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ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
DOCKET CONTROL

DATE: FEBRUARY 16, 2016

DOCKET NO.: W-01732A-15-0131 and W-01303A-15-0131

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Scott M. Hesla. The recommendation has been filed in the form of an Opinion and Order on:

WILLOW VALLEY WATER CO., INC. and EPCOR WATER ARIZONA, INC.
(SALE OF ASSETS and TRANSFER OF CC&N)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and thirteen (13) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

FEBRUARY 25, 2016

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Open Meeting to be held on:

MARCH 2, 2016 AND MARCH 3, 2016

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602) 542-4250. For information about the Open Meeting, contact the Executive Director's Office at (602) 542-3931.

Arizona Corporation Commission
DOCKETED
FEB 16 2016
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JODI A. JERICH
EXECUTIVE DIRECTOR

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

DOUG LITTLE – Chairman
BOB STUMP
BOB BURNS
TOM FORESE
ANDY TOBIN

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 DECISION NO. _____ **OPINION AND ORDER**

DATES OF HEARING:	August 10, 2015 (Procedural Conference); November 16, 2015 (Public Comment); and November 19 and 20, 2015 (Evidentiary Hearing)
PLACE OF HEARING:	Phoenix, Arizona
ADMINISTRATIVE LAW JUDGE:	Scott M. Hesla
APPEARANCES:	Mr. Timothy Sabo, SNELL & WILMER, on behalf of Willow Valley Water Co., Inc.; Mr. Stanley B. Lutz, LEWIS ROCA ROTHGERBER CHRISTIE, on behalf of EPCOR Water Arizona, Inc.; Mr. Daniel Pozefsky and Mr. Jordy Fuentes, on behalf of Residential Utility Consumer Office; and Ms. Robin Mitchell, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

I. PROCEDURAL HISTORY.

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

On May 5, 2015, the Residential Utility Consumer Office ("RUCO") filed an Application to Intervene which was granted by Procedural Order on May 19, 2015.

On June 1, 2015, EPCOR filed a Supplement to Application seeking approval of a surcharge mechanism to recover the portion of the purchase price in excess of Willow Valley's rate base ("amended application").

On July 27, 2015, RUCO filed a Request for a Procedural Order requesting that a procedural order be issued establishing dates for filing testimony and scheduling a hearing.

On July 30, 2015, the Commission's Utilities Division ("Staff") filed a Letter of Sufficiency indicating that the amended application meets the sufficiency requirements outlined in the Arizona Administrative Code ("A.A.C") R14-2-402. According to Staff, the Commission has 150 days from the date the amended application is deemed sufficient to conclude its substantive review ("timeclock").

On July 30, 2015, a Procedural Order was issued scheduling a procedural conference to discuss scheduling and other procedural matters.

On August 10, 2015, a procedural conference was held as scheduled, with EPCOR, Willow Valley, RUCO, and Staff appearing through counsel. At the procedural conference, a discussion was held regarding the status of and manner in which to proceed with the application. Due to the complexity of this case, it was determined reasonable and appropriate to extend the timeclock for an additional 60 days to allow sufficient time for the parties to conclude discovery and prepare their respective cases.[1] EPCOR proposed to confer with the other parties and file an agreed upon procedural schedule no later than August 31, 2015.

On August 14, 2015, a Procedural Order was issued memorializing the dates established in the preceding procedural conference.

On August 31, 2015, EPCOR filed a Proposed Schedule proposing procedural dates agreed upon by the parties.

On September 3, 2015, a Procedural Order was issued adopting the procedural dates proposed by the parties and establishing various other procedural requirements, dates, and deadlines.

On October 1, 2015, Willow Valley filed affidavits verifying that notice of the amended

[1] EPCOR, RUCO, and Staff indicated agreement to extend the timeclock due to the complexity of this case. Willow Valley objected to an extension of the timeclock indicating that it preferred to have this matter resolved as expeditiously as possible. Willow Valley affirmed that neither its shareholders nor its customers would suffer detrimental harm as a result of extending the timeclock for an additional 60 days.

application and hearing thereon was mailed to customers on September 18, 2015, and published in the *Mohave Daily News* on September 23, 2015.

On October 9, 2015, RUCO and Staff filed the direct testimonies of their respective witnesses.

On October 23, 2015, Willow Valley and EPCOR filed the rebuttal testimonies of their respective witnesses.

On November 4, 2015, Willow Valley filed the affidavit of Mr. Michael Liebman, Chief Financial Officer of Global Water Resources, Inc.

Also on November 4, 2015, RUCO filed, as an omnibus motion, a Request for an Extension of Time to File Surrebuttal Testimony, a Request to Reschedule Evidentiary Hearing, and an Objection to Affidavit of Mr. Liebman.

