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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

Arizona Corporation Commission
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RUCO'S CLOSING BRIEF

The RESIDENTIAL UTILITY CONSUMER OFFICE ("RUCO") hereby files its Closing Brief in the matter of WILLOW VALLEY WATER CO. AND EPCOR WATER ARIZONA, INC.'s ("Applicants") application for approval of the sale of assets and transfer of Certificate of Convenience and Necessity.

INTRODUCTION

Approval of EPCOR and Willow Valley's application is not in the public interest for numerous reasons. The proposal is basically a request for a change in ownership between two "well qualified" utilities at relatively large expense to the customers. See RUCO-2 at 4. A transfer of ownership between two well qualified water utilities is not the type of transfer that RUCO or Staff envisions merits an acquisition adjustment. An acquisition adjustment should only be considered where the purpose is to acquire a troubled water utility, which is not the present case. If the Commission is serious about a policy which would reward an acquisition adjustment to incentivize financially well-qualified water utilities to acquire non-viable water companies, awarding an acquisition adjustment here would be counter-productive to such a policy. A serious discussion should be limited to the intended purpose of the acquisition of troubled water companies, and not extending the notion of an acquisition adjustment at the inception of its consideration.

Perhaps even more troubling from the ratepayer perspective, is the Applicants' request to deny its customers credit of $260,224[1] of income taxes that these ratepayers paid. In the absence of this transfer, the ratepayers would be credited for the payment of these income taxes through a reduction to Willow Valley's ratebase. But because of the way the Applicants structured this transfer, the Applicantion will deny the ratepayers credit for these taxes paid since the reduction to Willow's ratebase will not transfer with the sale. Sadly, there are ways to remedy this clear inequity but neither the Applicants nor Staff believe it is worth the time or effort or expense to look into it any farther.

In the absence of the costs, the Applicants admittingly cannot quantify the benefits. S-2. It is not because there are so many benefits or the benefits are so great that quantifying them would be impossible, it is because to quantify them would be speculative at best. Id., RUCO-9. Staff has quantified the "acquisition premium," however, at $562,335 on a purchase price of $2,494,834 or 22.54 percent. S-5 at 8. So what we have in this record are quantifiable costs which are significant relative to the purchase price and **absolutely no verified quantifiable**

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[1] For ease of reference, all exhibits will be identified by exhibit number and all transcript references will be identified by page number in the transcript. S-5 at 7,

benefits. The record in this case should raise all types of red flags, does not support the transfer, and should serve as the basis for the rejection of the Application.

THE COMMISSION SHOULD ESTABLISH A REGULATORY LIABILITY OR AT THE VERY LEAST REQUIRE THE APPLICANTS TO SUBMIT A REQUEST FOR A RULING FROM THE IRS ON THE ISSUE OF THE ACCUMULATED DEFERRED INCOME TAXES ('ADIT")

The issue of ADIT has to do with the timing difference between what is recorded on the Company's Books as depreciation expense and what the Company records for tax purposes. RUCO-7 at 19. The net total of the income taxes paid by Willow's customers which will have been deferred but not paid to the IRS prior to the transfer is $260,224. Id. at 20. In the absence of the transfer these accumulated and deferred taxes would be credited to Willow's ratepayers through an offset to Willow's ratebase – which translates to lower rates. Id. at 20.

The ratebase that will be transferred, however, under the Application will not include the ADIT offset. The deferred ADIT balances will remain with the seller. Id. at 20. This inherent inequity is the result of the manner in which the Applicants set up the transfer – in other words, whether intentional or not the effect of the way this transfer is organized is Willow's customers will not get credit for the income taxes paid. For this reason alone, the transfer is not in the public interest.

Both Staff[2] and RUCO have attempted to address this gross inequity by the creation of a regulatory liability whose purpose would be to offset the inequity. Willow Valley, however, through its lay witness[3], Paul Walker, argues that the establishment of a regulatory liability would violate IRS tax normalization rules and potentially deny EPCOR the use of accelerated depreciation. Willow - 6 at 3-7. Mr. Walker, who testified that he is "...not opining on the tax

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[2] Staff in its surrebuttal case withdrew its recommendation to create a regulatory liability. S-6 at 3. Staff provided no alternative to address the inequity. Id.

