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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
DOCKET CONTROL

COMMISSIONERS

DOUG LITTLE, Chairman
BOB STUMP
ROBERT BURNS
TOM FORESE
ANDY TOBIN

IN THE MATTER OF THE APPLICATION OF GRANITE MOUNTAIN WATER CO., INC., FOR A RATE INCREASE.	DOCKET NO. W-02467A-14-0230
IN THE MATTER OF THE APPLICATION OF CHINO MEADOWS II WATER CO., INC. FOR A RATE INCREASE.	DOCKET NO. W-02370A-14-0231

INITIAL JOINT BRIEF OF
GRANITE MOUNTAIN WATER CO., INC., AND
CHINO MEADOWS II WATER CO., INC.

Granite Mountain Water Co., Inc. and Granite Meadows II Water Co., Inc. hereby submit their Initial Joint Brief in the above-captioned case.

Respectfully submitted on April 22, 2016, by:

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Granite Mountain Water Co., Inc. ("Granite") and Chino Meadows II Water Co., Inc. ("Chino") hereby submit their Initial Joint Brief in the above-captioned case. (Granite and Chino will be referred to jointly as "the Companies.")

I. INTRODUCTION

Decision No. 74834 required Granite to file a rate case by June 30, 2014, using a test year ending December 31, 2013. Decision No. 72896 required Chino to "file its next general rate case using the same test year as is used in the next rate case for its sister utility, Granite Mountain Water Company, Inc." In compliance with these decisions, these cases began 22 months ago on June 30, 2014, with the filings of the Companies' separate rate applications.[1]

Each applicant is a very small. Granite is a Class E water company and Chino is a Class D water company.

[1] As amended on October 16, 2014.

II. COMMON ISSUES

The following issues are common to both rate cases.

A. Allocation of Common Costs

1. Staff's recommendations impair the Companies' ability to recover common costs

Granite and Chino are sister companies operated from a common office using common staff.[2] In addition, a third much smaller company, Antelope Lakes Water Company ("Antelope") is affiliated with Granite and Chino and operated from the common office using common staff as well.[3] As discussed by Staff witness Hunsaker, the position taken in one case can impact the position in the other case, particularly with respect to allocated common costs. For this reason the positions taken in both cases, in addition to being evaluated independently, must be evaluated as a whole and in consideration of the overall impact to the combined operations of Granite and Chino.

The Companies have historically allocated costs based on customer counts, which are currently 88% Chino/12% Granite.[4] The Companies continues to believe that customer counts represent the simplest and most accurate way to allocate costs and that customer counts should dominate any cost allocation model between Chino and Granite. Staff's initially proposed a complex 4-factor allocation methodology that allocated only 70.12% of costs to Chino and 26.93% to Granite. This dramatically shifted $49,006 in costs and related revenue from Chino to Granite, a very large number for two very small companies.

The Companies were concerned with this shift because Granite has fewer customers, lower water sales, higher levels of plant investment and higher rates.[5] In contrast, Chino is an established, mature company that provides 75% of the combined revenue of Chino and Granite. Shifting costs to Granite would create revenue instability for the water companies as a whole. Since Granite's water sales are only 15.5% of the combined total sales for Granite and Chino,

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[2] This paragraph, Granite Exhibit A-1 at 4; Chino Exhibit A-1 at 3.
[3] Antelope Lakes has only 2 customers.
[4] This paragraph, Granite Exhibit A-2 at 2; Chino Exhibit A-2 at 2.
[5] This paragraph, Granite Exhibit A-1 at 14; Chino Exhibit A-1 at 11.

each $10,000 shift in costs lowers rates for Chino by about $0.25 per 1,000 gallons while increasing rates in Granite by about $1.06 per 1,000 gallons. Due to this disparate impact to rates, aggressive shifting of costs to Granite is certain to increase revenue instability because Granite would almost certainly under-collect its authorized revenue by a significant magnitude. Staff's aggressive allocation of costs to Granite would hamper the common operation's ability to cover its common expenses and ultimately harm the operations of both Granite and Chino.