On November 5, 2015, Willow Valley filed a Response in Opposition to RUCO's omnibus motion.

On November 6, 2015, a telephonic procedural conference was convened, with EPCOR, Willow Valley, RUCO, and Staff appearing through counsel. In the interest of compromise, the parties agreed to modify the procedural schedule to resolve the issues raised in RUCO's omnibus motion.

On November 6, 2015, a Procedural Order was issued modifying the procedural schedule as agreed to by the parties.

On November 13, 2015, Staff and RUCO filed the surrebuttal testimonies of their respective witnesses.

On November 16, 2015, the public comment session was held as scheduled, with EPCOR, Willow Valley, RUCO, and Staff appearing through counsel. No members of the public appeared to provide comment.

On November 19 and 20, 2015, a full public hearing was convened as scheduled, with EPCOR, Willow Valley, RUCO, and Staff appearing through counsel.

On December 7, 2015, EPCOR, Willow Valley, RUCO, and Staff filed their respective Closing Briefs.

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II. BACKGROUND.

A. Willow Valley.

Willow Valley is a subsidiary of Global Water Resources, Inc. ("Global").[2] Willow Valley is an Arizona public service corporation authorized to provide water utility service in portions of Mohave County, Arizona.[3] Willow Valley provides water service to approximately 1,620 connections in its service area of approximately 4.29 square miles. Willow Valley's current rates and charges were established in Decision No. 74364 (February 26, 2014).[4]

Willow Valley's water system consists of 10 wells, with a total capacity of 1,765 gallons per minute; four storage tanks, with a combined capacity of 502,000 gallons; 12 booster pump stations; and associated distribution systems. During calendar year 2014, Willow Valley reported a total of 84,683,000 gallons pumped and 61,176,000 gallons sold, resulting in a water loss ratio of approximately 27.76 percent, which exceeds the 10 percent limit acceptable to Staff. Based on Staff's engineering analysis, Willow Valley has adequate production and storage capacity to serve existing customers and reasonable growth.[5]

According to the Arizona Department of Environmental Quality ("ADEQ") Drinking Water Compliance Status Report dated June 3, 2015, ADEQ has determined that Willow Valley is currently delivering water that meets water quality standards required by 40 C.F.R. §§ 141, *et seq.* (National Primary Drinking Water Regulations) and Arizona Administrative Code, Title 18, Chapter 4.[6]

The Arizona Department of Water Resources ("ADWR") has reported that Willow Valley is currently compliant with departmental requirements governing water providers and/or community water systems. Willow Valley is not located within an ADWR Active Management Area.[7]

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[2] Global acquired ownership of Willow Valley as part of the stock purchase of West Maricopa Combine, Inc. in the summer of 2006. (Exh. Willow-1 at 6-7). Since its acquisition of Willow Valley, Global estimates that it has invested over $3 million in plant investments to improve and upgrade the water system. (*Id.* at 13).

[3] *See* Decision Nos. 32436 (August 23, 1960); 34869 (November 20, 1963); 55434 (February 12, 1987); and 68610 (March 23, 2006).

[4] Exh. S-5 at 2.

[5] Exh. S-8 at Exhibit JWL.

[6] *Id.*

[7] *Id.*

Staff reviewed the Utilities Division compliance database and found no delinquent compliance items for Willow Valley.[8]

B. EPCOR.

EPCOR is an Arizona public service corporation authorized to provide water service in nine districts in Arizona. Among the districts operated by EPCOR are the Mohave and North Mohave Water Districts, located approximately ten miles north of Willow Valley's certificated service area. EPCOR currently serves approximately 128,000 water customers in Arizona, including 18,000 customers in the Mohave and North Mohave Water Districts. According to Staff, EPCOR has a significant presence in the Mohave County area which may result in economies of scale savings for Willow Valley in the future.[9]

III. AMENDED APPLICATION.

On March 23, 2015, EPCOR and Willow Valley entered into a purchase agreement for the sale of Willow Valley's assets, including its CC&N, to EPCOR. According to the amended application, EPCOR will pay a purchase price that is approximately 10 percent in excess of the rate base value of Willow Valley.[10] The amended application seeks approval of the sale and transfer of Willow Valley's assets as well as approval of an Acquisition Adjustment Mechanism ("AAM") to enable EPCOR the opportunity to recover the portion of the purchase price paid in excess of the value of Willow Valley's rate base (the "Acquisition Premium"). EPCOR will finance the transaction utilizing 100 percent equity. The Applicants state that they intend to close the transaction within 30 days after the Commission's approval of the amended application becomes non-appealable.

