Number:** RUCO 3.06

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**Q:** Of the amount recorded as Goodwill on the books of Willow Valley, has there been an impairment adjustment recorded and if so how much was the impairment adjustment?

**A:** An impairment adjustment of \$175,837 was recorded in June 2015.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** W-01303A-15-0131 and W-01732A-15-0131

**Response A1 provided by:** Mike Liebman  
**Title:** CFO, Global Water Resources, Inc.

**Address:** 21410 N. 19<sup>th</sup> Ave., Suite 220, Phoenix, AZ 85027

**Response A2 provided by:** Timothy J. Sabo  
Attorney for Willow Valley and Global Water Resources, Inc.

**Response to A3 provided by:** Sarah Mahler  
Manager, Rates

**Address:** 2355 W. Pinnacle Peak Road, Suite 300  
Phoenix, AZ 85027

**Company Response Number:** RUCO 4.03

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- Q:** Dividend Payouts to both EPCOR and Global's Parent Companies – Please include the dividend payouts to the ultimate parent Company for both EPCOR and Global (from all systems or districts) on a calendar year basis since 2010
- A1:** Willow Valley has not paid dividends to Global Water since the stock acquisition in 2006 as Willow Valley has operated in a loss position for each of the years in question, and has not had earnings available to distribute to the parent company.
- A2:** Dividends or other distributions by other Global Water utilities are not relevant to this docket, which is limited to the approval of the sale of Willow Valley's assets to EPCOR Water Arizona Inc.
- A3:** EWAZ objects to DR RUCO 4.03 to the extent that it is not relevant to the Commission's determination of the present action and is not reasonably calculated to lead to the discovery of admissible evidence. Without waiver of the foregoing objection, the dividends paid to EWAZ's corporate parent for June 2010 to June 2013 are available in the Company's most recently filed rate case, Docket No. WS-01303A-14-0010, at schedule E4 in any of the A-F schedules for that case.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** W-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Joanne Ellsworth  
**Title:** Director, Corporate and Regulatory Affairs  
Global Water Resources, Inc.

**Address:** 21410 N. 19<sup>th</sup> Ave., Suite 220, Phoenix AZ 85027

**Company Response Number:** RUCO 4.02

---

**Q:** Acquisition Adjustments – Based on the Answers to data request 4.01, did the Company or predecessor Companies ask for an acquisition adjustment in any prior CC&N case? If so, please identify the Commission Decision and docket number that discusses an acquisition adjustment.

**A:** This question is not applicable. See the response to RUCO Data Request 4.01.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Greg Barber  
**Title:** Controller

**Address:** 2355 W. Pinnacle Peak Road, Suite 300  
Phoenix, AZ 85027

**Company Response Number:** RUCO 4.04

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**Q:** Net Present Value ("NPV") Analysis – Did EPCOR do any type of NPV Analysis or revenue/cash stream projections to support its proposed acquisition of Willow Valley? If no analysis was prepared please explain why not?

**A:** Yes, we did a NPV Analysis for the Willow Valley acquisition. However, the purchase price was the result of arms-length negotiation between the buyer and seller and represents the lowest acquisition price that the current owner would accept to sell the Willow Valley systems. This negotiated acquisition price was the result of protracted negotiations with the seller who initially indicated an expectation of a higher acquisition price. The NPV analysis performed by EPCOR simply supported that negotiated price.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Greg Barber  
**Title:** Controller

**Address:** 2355 W. Pinnacle Peak Road, Suite 300  
Phoenix, AZ 85027

**Company Response Number:** RUCO 4.06

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**Q:** System Improvement Benefits ("SIB") Mechanism – What extent did the SIB have on the negotiated sales price?

**A:** The SIB did not have any impact on the negotiated sales price. The acquisition price was derived through negotiation, and represented the lowest acquisition price that would have motivated a sale from the current owner. This negotiated acquisition price was the result of protracted, arms-length negotiation between the buyer and seller, who initially indicated an expectation of a higher acquisition price.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** W-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Mike Liebman  
**Title:** CFO, Global Water Resources, Inc.

**Address:** 21410 N. 19<sup>th</sup> Ave., Suite 220, Phoenix, AZ 85027

**Company Response Number:** RUCO 4.11

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Q. Unexpended CIAC – Does Willow Valley have any unexpended CIAC? If so how much.

A. Willow Valley does not have any unexpended CIAC recorded.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** W-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Mike Liebman  
**Title:** CFO, Global Water Resources, Inc.

**Address:** 21410 N. 19<sup>th</sup> Ave., Suite 220, Phoenix, AZ 85027

**Company Response Number:** RUCO 4.18

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- Q. Excessive Accumulated Depreciation Balances – Please list the plant accounts that have accumulated depreciation balances that are larger than the plant asset.
- A. Willow Valley does not have any accumulated depreciation balances larger than the related plant asset.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** W-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Mike Liebman  
**Title:** CFO, Global Water Resources, Inc.

**Address:** 21410 N. 19<sup>th</sup> Ave., Suite 220, Phoenix, AZ 85027

**Company Response Number:** RUCO 4.19

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Q. Debit Accumulated Depreciation Balances – Does Willow Valley have any debit accumulated depreciation balances?

A. Willow Valley does not have any debit accumulated depreciation balances.

**COMPANY:** EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.  
**DOCKET NO:** WS-01303A-15-0131 and W-01732A-15-0131

**Response provided by:** Sheryl L. Hubbard  
**Title:** Director, Regulatory & Rates

**Address:** 2355 W. Pinnacle Peak Road, Suite 300  
Phoenix, AZ 85027

**Company Response Number:** STF GWB 4.6

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\*\*\*For all data requests for which you do not have the information requested, please state such and skip to the next data request. Also, for responses to data requests that may be voluminous or overly burdensome, please contact the assigned analyst, Gerald W. Becker, at 602-542-0831 to discuss.

Q: Accumulated Deferred Income Taxes ("ADIT") – In response to data request GWB1.1, EWAZ does not give any recognition the ADIT balances provided in response to data request GWB1.6 of \$293,862 ADIT credit offset by a \$33,638 ADIT debit for a net ADIT credit of \$260,224.

- i. Please confirm that the above amounts are correct and the ADIT credit would serve to reduce rate base in a future proceeding.
- ii. Please provide the reasons that ratepayers should be deprived of the benefits of an ADIT liability in a future rate proceeding.

- A:
- i. Under Global Water Resources ownership of Willow Valley Water Company, and absent any changes in the balances in the ADIT accounts, the net ADIT credit would be included as a reduction to rate base in future rate proceedings.
  - ii. In an asset sale, deferred income tax asset and liability balances remain with the seller. Unlike a stock purchase transaction, tax attributes like deferred taxes and net operating losses do not convey to the buyer in an asset sale. The customers of the new owner will benefit from the buildup of ADIT liabilities associated with the excess tax depreciation over book depreciation to be recorded in the initial post acquisition years.

# **ATTACHMENT C**

## M E M O R A N D U M

TO: THE COMMISSION

FROM: Utilities Division

DATE: June 29, 2001

RE: WATER TASK FORCE OF THE ARIZONA CORPORATION COMMISSION  
(DOCKET NO. W-00000C-98-0153)  
(DECISION NO. 62993)

On November 3, 2000, the Commission issued Decision No. 62993. This decision approved Staff's recommendations regarding the Commission's Water Task Force. The Commission directed Staff to work with interested parties to develop policy statements, some of which are due by June 30, 2001. Staff has had a number of meetings with interested parties to discuss the issues and resolve parties' concerns on many occasions, as noted below. The reports addressing specific subjects reflect a consensus of the working groups. In only one working group did Staff disagree with a portion of the group's resolution of an issue, which is also discussed below. The reports address the following issues:

Finding of Fact No. 9 from Decision No. 62993 ordered Staff to develop a policy statement regarding Certificates of Convenience and Necessity for water systems. Attachment A to this memorandum is a proposal for this policy developed in a meeting with interested parties.

Finding of Fact No. 11 ordered Staff to develop a policy statement regarding acquisition adjustments and rate of return premiums for water systems. Attachment B to this memorandum is a proposal for this policy, which was developed based on several meetings with interested parties

Finding of Fact No. 29 ordered Staff to develop a policy statement regarding tiered rates. Attachment C to this memorandum is Staff's proposal for this policy, which was developed after several meetings with interested parties.

Finding of Fact No. 31 ordered Staff to develop a policy statement regarding recovery of costs related to the Central Arizona Project. Attachment D is Staff's proposal for this policy, which was developed after several meetings with interested parties. Staff is in agreement with this proposal, except for the portion which deals with the definition of the term "use." The attached policy defines "use" as those methods considered as "use" by the Arizona Department of Water Resources (ADWR). The current regulations of ADWR allow a water company to be in compliance with its requirements as long as the water system uses its CAP water anywhere within the same Active Management Area (AMA) in which the water system is located. This approach is contrary to the position the Commission took in a recent Vail Water Company (Vail) rate case.

THE COMMISSION

June 29, 2001

Page 2

In Decision No. 62450, the Commission approved Vail's cost recovery of its CAP costs with specific mandates regarding Vail's long-term plans for the CAP water. At present Vail is using its CAP water in an "in lieu recharge project". Vail's CAP water is being used by a farm in Red Rock in lieu of the farm using groundwater. Because the farm in Red Rock is in the same AMA (Tucson AMA) as Vail, Vail gets credit for this use by the farm and therefore, is in compliance with ADWR requirements, even though the farm is approximately 60 miles from Vail. Staff believes that the water being recharged in Red Rock will never actually directly benefit the aquifer in Vail and therefore, never benefit the customers of Vail. This was the basis for the Staff recommendations that were adopted by the Commission in Decision No. 62450. The Commission ordered Vail to submit, within 10 years of the Decision, a plan to use its CAP water directly in its certificated area. Decision No. 62450 also ordered Vail to actually begin using its CAP water within its certificated area within 15 years of the Decision.

For these reasons, Staff recommends that the Commission slightly, but significantly, modify the definition of "use" contained in Attachment D by adding the condition that the water system would have to use its CAP water within its certificated area.

Staff recommends that these policy statements be discussed at an Open Meeting at the Commission's convenience.