[3] Willow-6 at 4.

consequences raised by the forced transfer of ADIT from one owner to another…" also testified that establishing a regulatory liability is "very poor policy." Id. at 4. According to Mr. Walker, this recommendation will end this transaction and create a "phenomenally high level of regulatory uncertainty." Id. Mr. Walker's testimony reveals just how thin the basis for this transfer really is. His argument, made on behalf of the seller, not the buyer who would be saddled with the liability, is that if we cannot structure asset transfers in a manner that deprives utility customer's credit for the payment of the income taxes that they have paid, then utilities will not partake in asset transfers. Mr. Walker has it backwards - designing an approach to offset a gross inequity is not poor public policy, approving asset transfers that will deprive customers credit for income tax expenses that they have already paid is poor public policy and not in the public interest. It would create a perverse incentive as well as a bad precedent which would undoubtedly encourage similar type transfers in the future.

There are numerous ways that the Commission can protect the ratepayers and assure that the ratepayers get credit for the ADIT. Of course, under any of these approaches, the Buyer would not get the benefit of the unjust windfall. First, as already mentioned, the Commission could establish a regulatory liability as a requirement for approval. Transcript at 25. There is no guarantee, as even Staff admits, that the establishment of a regulatory liability will violate the IRS' normalization rules. RUCO -1 at 18. Transcript at 436. At this point nobody knows how the IRS would treat a regulatory liability. But RUCO understands how it could raise a concern. The answer, however, is not to simply disregard it as Staff and the Applicants recommend. The only way to definitively know how the IRS would treat the regulatory liability for tax purposes is to request a private letter ruling ("PLR") from the IRS. RUCO-1 at 20. RUCO's witness, Ralph Smith, arguably the only expert qualified in this matter to address this issue, noted that a PLR made before transaction approval, and based specifically on the fact situation presented in this case would be one way that the normalization concerns raised could be fully vetted. Id. There was no PLR done in this case nor is there one pending. While it may be costly, time consuming and otherwise a pain, if the Applicants insist on moving forward with the Application structured in its current fashion, a PLR should be required. To simply overlook or dispatch with it as the Applicants and Staff suggest, is not in the public interest.

Mr. Smith testified that he is not aware of any instance where the IRS has denied a Company the use of accelerated depreciation. Transcript at 103. Mr. Smith further indicated that the IRS typically allows companies that cross the line in situations where there is not clarity an opportunity to remedy the problem. Transcript at 105.

The simple truth is that Willow's ratepayers would not be harmed by the extinguishment of ADIT had the Applicants structured the transfer differently or if there is no transfer. The fact that the Applicants did not structure it differently and will not now consider it is very telling. Mr. Smith notes that it is preferable to avoid having the utility ADIT extinguished due to the structure – when other ways to structure the transfer exist which would avoid the ADIT from being extinguished. RUCO-1 at 17. In the recent FORTIS acquisition of Unisource Energy Corporation, the transaction was structured as a stock transfer thus avoiding the harm to the ratepayer from the extinguishment of the utilities ADIT. Id. at 17.

Second, the Commission could address the inequity by requiring a rate freeze for the acquired utility. Id. at 26. Another option would be the requirement of ratepayer credits or a fund established by EPCOR that would be used to offset future rate increases. Id.

The point here is if the Commission wants to approve this transaction, there are options to address the ADIT issue. There is no argument that supports a result where customers lose credit for income taxes already paid on behalf of Willow. This is poor public policy, grossly unfair and against the public interest.

One final point on the ADIT issue concerns what appears to be the rationalization offered by the Applicants and Staff (as of Staff's surrebuttal case) for the harmful ADIT positions - the ratepayer loss is offset by the financial gains associated with the superior capitalized Company. Transcript at 440, S-5 at 10. The thinking seems to be that if one thinks hard enough anything can be rationalized given the shortcomings of this argument. First, as even Staff's witness Darron Carlson acknowledges, all the numbers associated with those benefits are "pure conjecture." Transcript at 440. Staff or no one for that matter has any real idea whether these benefits cancel out the harm caused by the loss of the ADIT. Id. RUCO can only surmise that Staff's updated position refers at least in part to Mr. Becker's calculations of the benefits associated with Willow's superior capital structure that will result from the transfer. S-5 at 10.