All parties agree that the proposed sale and transfer involves a transaction between two well-qualified, well-run, and well-capitalized companies.[11] As a result, no party disputes that EPCOR is a fit and proper entity to receive the assets and certificated area of Willow Valley. The issues of disagreement among the parties involve: (1) whether the Commission should approve the AAM; and (2) whether the Commission should recognize Willow Valley's accumulated deferred income tax

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[8] Exh. S-8 at Exhibit JWL.

[9] *Id.*

[10] As of the date of filing the amended application, the proposed purchase price of Willow Valley was $2,494,834, which was $226,803 more than the rate base value of Willow Valley's system.

[11] Tr. at 140-41; 249-50; 429; 503; and 557.

("ADIT") balance as a regulatory liability for ratemaking purposes.

A. Acquisition Adjustment Mechanism ("AAM").

The proposed AAM conditions recovery of the Acquisition Premium to the success of a five-year capital improvement plan identified by EPCOR as necessary to address existing water losses and improve the overall operability of the system. EPCOR estimates that the five-year plan will cost approximately $1 million and include the following projects: (1) replacement of distribution valves that are currently inoperable; (2) maintenance and repairs to the three existing storage tanks; (3) redesign the backwash effluent discharge retention system to prevent leaching into the aquifer; (4) replacement of leaking service lines; (5) repair or replacement of failed flow, backwash, and customer meters; (6) system interconnect between the King Street and Lake Cimarron areas of the existing Willow Valley system to provide operational flexibility and redundancy; and (7) and other infrastructure projects later determined necessary by EPCOR.[12]

Under the proposed AAM, the Acquisition Premium would be recovered through a monthly surcharge over a period years, with recovery of the surcharge phased-in as the expenditures associated with the five-year plan are completed.[13] The monthly surcharge amount would be calculated in Willow Valley's next rate case and updated in each subsequent rate case.[14] According to EPCOR, there are four variables to the surcharge calculation: (1) the cost of the projects included in the five-year plan; (2) the premium incentive applied to the estimated costs of the five-year plan (EPCOR is requesting a 20 percent premium); (3) the rate of return authorized by the Commission; and (4) the length of time EPCOR would be allowed to collect the surcharge from customers (EPCOR is requesting a 15-year period).[15] The result of that calculation would then be multiplied by the gross revenue conversion factor to generate the amount of yearly revenue required from ratepayers. EPCOR estimates that the monthly surcharge would be $1.21 per month per customer over the next 15 years, assuming the cost of the five-year plan is $1 million; the premium incentive is 20 percent; a 6.72 percent rate of return;

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[12] Exh. EWAZ-1 at 3-4. Global's president, Mr. Ron Fleming, testified that the Willow Valley system would benefit from the system improvements identified by EPCOR. However, Mr. Fleming testified that Global has no plans for a similar program given "the many years of financial losses experienced by Willow Valley, combined with having already [invested] nearly $3.3 million into Willow Valley, with no return on [that] investment." (Exh. Willow-1 at 6).

[13] Exh. EWAZ-3 at 4.

[14] Exh. EWAZ-4 at 5-6.

[15] *Id.* at 8-9; Tr. 369-372.

and a 15-year recovery period.[16] EPCOR states that is not seeking to include the Acquisition Premium in rate base.[17]

According to EPCOR, the AAM surcharge in effect at the end of the five-year period would cease if the current water loss ratio has not been reduced by 25 percent,[18] and the surcharge would not resume until EPCOR has demonstrated that the system's water loss ratio has declined by that percentage.[19] The surcharge would terminate upon the earlier of the full recovery of the Acquisition Premium or expiration of the authorized recovery period.[20] EPCOR represents that it will work with Staff to develop a specific Plan of Administration if the AAM is approved in this proceeding.[21]

EPCOR

EPCOR argues that recovery of an Acquisition Premium in a transaction involving two-well financed and run utilities is consistent with the Commission's long-stated desire to encourage the consolidation and regionalization of water utilities in Arizona.[22] EPCOR notes that the Commission has previously considered acquisition adjustments in other cases: Decision No. 61307 (December 31, 1998) wherein the Commission approved an accounting order for an acquisition adjustment to incent the acquisition of a small, troubled water utility;[23] and Decision No. 63584 (April 24, 2001) wherein the Commission deferred consideration of an acquisition premium until the utility's next rate case and conditioned recovery upon a showing that "clear, quantifiable and substantial net benefits have been realized by ratepayers…which would not have been realized had the transaction not occurred."[24]

EPCOR claims that the positions of Staff and RUCO that no acquisition adjustment be permitted in this case are contrary to Commission policy and result in regulatory uncertainty that

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[16] Exh. EWAZ-4 at 7.