Deborah R. Scott  
Director  
Utilities Division

DRS:SMO:

ORIGINATOR: Steven M. Olea

Phoenix Office  
Arizona Corporation Commission  
1200 W. Washington St.  
Phoenix, AZ 85007  
(602) 542-4251  
(800) 222-7000

**Utilities Division**  
**Steven M. Olea - Director**

Tucson Office  
Arizona Corporation Commission  
400 W. Congress, Ste. 218  
Tucson, AZ 85701  
(520) 628-6550  
(800) 535-0148

Electric Gas Telephone Water / Sewer Consumer Services

## Attachment B

### Proposed Policy for Class D and E Water System Acquisitions

The purpose of the acquisition policy is to try to encourage acquisition and consolidation of small water utilities operating in the state. For purposes of this policy, small water utilities are limited to Class D and E water utilities, i.e., less than \$250,000 of operating revenue in the most recent calendar year. Acquisition of small water utilities should result in improved water quality and/or service for the customers.

Decision No. 62993, dated November 3, 2000, established six general conditions a water company must meet to qualify for an acquisition adjustment or rate of return premium. Per that Decision, the acquisition incentive may be granted in one of two ways: (1) recovery of an amount paid in excess of the book value of the acquired company's assets (acquisition adjustment), or (2) a rate of return premium, but not both. This policy develops criteria and procedures for determining the amount of acquisition incentive that will be eligible for recovery in rates following acquisition of a small water utility.

The purchase price for a small water utility could exceed the book value of its plant in service, resulting in a positive acquisition adjustment. This policy applies exclusively to positive acquisition adjustments, and negative acquisition adjustments shall not be recognized for rate-making purposes.

In certain cases, a rate of return premium may be allowed instead of an acquisition adjustment. Once the rate of return percentage is determined, a premium amount will increase that percentage. The premium percentage will be allowed in rates for a period of time that the Commission determines is appropriate to provide an acquisition incentive.

Following is the list of six conditions a company must prove by a preponderance of the evidence in order to obtain an acquisition adjustment or rate of return premium in rates, as well as criteria to meet those conditions.

**1. The Acquired Company Is A Class D Or E.**

- This policy is to be applied to the acquisition of Class D and E water utilities, i.e., those having less than \$250,000 of operating revenue in the most recent calendar year.

**1. The Acquisition Will Not Negatively Affect The Viability Of The Acquirer.**

- The acquiring company shall provide documentation that satisfactorily demonstrates its continued financial viability subsequent to the acquisition. Staff will not recommend approval of a proposed acquisition that would be potentially detrimental to an acquirer's financial viability.

**1. The Acquired System's Customers Will Receive Improved Service In A Reasonable Timeframe.**

- The acquiring company shall submit a plan for improving service to the customers of the acquired system. The plan shall include, but not be limited to, a detailed listing of the current violations and deficiencies of the water company to be acquired, as well as the acquirer's proposed solutions and the related costs. Additionally, the plan must also include a proposal for how the rates of the small water utility's customers will be affected. The acquirer's plan should also provide estimated implementation dates for each system or service improvement. A service improvement plan might include, but is not limited to, the following:
  - a. Delivering water to customers that meets the quality standards of the Arizona Department of Environmental Quality ("ADEQ") and the Safe Drinking Water Act.
  - b. Satisfactory resolution of outstanding violations with ADEQ and the Arizona Department of Water Resources ("ADWR").
  - c. Developing a reliable source of water supply.
  - d. Developing appropriate water storage capacity.
  - e. Improved water pressure, either higher or lower, within the distribution system.
  - f. Replacement of inadequate, insufficient, deteriorated, and/or inefficient infrastructure.
  - g. Improving billing procedures, customer complaint resolution, and service response times.

**1. The Purchase Price Is Fair And Reasonable (Even Though That Price May Be More Than The Original Cost Less Depreciation Book Value) And Conducted Through An Arm's Length Negotiation.**

- One factor that would contribute to recommending an acquisition incentive is if the net plant value is either very small or zero, due to substantially or fully depreciated assets that require replacement. Although the water company assets may reflect zero net book value on the records, the assets in theory still have value due to the fact that they generate a future revenue stream. To determine if the purchase price and resulting acquisition incentive amount is fair and reasonable, Staff's evaluation shall include, but not be limited to, the following criteria:
  - a. The purchase price must be the result of good faith negotiations between the two transacting entities.
  - b. The acquisition must be conducted through an arm's length transaction, and the two parties must not be affiliates as defined by A.A.C. R14-2-801.1.
  - c. Present value of future cash flows.

**1. The Recovery Period For The Acquisition Adjustment Should Be For A Specific Minimum Time.**

- Staff will evaluate the acquisition adjustment recovery period to be fair and reasonable to both the acquirer, and the customers of the small water utility. The specific recovery period shall be set on a case-by-case basis and shall be consistent with the period over which customers are expected to benefit, as well as mitigate the impact of cost recovery on rates.
- If a rate of return premium is sought by the acquiring company, Staff will determine the premium percentage and recovery period on a case-by-case basis. Recovery via the rate of return premium will be calculated to recoup only the excess of the purchase price over the book value of the plant in service.

#### **1. The Acquisition Is In The Public Interest**

Staff will investigate the acquirer's compliance history with the ADEQ and the ADWR to determine if it is a fit and proper entity to acquire a small water utility. Acquisition incentives will not be granted to entities that are currently in violation of rules set forth by ADEQ and/or ADWR.

The acquisition of a small water utility would comply with the standard of public interest if the above detailed five conditions are met, and no ADEQ and/or ADWR rule violations are pending. Additionally, the following circumstances may further demonstrate how an acquisition could be in the public interest:

- The small water utility is insolvent, defined as "unable or having ceased to pay debts as they fall due in the usual course of business".
- The small water utility will have increased opportunities to obtain short-term financing as a result of the acquisition. This will enable the company to make improvements to, and correct deficiencies within its water system that would enable it to serve water that meets the quality standards set forth in the Safe Drinking Water Act.
- Short-term and long-term cost savings can be demonstrated as a result of the acquisition, as well as efficiencies and economies of scale.
- As a result of the acquisition, delinquent remittance of transaction privilege tax and/or property tax by the small water utility to the Arizona Department of Revenue will be satisfied.

#### **PROPOSED PROCEDURE**

Once the two entities enter into a transfer/purchase agreement, they will submit a joint application to the Commission pursuant to Arizona Administrative Code Section R14-2-103. The joint application should include the following information:

- a. A Commission approved rate application for water companies with annual gross operating revenues of less than \$250,000 for the small water utility to be acquired as of the most recent fiscal year end, or all the information required in such a rate case application along with a request for a Commission accounting order delineating how the acquisition incentive will be treated.
- b. Financial statements of the acquirer as of the most recent fiscal year end.
- c. Disclosure of transaction as either an asset purchase and Certificate of Convenience and Necessity transfer, or stock purchase.

- d. A copy of the purchase agreement/sale document including the proposed purchase price.
- e. A detailed explanation and supporting evidence to demonstrate how the acquisition meets the six conditions to be eligible for recovery of an acquisition adjustment in rates.
- f. A list and explanation of current known deficiencies of the system to be acquired as well as the acquirer's proposed solutions to remedy the deficiencies, along with the costs, and timeframe for implementing the solutions.
- g. Reconstruction Cost New (RCN) for the small water utility to be acquired or adequate information for an RCN study to be performed.
- h. A detailed calculation of the proposed acquisition adjustment requested to be eligible for recovery in rates, a proposal for its method of recovery, and a calculation of its effect on rates.

Upon submission of the application, Staff will analyze the documentation to determine whether the acquisition meets the six conditions identified in Decision No. 62993, by:

1. Analyzing the company's financial information to determine that it is a Class D or E water utility.
2. Assessing the acquiring entity's financial resources to determine if sufficient financial resources are available to acquire a small water utility without jeopardizing the acquirer's good financial standing.
3. Evaluating the acquirer's proposed actions to assess whether customers of the acquired small water utility will receive improved service within a reasonable timeframe.
4. Evaluating the original cost of the existing plant assets on the acquired utility's books, as well as RCN amounts. Staff will then compare those two amounts with the proposed purchase price to determine if the purchase price is fair and reasonable; if the purchase price was negotiated, and if the sale will be conducted, through an arms length transaction; and what amount of acquisition adjustment or rate of return premium, if any, will be allowed.
5. Classifying the acquisition incentive as either a regulatory asset (acquisition adjustment) or a rate of return premium, to be recovered over a specific time.
6. Reviewing the documentation provided in response to the five conditions set forth, as well as other potential benefits identified by the acquirer and determine if the acquisition meets the criteria of public interest. Staff will also evaluate whether the acquirer is a "fit and proper" entity to purchase a small water utility.
7. Requesting and analyzing other information/data that Staff and/or the Commission deems necessary for a particular case.

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ORIGINAL



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MEMORANDUM  
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TO: Docket Control Center

FROM: Steven M. Olea  
Director  
Utilities Division

AZ CORP COMMISSION  
DOCKET CONTROL

Arizona Corporation Commission

DOCKETED

MAR 19 2012

DATE: March 19, 2012

DOCKETED BY	<i>MUN</i>
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RE: STAFF REPORT FOR COMPLIANCE FILING IN THE MATTER OF THE APPLICATION OF GLOBAL WATER FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES FOR UTILITY SERVICE DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF ITS PROPERTY THROUGHOUT THE STATE OF ARIZONA. DOCKET NOS. SW-20445A-09-0077, W-02451A-09-0078, W-01732A-09-0079, W-20446A-09-0080, W-02450A-09-0081 AND W-01212A-09-0082

Attached is the Staff Report, pursuant to the compliance filing ordered in the above-named docket, resulting from the series of workshops held in Docket No. W-00000C-06-0149, Generic Evaluation of the Regulator Impacts from the Use of Non-Traditional Financing Arrangements by Water Utilities and Their Affiliates.<sup>1</sup>

Staff recommends:

1. Consideration of authorizing utilities to record and defer depreciation and a cost of money using an Allowance For Funds Used During Construction ("AFUDC") rate on qualified plant replacements<sup>2</sup> for up to 24 months<sup>3</sup> after the in-service date to mitigate the effects of regulatory lag.
2. Consideration of allowing acquisition premiums and/or a premium on the rate of return on a case by case basis and subject to certain conditions, in those cases where the impacts may be offset to some extent by the effects of operational improvements. If granted, acquisition premiums would be subject to review and re-justification in future proceedings.
3. Consideration of establishing a mechanism to recognize the effect of delays in the processing of rate cases when applicant is not culpable for those delays.