Mr. Becker did not associate his attempt to quantify this benefit with the ADIT loss in his Direct testimony and, in fact, recommended the regulatory liability in his Direct testimony. S-5 at 16. Instead, Mr. Becker and Staff in its Direct case seemed far more concerned with the fact that the transaction "might" result in EPCOR taking a position that Willow Valley is supported by a 100 percent equity structure post transfer. Id. at 14. Staff attempted to ascertain what EPCOR intends as a capital structure and was told by EPCOR that it basically could not answer because it would be speculative. Id. at 15. EPCOR further stated that speculation to the potential changes to capital structure prior to Willow Valley's next rate case would be "premature." RUCO-15. Mr. Bradford, EPCOR's witness, stated with regards to any benefit related to this - they "...are by their nature not quantifiable..." S-2. Again, Mr. Carlson even acknowledged that the numbers were "purely conjecture". Transcript at 440.

In sum, to now try and quantify a benefit through a back of the envelope calculation when the Company itself is saying it is premature and everyone agrees it is speculative is disingenuous and should be given no weight. Certainly, it should not be used as a reason for the Commission to set a precedent and perhaps a policy which would create perverse incentives by denying ratepayers credit for income taxes paid in change of possession transactions. The Commission should dismiss the application as it is not in the public interest.

THE COMMISSION SHOULD REJECT THE APPLICANTS' REQUEST FOR AN ACQUISITION ADJUSTMENT.

RUCO remains committed to the notion of an acquisition adjustment where a water company seeks to acquire a troubled or non-viable company. RUCO, perhaps, mistakenly, was under the impression that the Commission had endorsed the concept in situations where the intent was to move towards the elimination of troubled water companies with no or very limited rate base who were on the margin with regard to service. Apparently, Staff is under the same impression. Transcript at 446-452.

The situation here is different. Where there are two well qualified companies the ratepayer benefits are limited, if they exist at all, and an acquisition adjustment is not appropriate. In fact, it is puzzling that the Applicants would even ask for an acquisition adjustment in this case. First, the Applicants want to harm Willow's customers significantly by not crediting them at all for income taxes they paid while under Global's ownership. This amounts to a "premium" that ratepayers will pay greater than 10 percent of the purchase amount for a service they are already receiving. Moreover, but for this transfer, these customers will get the credit for the income taxes they paid and the same service – so what are they getting – non-quantifiable illusory benefits?

Next, the Applicants want the Commission to preapprove a 20 percent acquisition incentive for infrastructure EPCOR intends to put in the ground which it approximates will be $1 million in order to reduce water loss. EPCOR should not need an incentive to do something it is tasked with doing as part of its obligation to provide safe and reliable drinking water at a reasonable price. This is an overreach which will no-doubt have far reaching consequences. EPCOR will undoubtedly seek ratebase treatment of this infrastructure and will then be able to earn a return on the infrastructure. Traditionally, the opportunity to earn a return on one's investment without the concern of competition is the incentive for the utility to operate the business. Now the Applicants seek a further incentive to provide service – where will the Commission draw the line for all the requests that will undoubtedly follow by utilities who seek added incentives to provide service?

Acquisition adjustments are not by any means traditional ratemaking and the Commission has historically denied acquisition adjustments. The water industry seeks acquisition adjustments as a tool to solve the troubled water company dilemma in Arizona. The notion is noble and warrants consideration. But the purpose is to address troubled water companies, not to enrich two well qualified companies. RUCO is very-troubled by the request and views it as a bad omen for what should be a noble and warranted policy going forward.

There are other reasons why this deal does not warrant an acquisition adjustment. The Applicants seek pre-approval of a 20 percent premium on the revenue requirement needed to recover the infrastructure whose cost remains unknown. Transcript at 258-259. While EPCOR estimates the cost to be $1 million, Mr. Fleming estimates the cost could be up to $5 million. Transcript at 161. The record is unclear exactly what this $1 million will buy and how much water loss will actually be reduced. Mr. Bradford gives the impression that the 5-year plan will lead to a 25 percent reduction on the current 26.1 percent total. R-10. However, EPCOR's rate manager, Sarah Mahler "clarifies" Mr. Bradford's testimony in response to a data request wherein she indicates that what Mr. Bradford meant was that the plan will reduce water loss by one quarter of the current water loss or 6.5 percent for a total of 19.6 percent in year 5. R-10. The 19.6 percent request still remains above Staff's maximum limit of 15 percent. S-8, Engineering Report at 2.