[17] In Decision No. 68412 (Jan. 23, 2006), we noted that "Commission only allows a return on an acquisition premium adjustment in extraordinary settings." (*Id.* at 7, f.n. 3).

[18] For example, using Willow Valley's water loss ratio for 2014 (27.76 percent), the proposed AAM would cease if EPCOR fails to reduce the water loss ratio to 20.82 percent (25 percent of 27.76 percent) within the five year period. (Tr. at 357). Under the proposed AAM, any surcharge money collected in the preceding five years would not be returned to customers if EPCOR fails to reduce its water loss ratio by 25 percent. (Tr. at 312-313).

[19] Exh. EWAZ-1 at 5.

[20] Exh. EWAZ-4 at 8.

[21] Exh. EWAZ-3 at 5-6.

[22] EPCOR Closing Brief ("Cl. Br.") at 4-5.

[23] The acquisition costs included: outstanding water delivery payments; delinquent property taxes and penalties; regulatory compliance costs; and system assets. (Decision No. 61307 at 5-6).

[24] Decision No. 63584 at 15-16.

provides a significant disincentive to industry consolidation. EPCOR asserts that consolidation of water utilities will remain rare unless the Commission acknowledges the fact that small water utilities are unwilling to sell their utilities at net book value.[25]

EPCOR submits that the AAM proposed in this case could be used as a template in other cases to incentivize water industry consolidation in Arizona. According to EPCOR, the AAM provides an incentive for utilities to acquire smaller water companies by: recognizing that the value of a utility, even a small, troubled utility, often exceeds the net book value of its assets shown in Commission annual reports; and requiring an acquiring utility to make substantial, accelerated, and verifiable investments that provide quantifiable benefits to the customers in the acquired system that address issues inherent to that system.[26]

EPCOR argues that the proposed transaction provides a number of benefits to ratepayers including: more reliable water service as failing infrastructure is replaced; reduced operational costs due to EPCOR's closer proximity to the certificated area of Willow Valley; and reduced cost of debt resulting from EPCOR's stronger credit rating. In addition, EPCOR argues that the AAM provides a quantifiable benefit to ratepayers because recovery of the surcharge is predicated on EPCOR reducing the existing water loss ratio by 25 percent within five years.[27]

EPCOR states that the AAM would be implemented as part of a future rate case which would allow the Commission to fully vet and determine the prudency of the investments made by EPCOR, the fair value of Willow Valley's rate base, and EPCOR's compliance with its commitment to reduce water loss. According to EPCOR, the proposed process would, in accordance with Decision No. 63584, allow the Commission to determine whether EPCOR has provided clear and quantifiable net benefits to ratepayers.[28]

Willow Valley

Willow Valley argues that the proposed transaction will benefit ratepayers because EPCOR's existing systems and operations in Mohave County are closer in proximity than Global's headquarters

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[25] EPCOR Cl. Br. at 5-6.
[26] *Id.* at 6.
[27] *Id.* at 7.
[28] *Id.* at 11.

in Phoenix and main service areas in Pinal County. As a result, Willow Valley asserts that its customers will benefit from operational efficiencies, including improved emergency response time and economies of scale savings. Further, Willow Valley argues that EPCOR has a more balanced capital structure and lower cost of capital which should also benefit ratepayers in the next general rate case.[29]

Willow Valley states that the AAM is a new and substantial approach towards encouraging industry consolidation. According to Willow Valley, the AAM is akin to a "return premium" whereby EPCOR will receive a slightly higher rate of return on infrastructure investments identified to address water loss, but only if water loss is reduced by a specified amount. Willow Valley asserts that the "return premium" method has proven successful in promoting water industry consolidation in other states, including Pennsylvania.[30]

Willow Valley contends that despite the millions of dollars invested by Global, Willow Valley remains a troubled water utility. According to Willow Valley, it is experiencing very high water loss due to deteriorated pipes. Willow Valley asserts that authorizing a return premium on new investments made by a new utility owner is a reasonable step towards encouraging the consolidation of troubled water companies.[31]

RUCO

RUCO asserts that the proposed transfer of ownership does not merit an acquisition adjustment because the transaction involves two well-qualified water utilities. According to RUCO, an acquisition adjustment should only be considered where the purpose is to incentivize the acquisition of a troubled water utility, not to enrich two-well qualified utilities. Since Willow Valley is currently owned by a well-qualified company (Global), RUCO argues that awarding an acquisition adjustment to EPCOR in this case would be counterproductive to the goal of incentivizing the acquisition of troubled water utilities.[32]