Staff responded to the Companies' concerns not by altering its complex 4-factor cost allocation model, but by arbitrarily proposing to allocate slightly more costs to Chino and fewer to Granite.[6] Staff's current recommendation is 74% to Granite and 25% to Granite. This recommendation shifts $10,634 less in expense from Chino to Granite compared to Staff's original recommendation. This, on its face, appears to at least partially address the Companies' cost allocation concerns. However, because Staff failed to increase Chino's revenue requirement to recover these additional expenses, neither Granite nor Chino will be able to recover these expenses. So instead of Granite being unlikely to recover $10,634 in common expenses, Staff would instead guarantee that neither Granite nor Chino would recover these $10,634 in common expenses. The net effect of Staff's revised incomplete allocation would make the combined operations of Granite and Chino worse off.

Granite and Chino are both small companies facing the numerous challenges and issues faced by small companies throughout Arizona.[7] Like other small water companies, Granite and Chino need to be properly positioned for consolidation and, until that can occur, they need to remain viable and have sufficient earnings to encourage investment in infrastructure.[8]

Chino has increased rates by less than one percent over the past 20 years and is only requesting a modest increase in this case.[9] In contrast, Granite is attempting to recover significant investment in new plant and is facing a large rate increase. Staff would further

[6] This paragraph, Granite Exhibit A-2 at 2-3; Chino Exhibit A-2 at 3.
[7] This paragraph, Granite Exhibit A-2 at 3; Chino Exhibit A-2 at 5.
[8] This paragraph, Granite Exhibit A-2 at 3; Chino Exhibit A-2 at 5.
[9] This paragraph, Granite Exhibit A-2 at 3; Chino Exhibit A-2 at 5.

amplify the Granite rate increase by significantly shifting common costs to Granite while Chino's rates unchanged. Both Granite and Chino need sufficient revenue to allow for future improvements and to attract new investment into their water systems.

Staff's proposed abrupt cost shift from Chino to Granite would destabilize the revenue of both companies, further reduce the common operation's ability to cover its common expenses, and further harm the operations of both Chino and Granite.[10] Ultimately, the proposed cost shift could impair the Companies' ability to implement the operational improvements desired by Staff and committed to by the Companies.

Lastly, Staff's proposal moves the Companies contrary to industry trends.[11] The Commission and industry are exploring ways to encourage consolidation and to make it easier for small water companies to be acquired by larger, better capitalized companies. Even California has taken steps to improve the financial health of its small water companies and to make them more attractive for new investment. Unfortunately, the cost shift embedded in Staff's recommendation runs contrary to these Commission, industry, and neighboring-state regulatory policies.

2. Staff's allocation factors are unusual and inappropriate

The Companies object to Staff's use of a complex 4-factor allocation method generally and believes the factors used are inappropriate.[12] Mr. Jones testified that Staff's proposed use of Revenues and Sales (gallons pumped) as cost allocation factors is unusual and that he had never seen those factors used. Further, allocating based on net plant, rather than gross plant is, in Mr. Jones' experience, contrary to common practice and particularly problematic for Chino with its mature, depreciated rate base.

Chino's authorized depreciation rates are clearly in excess of the actual physical depreciation of its plant.[13] This has caused Chino's net plant balance to be unrealistically low

[10] This paragraph, Granite Exhibit A-2 at 3; Chino Exhibit A-2 at 5-6.
[11] This paragraph, Granite Exhibit A-2 at 3-4; Chino Exhibit A-2 at 6.
[12] This paragraph, Granite Exhibit A-1 at 14; Chino Exhibit A-1 at 11.
[13] This paragraph, Granite Exhibit A-1 at 14-15; Chino Exhibit A-1 at 11-12.

and not representative of the scope of Chino's operation. Gross plant would be a much better measure of the relative scope of Chino's operation. However, even gross plant falls somewhat short of presenting an accurate portrayal of Chino. This is because Chino was originally acquired by Mr. Levie through a bankruptcy sale and, pursuant to Commission orders, Chino's books reflect the discounted purchase price rather than the actual original cost of the original plant in service. Chino's aging plant further distorts the relationship between the two companies. Chino's older plant requires significant staff effort as compared to Granite's relatively new plant. This reality is not captured when comparing even gross plant balances. So, it would also be inappropriate to rely too heavily on gross plant as an allocation factor, let alone net plant.