<sup>1</sup> Staff will prepare separate reports to address distribution system improvement charge ("DSIC") and the treatment of income taxation for S corporations and limited liability companies.

<sup>2</sup> At a minimum qualified plant would need to be found used and useful during the 24-month period.

<sup>3</sup> Terminates before 24 months if rates become effective that include the qualified plant in rate base in the 24-month period.

4. That monies received pursuant to Infrastructure Coordination and Financing Agreements ("ICFAs") continue to be treated as Contributions in Aid of Construction ("CIAC"). This recommendation may be modified as a result of the pending review of Global's ICFAs by an independent Certified Public Accountant firm.

SMO:GWB:kdh

Originator: Gerald W. Becker

Service List for: Global Water – Palo Verde Utilities Company et al  
Docket Nos. SW-20445A-09-0077 et al.

Mr. Timothy J. Sabo, Esq.  
Roshka DeWulf & Patten, PLC  
One Arizona Center  
400 E. Van Buren Ste. 800  
Phoenix, Arizona 85004

Mr. Dan Pozefsky  
Chief Counsel, RUCO  
1110 W. Washington Street, Suite 220  
Phoenix, Arizona 85007

Mr. Michael T. Hallam  
Lewis & Roca  
40 N. Central Avenue, Suite 1900  
Phoenix, Arizona 85004

Mr. Garry D. Hays  
Law Offices of Garry D. Hays  
1702 E. Highland Avenue, Suite 204  
Phoenix, Arizona 85016

Mr. Jeffrey W. Crockett, Esq.  
Brownstein, Hyatt, Farber & Schreck  
40 N. Central Avenue, 14th Floor  
Phoenix, Arizona 85004

Mr. Court Rich  
6613 N. Scottsdale Road, Suite 200  
Scottsdale, Arizona 85250

Mr. Rick Fernandez  
25849 W. Burgess Lane  
Buckeye, Arizona 85326

Mr. Greg Patterson  
916 W. Adams Street, Suite 3  
Phoenix, Arizona 85007

Mr. Paul Walker  
3131 E. Camelback Road, Suite 200  
Phoenix, Arizona 85016

Mr. Gary Yaquinto  
2100 N. Central Avenue, Suite 210  
Phoenix, Arizona 85004

Mr. Bryan O'Reilly  
50 S. Jones Boulevard, Suite 1  
Las Vegas, Nevada 89107

**STAFF REPORT  
UTILITIES DIVISION  
ARIZONA CORPORATION COMMISSION**

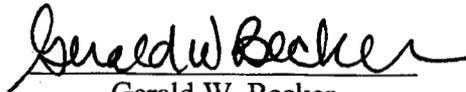
**STAFF REPORT FOR COMPLIANCE FILING IN THE MATTER OF THE  
APPLICATION OF GLOBAL WATER FOR THE ESTABLISHMENT OF JUST AND  
REASONABLE RATES AND CHARGES FOR UTILITY SERVICE DESIGNED TO  
REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF ITS  
PROPERTY THROUGHOUT THE STATE OF ARIZONA**

**DOCKET NOS. SW-20445A-09-0077  
W-02451A-09-0078  
W-01732A-09-0079  
W-20446A-09-0080  
W-02450A-09-0081  
W-01212A-09-0082**

**MARCH 19, 2012**

## STAFF ACKNOWLEDGMENT

Staff report for compliance filing in the matter of the application of Global Water for the establishment of just and reasonable rates and charges for utility service designed to realize a reasonable rate of return on the fair value of its property throughout the state of Arizona was the responsibility of the Staff members listed below.

A handwritten signature in cursive script, reading "Gerald W. Becker". The signature is written in black ink and is positioned above a horizontal line.

Gerald W. Becker  
Public Utilities Analyst V

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**ATTACHMENT**

EXCERPT FROM DECISION NO 71878 .....	ATTACHMENT A
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### **Introduction**

On February 20, 2009, Global Water - Palo Verde Utilities Company ; Valencia Water Company - Greater Buckeye Division ; Willow Valley Water Company, Inc.; Global Water - Santa Cruz Water Company; Water Utility of Greater Tonopah, Inc.; and Valencia Water Company – Town Division, (collectively “Global” or “Company”) filed with the Arizona Corporation Commission (“Commission”) applications in the above-captioned dockets seeking increases in their respective permanent base rates and other associated charges. Decision No. 71878 arose from that proceeding in Docket Nos. SW-20445A-09-0077 et al.

In Decision No. 71878, the Commission approved Staff’s recommendation that approximately \$60.1 million of monies received under Infrastructure Coordination and Financing Agreements (“ICFAs”) be imputed as Contributions in Aid of Construction (“CIAC”). Decision No. 71878 further ordered that a generic investigation be commenced which looks at how best to achieve the Commission’s objectives with regard to encouraging the acquisition of troubled water companies and the development of regional infrastructure where appropriate. The workshop was to address whether ICFAs, or other mechanisms, if properly segregated and accounted for, could be utilized to finance the actual acquisition of troubled water companies, and a portion of the carrying costs associated with the unused water and wastewater facilities or infrastructure determined to meet the Commission’s objectives in this regard.

To comply with Decision No. 71878, Staff held a series of workshops. The workshop dates and subject matters are shown below:

November 1, 2010 – Introduction and timelines.

January 14, 2011 – Distribution System Improvement Charges (“DSICs”)

February 25, 2011 – Acquisition Adjustments and Rate of Return Premiums.

March 25, 2011- Imputed Income Tax for S Corporations and certain LLCs

June 16, 2011 – Generalized Cost of Equity. See also Docket No. 08-0149,

June 24, 2011 – ICFAs

November 4, 2011 – Cost of Equity, ICFAs, and Conclude Workshops

### **Purpose of the Workshops**

The purpose of the workshops was to comply with the requirements of Decision No. 71878<sup>1</sup> as shown on Attachment A.

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<sup>1</sup> Decision No 71878, 89 at 9-20.

### Staff Analysis

Staff attended the workshops and has reviewed the filings of the various participants. In this filing Staff's comments are limited to its recommendations on:

1. Post-in-Service Allowance for Funds Used During Construction ("AFUDC") and Deferred Depreciation
2. Acquisition premiums and/or rate of return premiums.
3. A possible mechanism to capture the effects of untimely delays in the processing of a rate case.
4. Continued treatment of ICFAs per Decision No. 71878 pending results of an independent audit.

### Post-in-Service AFUDC and Deferred Depreciation

At one of the workshops, participants expressed concern regarding the inability to earn an awarded Rate of Return ("ROR") due to the carrying costs incurred between the time when Construction Work in Progress ("CWIP") is transferred to Utility Plant in Service ("UPIS") and considered for recognition in rate bases. This occurs because the recording of AFUDC ceases when CWIP is transferred to UPIS.

Under present treatment, utilities record projects in the CWIP accounts and are allowed to record AFUDC on those balances using a rate that equals the utility's cost of capital. Upon transferring the cost of the completed project from CWIP to UPIS, the recording of AFUDC ceases and the utility begins depreciating the asset. During the interim period between the transfer from CWIP to UPIS and the date when the asset may be recognized in rate base, the utility bears the carrying costs of the asset which are unavoidable and unrecoverable under the present regulatory process. Once a project is completed, it is transferred to UPIS.

Staff recommends that some consideration be given to mitigating the effects of carrying costs of net plant additions between rate proceedings. Under optimal conditions, a utility would transfer plant to UPIS concurrently with filing a rate case which would require up to 12 months to process. In addition, Staff prefers 12 months of data after a Company has received new rates before it can file another rate case. Realistically, the utility will bear the carrying costs of the incremental net plant additions during the interim period which is at least 24 months. While the utility is technically not entitled to earn on that incremental plant absent a fair value determination, Staff recommends that some consideration be given to mitigate effects of associated carrying costs which could be significant. Staff recommends the deferral of post-in-service AFUDC for a period of up to 24 months to mitigate the effect of regulatory lag.

Staff also recognizes that a utility records depreciation expense from the date that the asset is placed into service. If this occurs during or prior to the end of the test year in a rate proceeding, the utility incurs depreciation expense but has no opportunity to recover it. Similar to the reason associated with regulatory lag discussed more fully above regarding post-in-service

AFUDC, Staff further recommends that depreciation expense be deferred for a period of up to 24 months to mitigate the effects of regulatory lag. (The precise entries to effect this would need to be determined.)

The deferral of AFUDC and depreciation would allow a Company to request recovery of both amounts, which it would not normally be allowed to do absent an approved deferral.

### Acquisition Premiums

Some participants cite two instances when Staff recommended and the Commission approved an acquisition premium. In researching this issue, there are two cases to consider which may serve to clarify the record.

1. Paradise Valley Water Company ("PVWC")/Mummy Mountain Water Company ("Mummy Mountain") – In this proceeding, Docket Nos. W-01342A-98-0678 and W-01303A-98-0678, Decision No. 61307, the owners of Mummy Mountain sold their system for approximately \$150,000 which included a \$40,000 payment to the sellers, approximately \$47,000 forgiveness of debt for the utility service owed by the seller to the buyer (PVWC), \$32,000 of property taxes owed by the seller but to be paid by the buyer, and administrative costs of \$20,000 associated with the sale. Unfortunately, the record is silent regarding the net book value of the assets transferred to PVWC, and Mummy Mountain's most recent rate case, Docket No. W-01342A-91-0224, Decision No. 57877, is too stale to provide reliable information regarding an appropriate valuation of the business. Staff is therefore unable to ascertain the existence, or lack thereof, of an acquisition premium associated with this transaction.
2. The sale of the "McClain systems" to Northern and Southern Sunrise Water Companies – Staff reviewed the record underlying Decision Nos. 68412 and 68826. Dated January 23, 2006, Decision No. 68412 was a rate case which approved a negative goodwill of \$52,141 for substandard operating conditions of the McClain systems. Dated June 29, 2006, Decision No. 68826 approved the transfer of the "McClain systems" to Northern and Southern Sunrise Water Companies and approved acquisition costs of \$300,000, including \$100,000 for reorganization, bankruptcy and other costs, \$100,000 for Commission related activities, and \$100,000 for transition costs such as support for an interim operator, capitalized labor costs, etc.<sup>2</sup> Thus, Staff could not find any evidence of the Commission granting recovery of a true acquisition premium, although Staff also notes that it is aware of few requests by utilities to recover an acquisition premium.