RUCO further asserts that an acquisition adjustment should be rejected because the proposed transfer of ownership will not result in any quantifiable benefit to ratepayers. RUCO claims that any

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[29] Willow Valley Cl. Br. at 2.
[30] *Id.* at 5.
[31] *Id.* at 5-7.
[32] RUCO Cl. Br. at 1-2, 8.

benefit associated with EPCOR's more balanced capital structure is speculative and the 5-year capital plan is not a benefit associated with the transaction because Global would have to make similar improvements at no premium to ratepayers. According to RUCO, EPCOR does not need an additional incentive to invest in infrastructure that is part of its obligation to provide safe and reliable drinking water.[33]

RUCO also argues that the acquisition adjustment should be rejected because the Applicants did not perform a net present value analysis of the proposed transaction. RUCO states that when a change of ownership is contemplated, a buyer will typically perform 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. According to RUCO, such an analysis would provide insight on the merit of an acquisition adjustment and provide perspective on the future financial viability of Willow Valley. Since no net present value analysis of the proposed transaction was performed, RUCO suggests that EPCOR has failed to substantiate the value of the Acquisition Premium.[34]

RUCO states that in the past, Staff has cited six conditions that must be satisfied before the Commission should grant an acquisition adjustment: (1) the acquired utility is a Class D or E; (2) the acquisition will not negatively affect the viability of the acquirer; (3) the acquired system's customers will receive improved service in a reasonable timeframe; (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 transaction; (5) the recovery period for the acquisition adjustment should be for a specific minimum time; and (6) the acquisition is in the public interest.[35] RUCO argues that the proposed transaction does not meet any of the six conditions and urges the Commission to reject any acquisition adjustment.[36]

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[33] RUCO Cl. Br. at 7-8, 11.

[34] *Id.* at 9-10.

[35] In Decision No. 62993 (November 3, 2000) (Docket No. W-00000C-98-0153), the Commission ordered Staff to, among other things, develop a policy statement regarding acquisition adjustments and rate of return premiums for water systems. On June 29, 2001, Staff filed a proposed policy recommending that an acquisition adjustment or rate of return premium be awarded upon meeting the six conditions referenced above. The Commission has not approved Staff's proposed policy.

[36] RUCO Cl. Br. at 10-11.

Staff

Staff believes that acquisition premiums and other incentives to promote and encourage the consolidation of small water utilities in Arizona should be reserved for small, distressed, and otherwise troubled water utilities.[37] Staff argues that Willow Valley is not a small, distressed water utility and recommends that no acquisition premium or any type of similar incentive be granted as part of the proposed transaction.[38]

Staff notes several cases in which the Commission considered recovery of acquisition adjustments.[39] In Decision No. 68826 (June 29, 2006), the Commission approved the creation of a regulatory asset to allow recovery of acquisition costs to acquire "an extremely troubled utility that will benefit from having a well capitalized, safety oriented and efficient operator."[40] Similarly, in Decision No. 56551 (July 3, 1989), the Commission approved the recovery of an acquisition premium to incent the acquisition of a small utility that had been operating at a loss for many years and was providing unreliable service. Finally, in Decision No. 63584 (April 24, 2001), the Commission deferred consideration of an acquisition premium until the utility's next rate case and conditioned recovery upon a showing that "clear, quantifiable and substantial net benefits have been realized by ratepayers...which would not have been realized had the transaction not occurred."[41]

Staff does not believe the circumstances in this case support the recovery of the Acquisition Premium. According to Staff, the proposed transaction involves the acquisition of a well-qualified utility that is currently providing adequate, reliable service, and is operating in compliance with all regulatory requirements. Staff states that the infrastructure projects identified by EPCOR in its proposed five-year plan to reduce water loss are considered part of the utility's routine operating and maintenance expenses and should be addressed as part of the normal course of utility operations. In Staff's opinion, EPCOR has not demonstrated significant benefits to the ratepayers to warrant any type

[37] Exh. S-5 at 4.
[38] Tr. at 449-50; Staff Cl. Br. at 4.
[39] Staff Cl. Br. at 4-5.
[40] Decision No. 68826 at 11. The estimated acquisition costs involved in that proceeding included: reorganization costs, including participation in bankruptcy proceedings; Commission related activities; and transition costs, including support for an interim operator and capitalized labor costs. (Decision No. 68826 at 10-11).
[41] Decision No. 63584 at 15-16.

of acquisition premium, incentive, or other adjustment.[42]

B. Accumulated Deferred Income Taxes ("ADIT").

ADIT represents the timing difference that results from the use of straight line depreciation for regulatory purposes and accelerated depreciation used for state and federal income tax purposes. For ratemaking purposes, ADIT is normally a deduction from rate base. Since the proposed transaction is structured as a transfer of assets, the ADIT balance associated with the sold assets will be removed from Global's books because the balance will become payable to the United States Internal Revenue Service ("IRS"). As of the date of filing the amended application, Willow Valley had an ADIT balance of $260,224.