This confusion is not surprising giving the level of due diligence EPCOR has done with regard to the transfer. Mr. Bradford testified that "We've done a minimal due diligence to date as part of the asset sale." Transcript at 256. Mr. Bradford made it very clear that small transfers of this type do not warrant a "thorough" due diligence analysis. Transcript at 257. In addition, neither Company has done a net present value analysis.

Typically, where there is a change of ownership contemplated, the buyer will do a net present value analysis of future revenue streams to determine if the acquisition will be profitable and if the investment will provide the expected returns over a defined period of time. RUCO-7 at 10. Without this type of analysis, companies can put themselves in a difficult financial situation. Id. From the ratepayer's standpoint, it is necessary to see this information because it is generally understood that should the Company falter financially, it will be the ratepayers that bail the Company out in one way or another. Also, service quality and water quality is likely to be negatively affected by troubled finances. Id. While RUCO agrees it is the Company that decides whether to do a net present value, RUCO believes that such an analysis is imperative in change of ownership cases to protect the interests of ratepayers. A net present value analysis was done in the recent Fortis acquisition, and change in ownership cases involving UNS Gila River and APS. Transcript at 507 – 508.

The Applicants maintain that a net present analysis has no "relevance on whether the acquisition is in the public interest..." RUCO-8 at 14. The Applicants position is simply wrong – of course it is in the public interest to know what the Buyer's revenue projections are and whether this deal makes sense from a financial point of view. Such insight could help explain the grounds for the acquisition adjustment the Applicants seek and provide perspective to the Commission and the ratepayer on the anticipated financial viability of Willow Valley in the future. It is hard to imagine how the Applicant can even claim such insight is not in the public interest. The point is even further highlighted by the significant costs to the ratepayers the Applicants seek as a condition of this transfer.

Finally, in the past, Staff has cited six conditions it believes are necessary before the Commission grants an acquisition adjustment. RUCO-7 at 15. In this case Staff has recommended against an acquisition adjustment. S-5 at 10. Listed below are the conditions followed by RUCO's response to the conditions.

1. The acquired Company is a Class D or E.

   Willow Valley is operated by Global which is a holding company and, as such, does not qualify under Staff's first condition.

2. The acquisition will not negatively affect the viability of the acquirer.

   EWAZ claims they are financially viable, however, in their last rate case they claimed they were not unless they received a higher ROE. Further, RUCO noted several legal disputes that are still outstanding that could affect the Company's financial viability. Again in this case there was no present value analysis from which to get an idea of how EPCOR sees its financial future.

3. The acquired system's customers will receive improved service in a reasonable timeframe.

   There is no evidence of new improved service in a reasonable timeframe. There are no current Arizona Department of Environmental Quality ("ADEQ") violations or Arizona Department of Water Resources ("ADWR") violations. There is currently a reliable source of water, capacity, distribution, and customer service.

4. 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.

This is subject to debate as set forth in this Brief.

5. The recovery period for the acquisition adjustment should be for a specific minimum time.

The Company has offered various payback periods.

6. The Acquisition is in the public interest.

A list of the pro/cons makes this analysis a no-brainer.

PROS – arguably EPCOR's future plant commitment – but that is not a pro if it is necessary to provide service as Global would have to do this anyway at no premium to its customers. Better capital structure – speculative. Total verifiable pros – 0.0.

CONS - there has not been a showing of any quantifiable benefits to the ratepayer. The Company – EPCOR has not done an adequate due diligence analysis. There was no present value analysis. The transfer comes at too high of a cost to the ratepayer. Ratepayers will lose the ADIT credit. Ratepayers will pay a 20 percent acquisition premium of an unknown amount of plant. Ratepayers will not be better served – the current water company is not insolvent – in fact far from it. The Company is able to serve water that meets the quality standards as set forth in the Safe Drinking Water Act. Applicants seek a high acquisition premium. Poor precedent and policies going forward – future transfers structured this way to deny ratepayers ADIT credit, Acquisition Adjustments awarded for transfers that do not involve financially stressed companies.

CONCLUSION

The Commission should reject the Applicant's transfer request.

RESPECTFULLY SUBMITTED this 7th day of December, 2015.

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