While a policy of granting acquisition premiums has the theoretical potential to encourage healthy utilities to acquire non-viable utilities, it also has the undesirable effect of providing owners an incentive to underperform and become non-viable by design to place their utilities in a position to become a lucrative acquisition target. Thus, establishing a general policy

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<sup>2</sup> Decision No 68826, Findings of Fact, paragraph 47.

to grant acquisition premiums can have undesirable as well as desirable attributes. Accordingly, acquisition premiums are better considered on a case-by-case basis.

Staff concludes that the granting of acquisition premiums should be withheld at the time the proposed sale/transfer is being considered and that authority should be granted to allow potential recovery upon the acquiring utility meeting specified conditions such as 1) demonstrating clear, quantifiable and substantial benefits realized by ratepayers that are unlikely to have been realized had the transaction not occurred; 2) balancing the value of the realized benefits against the rate impact; and 3) granting any recovery of an acquisition premium over an extended time and requiring continued recovery to be re-justified in subsequent rate proceedings to encourage continuous delivery of improved, quality service.

#### Rate of Return Premiums

Rate of return premiums may be an alternative to acquisition premiums for encouraging healthy utilities to acquire non-viable utilities. However, unlike acquisition adjustments, it does not present the potential to encourage dysfunctional behavior by operators to intentionally underperform, and accordingly, it is generally a preferred mechanism. Rate of return premiums also have a benefit of inherently including a provision for revisiting the appropriateness of its continuation in each rate case. Staff concludes that the granting of rate of return premiums can be an appropriate mechanism for encouraging the acquisition of non-viable water companies under certain conditions. Similar to the granting of an acquisition premium as discussed above, granting of rate of return premiums should be predicated on the attainment of demonstrable, quantifiable and realized benefits to ratepayers that would not have occurred had the transaction not occurred. Rate of return premiums might be predicated on the attainment of certain operational goals and/or implementation of certain best management practices and/or other metrics.

#### Untimely Delays

The Arizona Administrative Code prescribes certain times for the processing of rate cases. The time lines vary from 360 days<sup>3</sup> for Class A and B utilities to 120 days for Class E utilities. In some instances, a case may experience delays for which an applicant is not culpable due to its actions or inactions. To the extent that a proposed rate increase is delayed, the applicant experiences a permanent loss of the incremental revenues that are ultimately approved. To mitigate the effect of foregone revenues under the aforementioned circumstances, Staff recommends the establishment of a deferral mechanism on a case by case basis to capture the estimated effect of untimely delays in the processing of rate applications. Such a mechanism would be subject to additional analysis in subsequent rate proceedings.

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<sup>3</sup> Time lines are from the "Sufficiency Date" when Staff determines that an application has met (initial) filing requirements.

**Continued Treatment of ICFAs Consistent with Decision No 71878**

At the time of this report, an audit of the ICFA monies received by Global and its parent under ICFAs through December 31, 2008, is underway. Staff will file a supplemental report upon receipt and review of the report from the independent audit firm.

**Conclusions and Recommendations**

Staff recommends:

1. Consideration of authorizing utilities to record and defer depreciation and a cost of money using an Allowance For Funds Used During Construction ("AFUDC") rate on qualified plant replacements<sup>4</sup> for up to 24 months<sup>5</sup> after the in-service date to mitigate the effects of regulatory lag.
2. Consideration of allowing acquisition premiums and/or a premium on the rate of return on a case by case basis and subject to certain conditions, in those cases where the impacts may be offset to some extent by the effects of operational improvements. If granted, acquisitions premium would be subject to review and re-justification in future proceedings.
3. Consideration of establishing a mechanism to recognize the effect of delays in the processing of rate cases when applicant is not culpable for those delays.
4. That monies received pursuant to Infrastructure Coordination and Financing Agreements ("ICFAs") continue to be treated as Contributions in Aid of Construction ("CIAC"). This recommendation may be modified as a result of the pending review of Global's ICFAs by an independent Certified Public Accountant firm.

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<sup>4</sup> At a minimum qualified plant would need to be found use and useful during the 24-month period.

<sup>5</sup> Terminates before 24 months if rates become effective that include the qualified plant in rate base in the 24-month period.

## ATTACHMENT A

Decision No. 71878:

*IT IS FURTHER ORDERED that a generic investigation shall be commenced which looks at how best to achieve the Commission's objectives with regard to encouraging the acquisition of troubled water companies and the development of regional infrastructure where appropriate. As part of this proceeding, the workshop shall address whether ICFAs, or other mechanisms, if properly segregated and accounted for, could be utilized to finance the actual acquisition of troubled water companies, and a portion of the carrying costs associated with the unused water and wastewater facilities or infrastructure determined to meet the Commission's objectives in this regard. Therefore, we will require Staff to notice and facilitate, and Global to participate in stakeholder workshops designed to address these issues, and make recommendations to the Commission on the issues discussed in the workshops, including whether it is appropriate to adopt the recommendations in the next Global Utility rate case, as well as other future rate cases. The workshops shall be noticed and held in the existing Generic Docket.*

*IT IS FURTHER ORDERED that Staff shall, within 30 days, provide notice to the parties to the Generic Docket, and to other stakeholders, of new workshops in Docket No. W-00000C-06-0149, for stakeholder workshops designed to address the issues set forth in Findings of Fact No. 84. Following the conclusion of the workshops, Staff shall, within 90 days, make recommendations to the Commission on the issues discussed in the workshops, including whether it is appropriate to adopt the recommendations in the next Global Utility rate case, as well as other future water cases.*

*IT IS FURTHER ORDERED that if the Commission workshop results in future treatment of ICFAs that is different than the result in this case, the Applicants may request review of the ICFAs subject to this Order in a future rate case for setting prospective rates consistent with the recommendations adopted from the future workshop process.*

# **ATTACHMENT D**

## Tolleson to get \$4.3M settlement in water treatment plant dispute

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Submitted by Emily Toepfer on Fri, 06/12/2015 - 12:00am

The Tolleson City Council on Tuesday approved a \$4.3 million settlement with one of its Wastewater Treatment Plant users following a yearlong dispute over upgrades.

EPCOR, a private utility company that provides water and wastewater services to Sun City customers, has two weeks to pay Tolleson under the agreement.

Tolleson's plant, 9501 W. Pima Road in Phoenix, has been in operation since 1968 and has the capacity to treat 8.1 million gallons of water per day.

The city has the potential to treat up to 2.1 million gallons per day, while EPCOR contracts for 5.2 million gallons and a third user, JBS Packerland-Tolleson, contracts for 800,000 gallons.

EPCOR has had a service agreement with Tolleson for wastewater treatment since June 1985, which states the company pays its share of operations and maintenance of equipment and facilities.

Tolleson started planning upgrades to the plant in 2010 in order to treat high levels of ammonia under the terms of its Arizona Pollutant Discharge Elimination System Permit, but EPCOR later refused to pay its 63 percent share of the cost, according to the claim.

The dispute centered on each party's interpretation of provisions in the agreement that pertained to identifying capital projects and determining EPCOR's share of costs, the claim states.

Tolleson filed a complaint against EPCOR in July 2014, and the company counterclaimed five months later.

In an effort to resolve the matter, the parties negotiated a fourth amendment to their service agreement, which better defined the rights and responsibilities of the parties, said Rick Hood, an attorney with Gust Rosenfeld, which represents Tolleson.

It also detailed the procedures by which studies are made and how future capital projects and engineers will be selected. In the end, Tolleson will have the final say, although a dispute resolution process was also established in the agreement.

"If there's a problem with a study or project, it will become known earlier, and through the dispute resolution process, it will be taken care of one way or the other before we get to the point where the city has put it out for bid, selected their engineer and began to incur costs," Hood said.

The total project cost through April was \$7.1 million. At the request of JBS, it also included adding capacity for another 130,000 gallons per day.

EPCOR agreed to pay its share at the same percent on any remaining balance for the ammonia project not yet billed.

Currently, the company uses only 3.2 million gallons per day of its 5.2-million-gallon contracted capacity, and the new agreement states it can reduce its capacity by up to 1.5 million gallons per day.

In that case, Tolleson would likely lower the plant's total capacity to 6.6 million gallons per day to reduce the size of future capital projects, the agreement states.

With the settlement approved, the lawsuit will be dismissed with prejudice and each party will pay its own legal fees.

"Going forward, it will strengthen our relationship with one of our partners, and we look forward to continuing to grow together," Tolleson City Manager Reyes Medrano Jr. said.

### **Previous plant dispute**

It wasn't the first time the city sued a partner over the plant. Tolleson filed a \$26 million claim in 2007 when Peoria discontinued use of the wastewater treatment plant and refused to pay its share of renovations.

At the time, \$42 million in upgrades were planned to bring the plant up to code standards. When Peoria decided not to participate, it cost \$25,000 to have new designs done, city officials said at the time.

An agreement was reached in April 2009 that required Peoria to pay Tolleson \$8.5 million — \$1.1 million in unpaid fees and \$7.4 million for the remainder of the litigation in three installments.

Upgrades included anaerobic digesters, solids thickening and solids dewatering systems, the digester gas system and boilers, ancillary solids equipment and piping.

Tolleson finished the renovations in March 2011, and they should last another 20 years, officials said.

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# Phoenix water company overcharged city \$2.7M, audit claims



Betty Reid, The Republic | azcentral.com

11:27 a.m. MST August 22, 2014



(Photo: Getty Images)

A city audit claims a north Phoenix private water and wastewater provider overcharged the city \$2.7 million over five years and also passed on an unnecessary tax to the city.

Officials with EPCOR Water, which sells water to Phoenix to serve Anthem Phoenix West, dispute some of the audit's findings and are working with the city to settle others.

Phoenix directly provides water to the majority of its residents. However, in this case, Phoenix buys water from EPCOR, which allows the city to use its pipes to serve residents.

Councilwoman Thelda Williams called the Phoenix audit results serious. She said Phoenix needs to double check any cost imposed by EPCOR, which also has caught flak recently from other areas of the Valley for its rates.

"I think the city needs to receive reimbursement, and we will monitor the situation closely," Williams said.