RUCO

RUCO argues that the amended application is not in the public interest because ratepayers will lose the benefit of the ADIT balance, namely the reduction to rate base, if the proposed transaction is approved. According to RUCO, approving asset transfers that deprive ratepayers credit for income tax expenses that they have already paid is poor public policy. RUCO asserts that there are numerous ways that the Commission can protect ratepayers from the loss of ADIT, including: creating a regulatory liability in the amount of the ADIT balance as a condition of approval; requiring the Applicants to restructure the proposed transaction as a stock transfer, which would preserve the ADIT balance; requiring a rate freeze for the acquired utility; or requiring EPCOR to establish a fund that would be used to offset future rate increases.[43]

In response to the positions of Willow Valley, EPCOR, and Staff that recognizing a regulatory liability in the amount of the ADIT balance may violate IRS regulations regarding normalization, RUCO submits that the Commission should require the Applicants to request a Private Letter Ruling ("PLR") from the IRS. According to RUCO, a PLR made before the transaction is approved, and based specifically on the facts of this case, is the only way that the normalization issue could be fully vetted. RUCO argues that while a PLR may be costly and time consuming, it should nonetheless be required because the loss of ADIT is unfair to ratepayers and against the public interest.[44]

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[42] Staff Cl. Br. at 5-6.
[43] RUCO Cl. Br. at 3-5.
[44] *Id.* at 4-5.

RUCO further disputes the positions of Willow Valley, EPCOR, and Staff that the IRS may deny EPCOR the use of accelerated depreciation in the future if it is found to be in violation of the IRS regulations regarding normalization. RUCO notes that its tax witness, Mr. Ralph Smith, testified that he is not aware of any instance where the IRS has issued such a penalty against a utility and indicated that the IRS typically allows utilities the opportunity to remedy violations before imposing penalties.[45]

RUCO also disputes the positions of Willow Valley, EPCOR, and Staff that the harm to ratepayers resulting from the loss of the ADIT balance is offset by the financial gains associated with the more favorable capital structure of EPCOR. According to RUCO, the various calculations proffered by the other parties are "pure conjecture" because potential changes to Willow Valley's capital structure will not be known and measurable until the next rate case.[46]

Willow Valley

Willow Valley argues that RUCO's proposal to create a regulatory liability in the amount of its ADIT balance should be rejected for several reasons. First, Willow Valley contends that the rate benefit of the ADIT offset to rate base is less than the rate benefit that will inure to ratepayers as a result of EPCOR's lower capital costs. Specifically, Willow Valley notes that Staff estimated the revenue requirement reduction of the ADIT offset as $26,000 per year, and the revenue requirement reduction resulting from EPCOR's lower capital costs as $29,000 per year.[47] Willow Valley further notes that its witness, Mr. Paul Walker, also estimated that the rate value benefit of the ADIT offset would be less than the rate value benefit resulting from EPCOR's lower capital costs.[48] As a result, Willow Valley asserts that ratepayers will be better off if the transaction is approved, particularly when the operational benefits associated with the transaction are taken into consideration.[49]

Next, Willow Valley argues that creating a regulatory liability in the amount of its ADIT balance creates a strong risk that the IRS will find a normalization violation. According to Willow Valley, a normalization violation would result in serious harm to ratepayers because EPCOR would be

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[45] RUCO Cl. Br. at 5.
[46] *Id.* at 6-7.
[47] Willow Valley Cl. Br. at 3; Tr. at 417-418, 458.
[48] Willow Valley Cl. Br. at 3; Tr. at 170-71, 219-221.
[49] Willow Valley Cl. Br. at 3.

precluded from using accelerated depreciation in the future.[50]

In response to RUCO, Willow Valley asserts that requesting a PLR from the IRS to resolve the normalization issue is impractical because: a favorable ruling from the IRS is not likely; the IRS process would require Willow Valley to hire tax attorneys and other experts at significant costs; and the IRS process could unduly delay the proposed transaction.[51] Willow Valley further asserts that RUCO's recommendation to restructure the transaction as a stock sale is not feasible because it would frustrate many months of negotiations and change the pricing of the transaction thereby jeopardizing the proposed transfer.[52]

EPCOR

EPCOR argues that creating a regulatory liability in the amount of Willow Valley's ADIT balance violates the IRS normalization rules. According to EPCOR, Global will have to pay the ADIT balance to the IRS if the proposed transaction is approved. EPCOR asserts that a normalization violation could result in EPCOR losing the ability to utilize accelerated depreciation for income tax purposes in any of its Arizona operations.[53]