3. The Companies' allocation is straight forward and supports cost recovery for both Granite and Chino

Use of Staff's four atypical factors introduces needless complexity for a small organization that needs simplicity to be successful.[14] The Companies propose a forward-looking customer-centered allocation based on test-year customers, projected customers (5-Yr forward looking) and gross plant in service as the basis of cost allocation. The Companies' recommendation results in a going-forward allocation of 80.5% to Chino and 19.5% to Granite. The Companies' approach is readily understood, consistent with the Companies' historic cost allocation methodology, and, at the same time, acknowledges that plant balances are traditionally used in cost allocation. The Companies' incremental approach to modifying the Companies' cost allocation preserves the Companies' ability to recover their common costs and should be adopted.

B. President's Salary

The Companies object to the deduction of 33% of total monthly hours for the Companies President as proposed by Staff.[15] This deduction is unnecessary because the salary paid to Mr. Levie of $37,700 already includes a deduction for Mr. Levie's time away from the office. Mr.

[14] This paragraph, Granite Exhibit A-1 at 15-16; Chino Exhibit A-1 at 12-13; Chino Exhibit A-2 at 3.
[15] This paragraph, Granite Exhibit A-1 at 13-14; Chino Exhibit A-1 at 10-11.

Levie is a half-time employee because he spends time away from the office and managing his other businesses. To remove costs a second time as recommended by Staff would be duplicative. The Companies propose a total half-time salary for Mr. Levie of $33,027. This amount is arrived at by taking the actual half-time salary paid to Mr. Levie of $37,700 and deducting the $4,673 deduction for duplication of effort with the Operations Manager as recommended by Staff. The Companies' proposed pre-allocation salary of $33,027 is a very reasonable salary for the Companies' President, who serves as the chief executive and legal counsel for both Chino and Granite, and should be adopted by the Commission. The resulting salary allocation to Granite for Mr. Levie should be $6,440 with $26,587 to Chino.

C. Arbitrary Fire-Related Plant Disallowances

Staff would arbitrarily remove 10% of the cost of plant in service from rate base by increasing both Granite's and Chino's CIAC balance.[16] The increase to the Companies' CIAC balance in turn reduces depreciation expense. This reduction to rate base is reduced by intervening amortization of the CIAC balance.[17] The Companies supported this plant through accounting records and there is no dispute that the amount represents plant in service. The Companies cannot provide detailed invoices for the plant because all of the Companies' records were destroyed when the Companies' offices were destroyed by fire. Despite the Companies' best efforts, the Companies were only able to obtain duplicate support for some of its plant. Unfortunately, the Companies were unable to obtain source documentation for this portion of the destroyed records because vendors were out of business or had purged their records. The fire was an event not within the Companies' control and it has made all reasonable efforts to reconstruct its plant records.

The fire was damaging enough to the Companies. Further damaging the Companies financially by disallowing rate base would be punitive. The Staff's arbitrary, punishing adjustment should be rejected.

[16] This paragraph, Granite Exhibit A-1 at 11; Chino Exhibit A-1 at 7-8.
[17] The Companies and Staff disagree as to the proper method to amortize the CIAC balance.

D. Income Tax Expense

The Parties largely agree on how to calculate income-tax expense.[18] However, because the Parties disagree on their revenue and expense recommendations the recommend income taxes at proposed rates are different.

E. Working Capital

The Parties agree on how to calculate the level of working capital. However, because the Parties disagree on their expense recommendations the recommend level of working capital differs.

F. Code of Conduct

The Companies are committed to improving record-keeping and cost accounting to address the issues raised by Staff in this case and to separate the costs related to unregulated affiliates from the cost related to the Companies and regulated affiliates.[19] The Companies do not oppose development of a Code of Affiliate Conduct as recommended by Staff. However, while a Code of Affiliate Conduct would govern relationships and transactions between the regulated and nonregulated affiliates, it should only be adopted by the regulated affiliates and applicable to the transactions recorded by the regulated affiliates that are under Commission jurisdiction. There is neither a jurisdictional basis nor a demonstrated need, for requiring non-regulated affiliates to adopt a Code of Conduct.

G. 4-Factor Allocation and Use of Detailed Time Sheets

For the reasons discussed above, the Companies oppose the use of Staff's allocation model.[20] In regard to the use of detailed time cards, the Companies do not support this as a separate recommendation. The use of time cards can and should be incorporated into the Code of Affiliate Conduct.