AZCENTRAL

[Water rates vary in Phoenix metro area](#)

[\(http://www.azcentral.com/story/news/local/surprise/2014/04/16/water-rates-vary-phoenix-metro-area/7751735/\)](http://www.azcentral.com/story/news/local/surprise/2014/04/16/water-rates-vary-phoenix-metro-area/7751735/)

The audit, released in June, examined services delivered from 2008 to 2013 to Anthem Phoenix West, west of the Interstate 17 and Anthem Way.

The Phoenix audit said the city bought about 1.9 millions of gallons of water over five years. The city paid EPCOR about \$6 million for the water and wastewater services.

## The audit included several findings:

- The city auditors believe it overpaid for water lost through leaks and breaks. It's EPCOR's responsibility to fix those leaks, officials said. However, Phoenix should have monitored the water loss, according to the audit.
- EPCOR taxed Phoenix for water resold to the residents. However, the city is exempt from the tax.
- EPCOR also raised fees — an increase auditors believe EPCOR failed to justify. This amounts to about \$2.7 million.

EPCOR officials said they are working with the city to resolve some of the issues.

The city has accepted an adjustment of \$5,387 for water-loss charges, city officials said.

The company is waiting for a refund from the Arizona Department of Revenue, which collected the tax from EPCOR, said Jeff Stuck, EPCOR Water director of operation. City officials said EPCOR agreed to seek the refund and repay \$1,214.

As for the rate increase, Stuck said the Arizona Corporation Commission approved it, so EPCOR had the right to charge the city. He said Phoenix should work with the commission to address the rate increase.



AZCENTRAL

[Sun City, Sun City West could see increased wastewater rates](#)

[\(http://www.azcentral.com/story/news/local/surprise/2014/08/12/sun-city-sun-city-west-wastewater-rates/13953033/\)](http://www.azcentral.com/story/news/local/surprise/2014/08/12/sun-city-sun-city-west-wastewater-rates/13953033/)

City officials had not raised water rates for two consecutive years.

However, the latest budget called for a new tax, which will cost an average homeowner an extra \$1.50 per month. Phoenix would base the tax on meter size, not water usage.

EPCOR provides water and sewer services to other parts of the Valley.

It has been under fire recently after [Sun City West Valley customers complained about its water and wastewater rates](http://www.azc.com/story/news/local/surprise/2014/08/12/sun-city-sun-city-west-wastewater-rates/13953033/) ([/story/news/local/surprise/2014/08/12/sun-city-sun-city-west-wastewater-rates/13953033/](http://www.azc.com/story/news/local/surprise/2014/08/12/sun-city-sun-city-west-wastewater-rates/13953033/)). Earlier this year, the Arizona Corporation Commission, which regulates utilities in the state, received complaint letters as well as petitions with thousands of signatures from homeowners requesting a review of rates.

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# **ATTACHMENT E**

# Accounting for Public Utilities

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basis that they were not considered used or useful in providing utility service. However, it may be argued that no relief results in an unfair burden to the utility in those situations where project decisions were initially based on good judgment to supply ratepayers with adequate service. Where prudence is demonstrated on the part of the utility, commissions often allow a deferral of the loss associated with the cancellation and an amortization to cost of service over some extended future period. (For further discussion, see § 4.04[11][d], below.)

The various rate base components are discussed in detail in the following sections. Because of the complexity and controversy surrounding the working capital component, especially cash working capital, Chapter 5 is devoted to that discussion.

#### § 4.04 Items Included in Rate Base

##### [1] Plant in Service

Plant in service is the most important component of a utility's rate base. This item commonly represents between 95 and 99 percent of the total rate base amount, after a deduction for related accumulated depreciation and amortization. The significance of plant in service is easily understood in light of the tremendous amount of capital invested in the construction of utility facilities. Major expenditures are required for land acquired for construction sites, construction material and supplies, operation of construction-related equipment, and construction-related labor activities. In addition, overhead allocations are required for those general expenses incurred which are, at least in part, due to utility construction (administrative payroll, engineering design, employee pension expense, sales tax, etc.). Furthermore, financing costs are generally capitalized as a component of plant cost during the construction period. In the case of electric power generation from nuclear fuels, the extensive costs of procurement, refinement, enrichment, and fabrication of the fuel are also capitalized as a separate component of the utility plant. Despite being the largest component of the rate base, utility plant is generally one of the less controversial areas in a rate proceeding. However, the prudence of expenditures or the usefulness of plant if large amounts of excess capacity exist is

sometimes challenged. The amount expended during construction also may be challenged.

## [2] Acquisition Adjustments

The general rule related to the acquisition of utility plant previously used in the utility function is that the rate base component for the plant includes only the original cost of the property to the first owner devoting the property to public service. Therefore, if a utility acquires major fixed assets (i.e., an operating unit or system) from another utility by purchase, merger, consolidation, liquidation, or otherwise at a price in excess of the seller's original cost (net of accumulated depreciation), the addition to the acquiring utility's rate base reflecting the acquired assets may be limited to the undepreciated original purchase price. The excess amount paid is referred to as an acquisition adjustment and is placed in a separate account to be treated for ratemaking purposes as so authorized by the jurisdictional regulatory commission. For example, electric utilities subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC) must place acquisition adjustment balances in Account 114—"Electric Plant Acquisition Adjustments." Instructions to the FERC's Uniform System of Accounts call for amortization of the adjustments to Account 406, "Amortization of Electric Plant Acquisition Adjustments," with amounts includible in operating expenses, pursuant to approval or order of the Commission. If the Commission has not approved the use of Account 406, the amortization is to be recorded in Account 425, "Miscellaneous Amortization" (below-the-line), over a period not longer than the estimated remaining life of the related properties (or 15 years in the case of land-related adjustments). See Chapter 11 for a detailed discussion of the Uniform Systems of Accounts.

The necessity of this separate accounting treatment is largely a consequence of certain abuses in the utility industry during the acquisition and merger period of the 1920s and 1930s. (See Chapter 2 for a detailed discussion.) Through the process of acquiring utility assets or entire utility companies at prices in excess of depreciated cost, purchasing utilities were able to write up their basis in plant assets. If these purchase prices were in excess of the "value" of the property, the utility was able to inflate its rate base artificially. This situation often occurred if the purchase was from an affiliated

company under the ownership of a common utility holding company. By effectively trading properties, commonly owned utilities were able to inflate their rate bases through transactions that lacked any economic substance.

The outgrowth of this situation was a general consensus among regulators that utility customers should not pay on an amount in excess of the cost when property was originally devoted to public service, since any excess represented only a change in ownership without any increase in the service function to utility ratepayers. By accounting for acquisition adjustments separately from plant in service, these excess costs could be better controlled by regulatory authorities as to their ultimate disposition.

Two basic questions surround the ratemaking treatment of the various amounts included in the acquisition adjustments account:

- (1) should any of the amounts be accorded rate base treatment; and
- (2) should the amortization of any of these balances be considered in cost of service?

Rate base and cost of service treatment are often inconsistent when commissions deal with the acquisition adjustments issue.

Acquisition adjustments are sometimes excluded from the rate base and amortized below-the-line under the premise that these excess costs provide no additional benefit to ratepayers and that to allow these investment dollars to earn a return or to allow recovery through cost of service treatment may unjustly penalize consumers. Rate base treatment and/or cost of service treatment, however, has been allowed by various regulatory commissions under a variety of circumstances. The reasons most commonly cited for allowing rate base and/or cost of service treatment of acquisition adjustments are as follows:

- (1) when acquisitions represent an essential or desirable part of an integration of facilities program devoted to serving the public better;
- (2) when acquisitions are clearly in the public interest, because operating efficiencies offset the excess price over net original cost; and
- (3) when acquisitions are determined to involve arm's-length bargaining.

A substantial number of cases exist where rate base and/or cost of service treatment has been allowed as a result of satisfying one or more of the criteria listed above. For example, in 1969, the Tennessee Public Service Commission allowed both rate base and cost of service treatment for acquisition adjustments of United Inter-Mountain Telephone Company, where the acquisitions were found to be in the best interest of the public and not for the purpose of inflating the rate base.<sup>4</sup> In the 1955 case of *Arlington County v. Virginia Electric Power Co.*,<sup>5</sup> the Virginia Supreme Court of Appeals ruled that the Virginia State Corporation Commission had properly allowed both rate base and cost of service treatment for an amount paid at arm's-length bargaining in excess of original cost when first devoted to public use. When the Louisiana Public Service Commission allowed Louisiana Power and Light Company rate base and cost of service treatment for certain acquisition adjustments, the Louisiana Commission relied upon several of the criteria previously discussed. To quote from the Louisiana Commission's 1946 decision:

"The owners of a public utility are entitled to earn and receive a fair rate of return upon the money prudently invested in property used and useful in rendering public service. Money is prudently invested, even though it is in excess of the original cost of the property purchased, if the excess of purchase price over original cost was paid as the result of arm's-length bargaining between nonassociated buyer and seller, if the excess was necessary for the integration of the property into a larger and more efficient system, and if the purchase necessitating the excess did or reasonably should have resulted in public benefit by improvement of service to customers or in lowered rates or both better service and lowered rates. This integration cost or excess of purchase price over original cost termed in prescribed system of accounts as 'Utility Plant Acquisition Adjustments' should remain a part of the prudent investment during the life of the physical property to which it was applied, and its extinguishment from the investment when and if required by the Commission, should be accomplished by amortization through annual charges to Operating Revenue Deductions during the life of the

<sup>4</sup> Re United Inter-Mountain Tel Co, 79 PUR3d 499 (Tenn 1969).

<sup>5</sup> 8 PUR3d 120 (Va 1955).

property remaining after the date of the purchase which created the excess.”<sup>6</sup>

While the FERC generally excludes acquisition adjustments from rate base treatment, it will permit the inclusion of these balances in the rate base for allocation purposes only (that is, allocating utility assets between jurisdictional and nonjurisdictional rate base) where the related state regulatory commission allows rate base treatment of the adjustments.