EPCOR contends that requiring the Applicants to obtain a PLR from the IRS is problematic because it is a complex, time consuming, and expensive proposition. Further, EPCOR contends requiring the Applicants to alter the details of the transaction to preserve the ADIT balance "presents a host of constitutional and practical concerns that [would] render [the sale] unworkable."[54]

Staff

Staff argues that recognition of the ADIT balance of as a regulatory liability may be inconsistent with IRS regulations regarding normalization.[55] According to Staff, if the Commission were to recognize ADIT as a regulatory liability in this case, EPCOR could find itself out of compliance with the IRS and lose its ability to claim accelerated depreciation in the future on all of its depreciable utility

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[50] Willow Valley Cl. Br. at 3.
[51] *Id.* at 4.
[52] *Id.* at 4-5.
[53] EPCOR Cl. Br. at 3.
[54] *Id.*
[55] Staff initially recommended that the ADIT balance be recognized as a regulatory liability (*see* Exh. S-5 at 9); however, Staff later withdrew this recommendation based upon its concern that recognition of ADIT as a regulatory liability may violate IRS regulations regarding normalization (*see* Exh. S-6 at 4; Staff Cl. Br. at 2-3).

plant in Arizona. Staff states that an inability to claim accelerated depreciation in the future could present a very serious situation for EPCOR and all of its ratepayers in Arizona.[56]

* * * * * * * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. The above discussion and findings are incorporated into this Findings of Fact by reference.

2. The Applicants recommend that the amended application be approved.[57]

3. RUCO recommends that the amended application be denied.[58]

4. Staff recommends that the amended application be approved, subject to the following conditions:

(1) that the Commission deny recognition of any acquisition premium that EPCOR pays for Willow Valley;

(2) that the Commission deny recognition of any acquisition adjustment or other premium to be applied to expenditures required in the ordinary course of business;

(3) that EPCOR be put on notice that Willow Valley should work towards a balanced capital structure and that a hypothetical capital structure may be deemed appropriate in a future rate proceeding if EPCOR fails to do so;[59]

(4) that EPCOR continue to comply with all previous decisions pertaining to this water system, and more specifically the requirements of Decision No. 74364 which requires annual reporting of the Willow Valley water losses until such time as annual water losses are less than 10 percent; and

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[56] Exh. S-6 at 4.
[57] EPCOR Cl. Br. at 12; Willow Valley Cl. Br. at 7.
[58] RUCO Cl. Br. at 12.
[59] Ms. Sarah Mahler, testifying on behalf of EPCOR, stated that Willow Valley will assume the prevailing capital structure of EPCOR at the time of any future rate case proceeding. (Exh. EWAZ-4 at 13). Mr. Carlson, testifying on behalf of Staff, stated that Staff would no longer be concerned with the capital structure of Willow Valley if the prevailing capital structure of EPCOR is assumed in the next rate case. (Tr. at 422.)

(5) that EPCOR file, within 90 days, a detailed analysis and plan to reduce water loss to 10 percent or less, or, if EPCOR believes it would not be cost effective to reduce water loss to less than 10 percent, a detailed cost benefit analysis report supporting that opinion.[60]

5. Consistent with Decision No. 63584, we find that recovery of any acquisition premium or similar adjustment "should be based on [EPCOR's] ability to demonstrate that clear, quantifiable and substantial net benefits have been realized by [Willow Valley's] ratepayers...which would not have been realized had the transaction not occurred."[61]

6. EPCOR argues that the proposed transaction provides a number of benefits to ratepayers including: more reliable water service as failing infrastructure is replaced; reduced operational costs due to EPCOR's closer proximity to the certificated area of Willow Valley; and reduced cost of debt resulting from EPCOR's stronger credit rating. In addition, EPCOR argues that the AAM provides a quantifiable benefit to ratepayers because recovery of the surcharge is predicated on EPCOR reducing the existing water loss ratio by 25 percent within five years.

7. Based on the record in this proceeding, it is unclear whether the proposed transaction will provide clear, quantifiable, and substantial net benefits to ratepayers. Even assuming the benefits articulated by EPCOR provide a substantial net benefit to ratepayers (a finding we do not make in this proceeding), the stated benefits will not be clear and quantifiable, if at all, until Willow Valley's next rate case. To approve the AAM before determining whether the proposed transaction will provide clear, quantifiable, and substantial net benefits to ratepayers would place the proverbial cart before the horse. Under the circumstances, we believe it is reasonable and appropriate to defer consideration of recovery of the Acquisition Premium through the proposed AAM until Willow Valley's next rate case. In light of the foregoing, we decline to adopt the recommendations of Staff and RUCO to deny recovery of the Acquisition Premium at this time.