As a general rule, when acquisition adjustments are allowed in the rate base, amortization to cost of service is also allowed, and, where a return is not allowed, amortization is required below-the-line. Some regulatory commissions, however, have allowed inconsistent treatment principally as a means of sharing the costs associated with acquisition adjustments between investors and ratepayers. For example, the North Carolina Utilities Commission allowed Duke Power Company to amortize certain acquisition adjustment balances to cost of service but disallowed rate base treatment.<sup>7</sup> On the other side, the Utah Public Service Commission allowed certain unamortized acquisition adjustments in the rate base of Utah Power and Light Company but required that the amortization flow below-the-line to “miscellaneous amortization.”<sup>8</sup>

Using a different approach, the Kansas State Corporation Commission allowed Western Resources, Inc. (formerly Kansas Power and Light Company) the opportunity to recover an acquisition premium (as well as a return on the premium) incurred in connection with its acquisition of Kansas Gas and Electric Company in 1992. Rather than permitting rate base treatment and amortization in cost of service, the Commission allowed Western Resources to retain part of the anticipated cost savings to be realized in future years from merging the operations of the two companies.<sup>9</sup>

On occasion, a utility may purchase used plant at a price lower than the net book value in the hands of the selling utility. These transactions are generally accounted for by a debit to plant in service for the net original cost with a credit to the acquisition adjustment

<sup>6</sup> Re Louisiana Power and Light, 65 PUR (NS) 23 (La 1946).

<sup>7</sup> Re Duke Power Co, 26 PUR4th 241 (NC 1978).

<sup>8</sup> Re Utah Power and Light, 48 PUR3d 153 (Utah 1962).

<sup>9</sup> Re Kansas Power & Light, 127 PUR4th 201 (Kan 1991).

account for the deficiency. In these cases, a similar question arises regarding the handling of the credit acquisition adjustments for ratemaking purposes. The regulatory commissions and courts have varied in their opinions as to the appropriate treatment of these balances and have not necessarily followed the same reasoning as followed regarding ratemaking treatment for debit adjustments. In general, credit balances are used to reduce the rate base and are also amortized above-the-line (as a reduction of operating expenses) with what appears to be greater frequency than corresponding treatment for debit adjustments. Consistent reasoning regarding the treatment of debit and credit adjustments, however, does exist and is exemplified in a 1973 order of the Vermont Public Service Board in a rate proceeding involving Vermont Gas Systems, Incorporated:

“ ‘Original cost’ relates to the cost incurred by the utility purchasing the facility, not the original cost of a prior owner. Assuming prudent investment, the stockholders should be allowed to earn a return on their actual ‘out-of-pocket’ investment; the fact that the marketplace may place a higher or lower valuation on the property does not affect the amount of the actual price paid by petitioner.”<sup>10</sup> (Emphasis added.)

The basis for disallowing rate base treatment of acquisition adjustments is the assumption that the rate base should include only the net original cost to the utility first devoting the property to public use. In cases where used property is purchased from non-utility sellers, there is no acquisition adjustment, since the property has not previously been utilized in providing utility services. In these cases, net original cost is the purchase price paid by the acquiring utility. A question that has occasionally been raised concerns the purchase of used property from another utility (rate regulated enterprise) not involved in the same utility operation and therefore subject to a different scheme of regulation. While this issue has not been raised often, it appears that in most cases the general rule is interpreted broadly to encompass the first regulated enterprise of any type devoting plant to public service. A court case related to this matter involved the purchase of electric transmission lines by Montana Power Company from Chicago, Milwaukee, St. Paul & Pacific Railroad. In this 1979 case, the U.S. Court of Appeals ruled that the property had previously been devoted to public

<sup>10</sup> Re Vermont Gas Sys, 100 PUR3d 209 (Vt 1973).

use by a regulated enterprise and that only the original cost to the original user should therefore be allowed in rate base.<sup>11</sup>

### [3] Accumulated Depreciation and Amortization

Recovery of the dollars invested in plant in service is permitted over the plant's estimated useful life by a systematic depreciation charge to cost of service, normally on a straight-line basis with an equal portion of the original cost investment (net of estimated salvage less removal costs) recovered in each period over the estimated service life of the related fixed assets. The subject of utility depreciation accounting is examined in detail in Chapter 6.

Deduction of the reserves accumulated for annual depreciation and amortization charges from a utility's rate base is an accepted principle of rate base development, with the reserve balances generally calculated on the same basis as that used for determining rate base plant in service (13-month average, year-end, etc.). Theoretically, the accumulated reserves have already been collected from utility customers through the cost of service treatment for depreciation and the resulting revenue requirements generated. Deducting accumulated reserves from the rate base prohibits the utility from earning a further return on costs that have been recovered and also avoids the confusion of attempting to equate net plant in service (unamortized cost investment) with any measure of current "value" of the property. It does not matter if net plant in service is not an accurate measure of the property's current value (and it most likely is not). Accumulated depreciation in investment cost jurisdictions is not designed to force net plant to equal current value but instead is simply used to reduce the rate base for that portion of plant investment and net salvage already recouped through rates.

For regulatory jurisdictions following the fair value approach to rate base development, determination of the appropriate accumulated depreciation balance is the subject of considerable controversy, with the specific techniques employed varying widely among the different regulatory commissions. With this approach, accumulated depreciation is more closely associated with an attempt to measure the "current value" of utility plant, with a corresponding recognition of the value that has been "used" since the plant was

<sup>11</sup> Montana Power Co v Federal Energy Regulatory Commn, 31 PUR4th 191 (9th Cir 1979).

placed in service. Examples of the methods employed for determining depreciation reserves under the fair value concept include:

- (1) determining the fair value of gross plant and then attempting to calculate the necessary depreciation reserve to reflect the cumulative loss in value in current dollars; and
- (2) determining the fair value of gross plant and then calculating the related depreciation reserve by multiplying gross plant by the same percentage as the ratio of original cost accumulated depreciation to gross original cost plant.

Concepts for estimating fair value depreciation are discussed in more detail in Chapter 6.

Sometimes, depreciation reserves are determined to be either too small or too large, usually as a result of either the experience being different than what was expected or the modification of future expectations. In those cases where the reserves are found to be too small, the reserve difference is commonly the result of two possible factors. Earlier estimates of service lives may have been too long as a result of changing circumstances, such as current technological advances and/or changes in regulatory operating requirements, or increases in the current estimates of removal costs when the associated plant will be retired.

The ratemaking treatment of reserve differences varies from one regulatory commission to another, especially in cases where the differences are significant. Usually, the difference is recovered or credited through the use of "remaining life" depreciation rates, in which the total unrecovered investment and net salvage is depreciated over its estimated remaining life. Occasionally, accumulated depreciation is adjusted upward to eliminate the deficiency, and the rate base is reduced for the entire accumulated reserve. When the accumulated reserve is adjusted, the debit side of the adjustment is either amortized to cost of service or eliminated against retained earnings. Amortization to cost of service is generally allowed where the utility can demonstrate that it was not negligent in failing to adjust depreciation rates at an earlier time, since the circumstances leading to the deficiency were largely unforeseen. In rare cases, commissions have not required rate base reduction for differences and still allowed amortization of the debit adjustment to cost of

# **ATTACHMENT F**

## ACQUISITION ADJUSTMENT

STATE	
Alabama	<p>The Commission regulates the rates of eight small water companies. There is no specific statutory authority dealing with water company acquisition adjustments. However, in <i>Re Mobile Gas Service Corporation</i>, 2003 WL 23101066 (Ala. P.S.C. Oct. 9, 2003), the Commission relied on prior precedent to find that a positive acquisition adjustment would be allowed in rate base where the following principal criteria are satisfied: (1) the purchase price was the result of arm's length negotiations; (2) the acquisition would produce operational efficiencies; and (3) the acquisition would promote the integration of facilities.</p>
Alaska	<p><i>In the Matter of Alaska Power Co. Application</i>, No. U-01-98, Order No. 1 (R.C.A. Feb. 25, 2002) ("The Commission has interpreted this statute [AS 42.05.441(b)] to permit recovery of an acquisition adjustment if the utility demonstrate that the acquisition will provide clear, tangible benefits to ratepayers in an amount at least equal to the acquisition adjustment. However, the Commission has interpreted this rule narrowly and has refused to permit acquisition adjustments in many cases.").</p>
Arizona	<p><i>In the Matter of the Joint Application of Citizens Utilities Company, et. al</i>, Decision No. 63584 (A.C.C. Apr. 24, 2001) ("Arizona-American is cautioned that the Commission will require Arizona-American to demonstrate that clear quantifiable and substantial net benefits to ratepayers have resulted from the acquisition of Citizens' systems that would not have been realized had the transaction not occurred before the Commission will consider recovery of any acquisition adjustment in a future rate proceeding.").</p>
Arkansas	<p>Ark. Code Ann. § 23-4-111 (2008)(Commission will use net book value unless adjustment warranted after consideration of factors such as the reasonableness of original cost and whether customers will receive known and measurable benefits at least equal to the incremental amount sought to be recovered.).</p>

<p><b>California</b></p>	<p><b>Cal. Pub. Util. Code § 2720 (2008)</b>(Commission will use fair market value to establish the rate base value of a distribution system of a public water system acquired by a water corporation. If fair market value exceeds reproduction cost, difference may be included in rate base if commission determines additional amount is fair and reasonable.)</p> <p><i>Application of Citizens Utilities Co. of California (U-87-W), a California Corp., and California-American Water Company, a California Corp., Decision 01-09-057 (Cal. P.U.C. Sept. 20, 2001)</i> (approving alternative sharing program, compliant with § 2720, whereby realized synergies go first to acquiring company to amortize acquisition premium, and second to customers and company in a 90%/10% split).</p>
<p><b>Colorado</b></p>	<p>No general policy has been established for dealing with water company acquisition adjustments. Commission staff was unable to recall any requests for acquisition adjustments by water companies. In other sectors, acquisition adjustments are considered on a case-by-case basis.</p>
<p><b>Connecticut</b></p>	<p><b>Conn. Gen. Stat. § 16-262o, § 16-262s (2008)</b> (all reasonable costs of the acquisition of troubled or economically not viable water systems may be recovered in rates).</p>
<p><b>Delaware</b></p>	<p><i>Re Tidewater Water Supply Co., Inc., 2000 WL 33121630 (Del. P.S.C. Nov. 21, 2000)</i> (Commission has an “established practice of not allowing rate base recognition of premiums over net book value paid by an acquirer of a utility,” barring exceptional circumstances).</p>
<p><b>District of Columbia</b></p>	<p><b><i>PRIVATE WATER SYSTEMS NOT REGULATED</i></b></p>
<p><b>Florida</b></p>	<p><b>Fla. Admin. Code 25-30.0371 (2008)</b> (positive acquisition adjustment not allowed in rate base absent extraordinary circumstances; negative acquisition adjustments recognized under certain circumstances).</p>
<p><b>Georgia</b></p>	<p><b><i>PRIVATE WATER SYSTEMS NOT REGULATED</i></b></p>

<p><b>Hawaii</b></p>	<p>The Commission has consistently disallowed the recovery of any acquisition adjustments from customers, but evaluates requests on a case-by-case basis.</p> <p><i>In the Matter of the Application of Citizens Communications Company, Kauai Electric Div. and Kauai Island Utility Co-op, Docket No. 02-0060, Order No. 19658 (Haw. P.U.C. Sept. 17, 2002)</i> (approving stipulation which included the following condition: "Applicants acknowledge the commission's policy to not allow recovery from utility customers of goodwill or acquisition premium amounts arising from utility merger and acquisition transactions. In accordance with this policy, [acquiring company] will not seek rate recovery of any goodwill amortization, acquisition premium costs or goodwill impairment changes . . . in future rate proceedings.").</p>
<p><b>Idaho</b></p>	<p><i>Re United Water Idaho Inc., 187 P.U.R.4th 312 (1998)</i> (approving an acquisition adjustment to the rate base "based on its findings that the acquisition benefits customers as well as its conclusion that the purchase price was fair and reasonable and arrived at through arms-length negotiation.").</p> <p><i>Re Resort Water Co., Inc., 2005 WL 673648 (Idaho P.U.C. Mar. 15, 2005)</i> ("It has been a consistent policy of the Commission that rate base not include the purchase price of a water system unless it could be reasonably shown that the customers have not previously paid for the water system assets . . . the amount to be included in rate base as an acquisition adjustment must be determined on a case-by-case basis").</p>
<p><b>Illinois</b></p>	<p><i>Re Consumers Illinois Water Co., 2003 WL 21108549 (Ill. C.C. Mar. 18, 2003)</i> (traditional practice of Commission is to require that acquisition adjustment be recorded below the line; however, under unique circumstances, ICC will include it in rate base).</p>

<p><b>Indiana</b></p>	<p><i>City of Ft. Wayne v. Util. Center, Inc., d/b/a/ Aquasource</i>, 840 N.E.2d 836 (Ind. Ct. App. 2006) (affirming Commission finding that, based on new owner's efforts to remedy problems at troubled utility and arms-length transaction, a return on the acquisition adjustment should be allowed).</p> <p><i>Re Indiana-American Water Co., Inc.</i> 238 P.U.R. 4th 428 (2004) (“[G]ranted a return on an acquisition adjustment but no return of an acquisition adjustment is consistent with past practice of this Commission.” The acquisition was found to have “resulted in cost savings in excess of the cost of capital investment needed to make those savings possible. . .”).</p> <p><i>Re Lincoln Util., Inc.</i>, 2006 WL 452338 (Ind. U.R.C. Jan. 25, 2006) (order authorizing water company to earn a return on acquisition adjustment).</p> <p><i>Re Indiana-American Water Co., Inc.</i> 2002 WL 32091039 (Ind. U.R.C. Nov. 6, 2002) (“It is the established policy of this Commission to allow an acquisition adjustment in rates in only two events, namely: 1. As a result of the acquisition, are there significant and demonstrable benefits flowing to the ratepayers, e.g. better service and/or lower rates? 2. Does the acquisition result in correction or salvage of an entity identified by this Commission as a ‘troubled’ utility?”).</p>
<p><b>Iowa</b></p>	<p><i>Office of Consumer Advocate v. Iowa Util. Bd.</i>, 454 N.W.2d 883, 113 P.U.R.4th 479 (Iowa 1990) (“According to prior board precedent, the acquisition amount may be included in the rate base if actual benefits to customers are established by the utility.”).</p>
<p><b>Kansas</b></p>	<p>The State Corporation Commission regulates a few very small water companies. There is no specific authority dealing with water company acquisition adjustments. However, in the gas and electric sectors, the Commission limits recovery of an acquisition premium to an amount that reflects the realistic level of savings that the Commission believes can be achieved by the merged company. <i>See In the Matter of the Application of Kansas City Power &amp; Light Co. for approval of its acquisition of all classes of the capital stock of Kansas Gas and Electric</i>, Docket Nos. 172, 745-U; 174, 155-D (Kan. S.C.C. Nov. 14, 1991).</p>
<p><b>Kentucky</b></p>	<p><i>Re Kentucky-American Water Co.</i>, 2005 WL 578209 (Ky. P.S.C. Feb. 28, 2005) (“[T]he net original cost of plant devoted to utility use is the fair value for rate-making purposes, unless the utility can prove, with conclusive evidence, that the overall operations and financial condition of the utility have benefited from acquisitions at prices in excess of net book value. Any utility seeking recovery of an acquisition adjustment must justify its purchase decision based on economic and quality of service criteria.”)(internal quotations omitted).</p>

<b>Louisiana</b>	No information available.
<b>Maine</b>	<p>As a general matter, acquisition adjustments are not allowed, but requests will be evaluated on a case-by-case basis. Commission staff was unable to recall any requests for acquisition adjustments by water companies in the past decade.</p> <p><b>Re Terms and Conditions of Edmund J. Quirion, 1995 WL 785875 (Me. P.U.C. Nov. 14, 1995)</b> (“We note that this Commission’s general policy has been to use the original cost minus depreciation as the proper method of determining the value of utility property. However, there may be circumstances under which acquisition cost might be considered.”).</p>
<b>Maryland</b>	<p>As a general matter, if sufficient customer benefits are shown the Commission may allow an acquisition adjustment and amortize it over several years. Commission staff noted requests for acquisition adjustments by water companies are rare.</p> <p><b>Re Greenridge Utilities, Inc., 1997 WL 998596 (Md. P.S.C. June 4, 1997)</b> (“The decision to allow inclusion of the acquisition adjustment in the Company’s rate base is predicated upon consideration of whether such inclusion provide a benefit to the ratepayers.”).</p>
<b>Massachusetts</b>	<p><b>Guidelines and Standards for Acquisitions and Mergers, D.P.U. 93-167-A at 6-7, 18-19 (1994)</b> (Companies may use savings that result from mergers and acquisitions to offset acquisition premiums and related transaction costs, based on a balancing of the benefits arising from the merger with the costs associated with the merger).</p> <p>Commission staff noted that a showing of savings must be made at the time of the acquisition, and not be based on generalized statements about potential merger benefits. While the policy has been focused on gas and electric company merger and acquisition activity, the precedents in <b>Guidelines and Standards for Acquisitions and Mergers</b> could potentially be applied to water companies.</p>
<b>Michigan</b>	<b>PRIVATE WATER SYSTEMS NOT REGULATED</b>
<b>Minnesota</b>	<b>PRIVATE WATER SYSTEMS NOT REGULATED</b>
<b>Mississippi</b>	<b>State of Miss. v. Miss. Pub. Serv. Comm’n, 435 So.2d 608 (Miss. 1983)</b> (“...public utilities’ amortization of acquisition adjustment is a proper component of cost of service and should be included as a proper operating expense

when proven by the utility to be beneficial.”).

**Missouri**

**Mo. Rev. Stat. § 393.146(11) (2008)**

“If the commission orders the acquisition of a small water or sewer corporation, the commission shall authorize the acquiring capable public utility to utilize the commission’s small company rate case procedure for establishing the rates to be applicable to the system being acquired. Such rates may be designed to recover the costs of operating the acquired system and to recover one hundred percent of the revenues necessary to provide a net after-tax return on the ratemaking rate base value of the small water or sewer corporation’s facilities acquired by the capable public utility, and the ratemaking rate base value of any improvements made to the facilities by the acquiring capable public utility subsequent to the acquisition, at a rate of return equivalent to one hundred basis points above the rate of return authorized for the acquiring capable public utility in its last general rate proceeding.

**Re Alliance Gas Energy Corp., 2008 WL 320768 (Mo. P.S.C. Feb. 5, 2008)** (observing that “there are strong precedents against allowing acquisition premiums to be reflected in rates when the assets are purchased at more than book value. For example, the Commission has stated that it will not require a company to write down its rate base when the assets are sold at less than book value.”).

**Re UtiliCorp United Inc., 2004 WL 431561 (Mo. P.S.C. Feb. 26, 2004)** (“Missouri has traditionally applied the net original cost standard when considering the ratemaking treatment of acquisition adjustments. That means that the purchasing utility has not been allowed to recover an acquisition premium from its ratepayers. But it also means that ratepayers do not receive lower rates through a decreased rate base when the utility receives a negative acquisition adjustment.”).

<p><b>Montana</b></p>	<p><b>Mont. Code Ann. § 69-3-109. Ascertain property values.</b></p> <p>“The commission may, in its discretion, investigate and ascertain the value of the property of each public utility actually used and useful for the convenience of the public. The commission is not bound to accept or use any particular value in determining rates. However, if any value is used, the value may not exceed the original cost of the property, except that the commission may include all or some of an acquisition adjustment for certain property purchased by a public utility in the purchasing utility’s rate base if the transfer of the property to the purchasing utility is in the public interest.”</p> <p><b>Re NorthWestern Corp., 259 P.U.R.4th 493 (2007)</b> (“It is a long held regulatory principle of this Commission that the value of plant in rate base is determined by original cost less depreciation. Original cost of utility property is determined when the asset is first dedicated to public service. The action of selling a utility, absent any compelling reason, is not sufficient to allow an adjustment in rate base to reflect acquisition costs.”).</p>
<p><b>Nebraska</b></p>	<p>No general policy has been established for dealing with water company acquisition adjustments. Commission staff was unable to recall any requests for acquisition adjustments by water companies. In other areas, the Commission sometimes allows acquisition adjustments.</p>
<p><b>Nevada</b></p>	<p>The Commission includes the original cost of the acquired system in rate base and does not recognize acquisition adjustments.</p>
<p><b>New Hampshire</b></p>	<p><b>Re Lakes Region Water Co., Inc., 2004 WL 3457746 (N.H. P.U.C. Sept. 23, 2004)</b> (after noting commission’s longstanding practice of not allowing recovery in excess of original cost, PUC ordered water company to book purchase price in excess of net book value as an acquisition adjustment so that it was not reflected in future customer rates).</p>
<p><b>New Jersey</b></p>	<p>No general policy has been established for dealing with water company acquisition adjustments but the Commission rarely grants acquisition adjustments and will require that a benefit to existing customers be shown by the requesting utility.</p> <p><b>Re Consumers New Jersey Water Company, 1995 WL 592835 (N.J.B.P.U. Sept. 20, 1995)</b>(adopting stipulation where given the “special and unique” circumstance of proven benefits of the acquisition to customers, company would be allowed an acquisition adjustment in next rate base by amortizing adjustment over a period of years and including the unamortized portion into rate base).</p>