8. We further decline to adopt RUCO's recommendation to create a regulatory liability in the amount of Willow Valley's current ADIT balance for several reasons. First, the ADIT balance

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[60] Exh. S-6 at 11; Exh. S-8 at Exhibit JWL.
[61] Decision No. 63584 at 15-16.

associated with the sold assets will be removed from Global's books because the balance will become payable to the IRS. Thus, there is no longer an ADIT balance to recognize. Second, we find that it is highly likely that requiring Willow Valley to carry an ADIT balance that no longer exists on its books under the guise of a regulatory liability would be in violation of the IRS normalization rules. As a result, we further find that requiring the Applicants to request a PLR from the IRS would be unnecessary and cause undue expense and delay.

9. We also decline to adopt RUCO's recommendation to require the Applicants to restructure the proposed transaction as a stock transfer in order to preserve the ADIT balance. We note that both Willow Valley and Staff estimated that any harm to ratepayers resulting from the loss of the ADIT balance will be offset by the reduced cost of debt resulting from EPCOR's stronger credit rating and more favorable capital structure.[62] Under the circumstances, we do not believe it is in the public interest to reject the proposed transaction.

10. Based on the record in this proceeding, Staff's recommendations in Findings of Fact No. 5, as modified herein, are reasonable and in the public interest. Accordingly, we find that the transfer of Willow Valley's water utility assets and Certificate of Convenience and Necessity to EPCOR should be approved, as discussed herein.

CONCLUSIONS OF LAW

1. Willow Valley Water Co., Inc. and EPCOR Water Arizona, Inc. are public service corporations within the meaning of Article XV of the Arizona Constitution and A.R.S. §§ 40-281, 40-282 and 40-285.

2. The Commission has jurisdiction over Willow Valley Water Co., Inc. and EPCOR Water Arizona, Inc. and the subject matter of the application.

3. Notice of the application was provided in accordance with the law.

4. There is a continuing need for the provision of water utility service in the certificated service area of Willow Valley Water Co., Inc.

[62] Tr. at 169-72; 417-18.

5. EPCOR Water Arizona, Inc. is a fit and proper entity to receive the assets and certificated area of Willow Valley Water Co., Inc.

6. It is in the public interest to approve the application subject to the recommendations of Staff as set forth in Findings of Fact No. 5, as modified herein.

ORDER

IT IS THEREFORE ORDERED that the joint application of Willow Valley Water Co., Inc. and EPCOR Water Arizona, Inc. for the sale of Willow Valley Water Co., Inc.'s water system assets and the transfer of its Certificate of Convenience and Necessity is approved as conditioned herein.

IT IS FURTHER ORDERED that, as discussed herein, consideration of the proposed Acquisition Adjustment Mechanism shall be deferred to Willow Valley Water Co., Inc.'s next general rate case.

IT IS FURTHER ORDERED that EPCOR Water Arizona, Inc. shall continue to charge water customers in the certificated service area of Willow Valley Water Co., Inc.'s currently authorized rates and charges.

IT IS FURTHER ORDERED that EPCOR Water Arizona, Inc. shall continue to comply with all Commission decisions and outstanding compliance matters previously required of Willow Valley Water Co., Inc. relating to the acquired water system.

IT IS FURTHER ORDERED that EPCOR Water Arizona, Inc. is hereby put on notice that Willow Valley Water Co., Inc. should work towards a balanced capital structure and that a hypothetical capital structure may be deemed appropriate in a future rate proceeding if EPCOR Water Arizona, Inc. fails to comply with this condition.

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IT IS FURTHER ORDERED that EPCOR Water Arizona, Inc. shall file with Docket Control, as a compliance item in this matter, within 90 days of the effective date of this Decision, a report containing a detailed analysis and plan to reduce water loss to 10 percent or less. If the EPCOR Water Arizona, Inc. believes it is not cost effective to reduce water loss to less than 10 percent, it should submit a detailed cost benefit analysis to support its opinion within the same time frame. In no case shall EPCOR Water Arizona, Inc. allow water loss to be greater than 15 percent.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN COMMISSIONER

COMMISSIONER COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I, JODI JERICH, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this _____day of _____ 2016.

JODI JERICH
EXECUTIVE DIRECTOR

DISSENT _____

DISSENT _____
SMH:ru

SERVICE LIST FOR: WILLOW VALLEY WATER CO., INC. AND EPCOR WATER ARIZONA, INC.

DOCKET NO.: W-01732A-15-0131 AND W-01303A-15-0131

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