<p><b>New Mexico</b></p>	<p><i>In the Matter of the Petition By New Mexico-American Water Company, Inc. to Change Its Service Rates, Case No. 2202 (N.M. P.S.C. Dec. 28, 1988)</i> (order approving stipulation that excluded the acquisition adjustment from the rate base and its amortization from the cost of service - acquired assets would be treated as if transferred at original cost.).</p> <p>Commission staff noted that general policy is to not allow an acquisition adjustment unless net benefit to customers is proven.</p>
<p><b>New York</b></p>	<p><i>Proceeding on Motion of the Commission to Establish a Policy to Provide Incentives for the Acquisition and Merger of Small Water Utilities, Case No. 93-W-0962 (N.Y. P.S.C. Aug. 8, 1994)</i> (established guidelines for acquisition of small water companies whereby, if certain customer benefits are shown, Commission may provide incentives such as inclusion of acquisition adjustment in rate base (if purchase price greater than acquired company rate base) or inclusion of acquired company rate base (if purchased for less than rate base)).</p> <p><i>Joint Petition of United Waterworks Inc. and South County Services Co., Inc. for Permission for United Waterworks to Acquire the Stock of South County Water Corp., Case No. 02-W-0949 (N.Y. P.S.C. May 21, 2004)</i> (citing to policy on acquisition of small water utilities, allowed acquiring company to include book value of stocks in rates instead of lower purchase price).</p> <p><i>Joint Petition of Aqua New York, Inc., f/k/a Kingsvale Water Co., Inc., and New York Water Service Corp., Case No. 06-W-0700 (N.Y. P.S.C. Dec. 20, 2006)</i> (the full amount of purchase premium treated as goodwill (not recoverable in rates) where acquisition was not of a small water utility).</p>
<p><b>North Carolina</b></p>	<p><i>In the Matter of Petition of Utilities, Inc., 147 N.C. App. 182, 555 S.E.2d 333 (2001)</i> (affirming Commission approach whereby it would refrain from allowing rate base treatment of an acquisition adjustment unless the purchasing utility established by the greater weight of the evidence that the purchase price was prudent and that both the existing customers of the acquiring utility and the customers of the acquired utility would be better off (or at least no worse off) with the proposed transfer, taking into consideration rate base treatment of any acquisition adjustment).</p>
<p><b>North Dakota</b></p>	<p><b>PRIVATE WATER SYSTEMS NOT REGULATED</b></p>
<p><b>Ohio</b></p>	<p>The Commission includes the original cost of the acquired system in rate base and does not allow acquisition adjustments. <i>Re Dayton Power and Light Co., 21 P.U.R.4th 376 (Oh. P.U.C. 1977)</i> (proposed acquisition adjustment should "clearly" be excluded from rate base given state's use of original cost.).</p>

Oklahoma	Acquisition adjustments are not allowed in rate base absent extraordinary circumstances, although requests are evaluated on a case-by-case basis. Commission staff did not recall any recent requests for acquisition adjustments by water companies.
Oregon	<b>Or. Admin. R. 860-036-0716 (2008)</b> (water utility may petition Commission for approval of acquisition adjustment in rates where benefits of acquisition outweigh the increase to customers' rates resulting from acquisition).
Pennsylvania	<b>66 Pa. C.S.A. § 1327 (2008)</b> (positive acquisition adjustments allowed under identified circumstances where small, troubled or non-viable water systems are acquired and improved; negative acquisition adjustments must be amortized to utility operating income unless, in the Commission's discretion, the public interest would not be served by doing so).
Rhode Island	Acquisition adjustments are generally not allowed, although they are evaluated on a case-by-case basis. Cost savings or other extraordinary circumstances may justify an acquisition adjustment. Commission staff did not recall any requests for acquisition adjustments by water companies in the past decade. <i>In re: Petition of Valley Gas Co., Bristol and Warren Gas Co. and Southern Union Company for Approval of Mergers, Docket Nos. D-00-02, D-00-03 (R.I. P.U.C. July 24, 2000)</i> (order approving a settlement agreement which contained the following term: "The Settling Parties agree that the Companies will not seek direct or indirect recovery of any acquisition premium in rates either through an amortization or rate base adjustment in future rate cases . . .").
South Carolina	<i>Re Georgia Water &amp; Well Serv., Inc., 233 P.U.R.4th 482 (2004)</i> ("If a regulatory agency determines that the cost was reasonable and beneficial to the customers, an above-the-line expense could be allowed as an Amortization of Utility Acquisition Adjustments." However, "[t]he prevailing rule relating to the acquisition of utility plant previously used in a regulated business is that the plant must continue to be recorded at the depreciated original cost to the first owner devoting the property to public service.")
South Dakota	<b>PRIVATE WATER SYSTEMS NOT REGULATED</b>
Tennessee	The Authority does not have a general policy on acquisition adjustments. Generally speaking, the purchase of utility plant previously used in providing utility service is recorded on the acquiring company's books at original cost, net of accumulated depreciation. Exceptions would be considered only if the price above the seller's original cost was clear in the public interest and would be addressed on a case-by-case basis.

Texas	<p><b>30 Tex. Admin Code § 291.31(d) (2008)</b>(positive acquisition adjustment allowed under identified circumstances).</p>
Utah	<p>Commission Staff stated that, in general, when the acquired asset is already a utility asset, the book value goes into rat base. When the acquired asset was not previously a utility asset, the purchase price goes in to the rate base. <i>Re Utah Power and Light Co., 53 P.U.R.4th 461 (Ut. P.S.C. May 23, 1983)</i> (“The commission agrees that in the context of acquiring assets already dedicated to the providing of public service the general rule for determining the value of such acquired property for rate-making purposes is depreciated book value . . .The commission also recognizes, however, that there may be exceptions to this general rule should sufficient benefits accrue to the acquiring public utility and its ratepayers to justify deviations from net book value treatment. It should be emphasized that this exception would be an unusual circumstance and would be evaluated on a case-by-case basis.”).</p>
Vermont	<p>Board includes acquisition adjustments below the line; never included in rates. Board staff was unable to recall any recent requests for acquisition adjustments by water companies.</p> <p><i>Joint Petition of Young’s Cable TV Corp. and Okemo Vue, Inc., 1986 WL 361091 (Vt. P.S.B. May 26, 1986)</i> (“the Board policy on rate-base acquisition adjustments is that permitted earnings on rate-base investment are limited to the depreciated cost of utility property when first placed into service, and that an upward rate base adjustment will not be permitted when ownership of the assets is directly or indirectly at a price in excess of their depreciated original cost.”)</p>
Virginia	<p><i>Re Virginia Natural Gas, Inc., 250 P.U.R.4th 421 (2006)</i> (“An acquisition adjustment is allowed only in extraordinary circumstances and may be authorized if the applicant utility satisfies certain criteria . . .(i) the purchase price was determined in an arms-length bargaining and (ii) the purchase was an investment made prudently for the benefit of the customers and the utility.”).</p>
Washington	<p><i>Washington Util. and Transp. Comm’n v. PacifiCorp, 2006 WL 1517095 (Wash U.T.C. Apr. 17, 2006)</i> (“When a utility purchases a plant, it may seek an acquisition premium adjustment to reflect that the price paid for the plant may be higher than its book value. However, the cost of the premium is not included in rate base unless the Commission allows such treatment after finding the underlying plant purchase was prudent.”).</p> <p><i>In the Matter of the Application of Herman Suess Applicant, For the Sale and Transfer of Assets to Pattison Water Co., 2005 WL 2660173 (Wash. U.T.C. June 15, 2005)</i> (Staff advised applicant that “absent a showing of commensurate benefits, acquisition adjustments are not included in rate base for inclusion in rates.”).</p>

<p><b>West Virginia</b></p>	<p>No general policy has been established for dealing with water company acquisition adjustments. Acquisition adjustments are often not allowed.</p> <p><i>Re West Virginia-American Water Co., 231 P.U.R.4th 423 (W. Va. P.S.C. Jan. 2, 2004)</i> (ordered negative acquisition adjustment to rate base).</p> <p><i>West Virginia-American Water Co. and East Bank Water Dep't., Case No. 00-1719-W-PC (W. Va. P.S.C. Feb. 6, 2001)</i> (ordered acquiring company to record the book cost of assets, and “[a]ny amount paid in excess of the net book value of the acquired assets, as adjusted, should be recorded in [the acquisition adjustment account] and be amortized over 20 years. Any amount of asset book value in excess of the amount paid will be considered as a contribution. Lastly, any necessary rate recognition relating to this acquisition will be given the appropriate treatment in the [next rate case].”).</p>
<p><b>Wisconsin</b></p>	<p><i>Joint Application for Approvals Related to Wisconsin Power and Light Company's Sale of its Beloit Area Water Utility Assets to the City of Beloit, 2003 WL 22220326 (Wis. P.U.C. Sept. 19, 2003)</i>(after finding sufficient benefits to customers, allowed city to recover in customer rates a straight-line amortization of acquisition adjustment over 25 years and a return on the unamortized balance).</p> <p><i>Preliminary Agreement of the Village of Footville, Rock County, as an Electric Public Utility, to Sell Its Electric Public Utility Plant to Wisconsin Power and Light Company, Dockets 2040-EA-100, 6680-EB-103 (Wis. P.U.C. Feb. 24, 1989)</i>(As a general matter, a utility must provide some substantial physical or electrical benefit to the purchaser's system in order to be exempted from the ordinary rule that utility customers pay no more than net book value. Redistribution of costs or spreading costs over more customers is not a system benefit in and of itself.).</p>
<p><b>Wyoming</b></p>	<p>No general policy has been established for dealing with water company acquisition adjustments. Commission staff was unable to recall any requests for acquisition adjustments by water companies. Requests would be reviewed on a case-by-case basis.</p>