[18] Specific Granite issues are discussed below.
[19] This paragraph, Granite Exhibit A-1 at 23; Chino Exhibit A-1 at 15.
[20] This paragraph, Granite Exhibit A-1 at 23; Chino Exhibit A-1 at 15-16.

H. Annual Report of Corporate Cost Allocations

Staff recommends that the Companies be required to file annual reports concerning cost allocations.[21] This recommendation is unnecessary. The Companies intend, to the extent possible, to update their practices to eliminate cost allocations between its regulated and unregulated affiliates. The Companies propose to document these changes in the Code of Affiliate Conduct. Additionally, the current Staff recommendation is not detailed enough to allow the Companies to determine what specifically would be reported.

I. Affiliate Receivables and Payables

As the Companies understand it, Staff makes the following recommendations:[22]

1. The Companies should collect all receivables from affiliates within one year from the Decision in this case.

2. The Companies should cease making any further personal loans or advances with Company funds.

3. The Companies should pay all payables to affiliates within 24 months of the Decision in this case.

4. The Companies should obtain specific authorization by the Commission for indebtedness payable, including amounts appearing in affiliate payable accounts.

The Companies accept parts 1 and 2 of the recommendation with the understanding the part 2 applies only to affiliates.[23] For example, the Companies do occasionally advance funds to unaffiliated employees with the funds being recovered from future pay checks. The Companies believe this practice is consistent with industry practices and that it should be able to continue the practice. The Companies do support the recommendations 3 and 4 with respect to <u>unregulated</u> affiliates.[24]

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[21] This paragraph, Granite Exhibit A-1 at 24; Chino Exhibit A-1 at 16.
[22] This paragraph, Granite Exhibit A-1 at 24-25; Chino Exhibit A-1 at 16-17.
[23] This paragraph, Granite Exhibit A-1 at 25; Chino Exhibit A-1 at 17.
[24] This paragraph, Granite Exhibit A-1 at 24; Chino Exhibit A-1 at 17.

The Companies do not agree with parts 3 and 4 of the recommendation concerning transactions between the regulated affiliates and cannot support the recommendations.[25] The affiliated companies are operated using common facilities and common staff and they are at different stages in their life cycles, with Chino being established and Granite and Antelope being relatively new companies dealing with high plant costs. The ability to use excess funds from one of the regulated affiliates to support the cash needs of another regulated affiliate is in the public interest, and the practice is consistent with the industry and Commission efforts to explore consolidation of smaller companies. Moreover, tracking these funds through the use of intercompany receivable/payable accounts is a convenient and efficient method to record the transactions that provides complete transparency to the Commission. As long as there is no interest charged and no expectation that the funds be repaid, as is the case here, there is no debt that requires approval by the Commission.

If Staff's recommendation is adopted, the Companies would be forced to adopt burdensome, formalized policies and potentially obtain approvals prior to transferring funds.[26] In all likelihood, the only solution to meeting the utilities' cash needs would be for the providing company to go through required corporate formalities and issue a potentially taxable distribution to Mr. Levie. In-turn, Mr. Levie would provide the after-tax portion of the dividend to the receiving company, to be recorded as additional paid in capital. In the end, the Companies would be in the same position—less any income tax effects— but efficiency and transparency would be lost. The Companies request that the Commission allow the Companies to continue their current practice of tracking the transfer of funds from one regulated affiliate to another regulated affiliate through the use of intercompany receivable/payable accounts. If and to the extent this practice requires Commission approval, the Companies asks the Commission to issue the required approval in this case or in the alternative waive the applicable requirement necessitating the approval.

[25] This paragraph, Granite Exhibit A-1 at 25; Chino Exhibit A-1 at 17-18.
[26] This paragraph, Granite Exhibit A-1 at 25; Chino Exhibit A-1 at 18.

J. Interim Manager

Staff asks for authority, without further action by the Commission, to appoint an interim manager if either Granite or Chino violated the adopted Code of Affiliate Conduct.[27] The Commission has heretofore justified appointment of an interim manager only in extraordinary circumstances, where public health and safety is jeopardized. And in every case, the appointment followed a public hearing where the affected utility had notice, an opportunity to appear and present evidence, and the Commission issued an order containing findings of fact and conclusion of law. Staff asks to bypass these due-process safeguards by delegating to itself the ability to appoint an interim manager if it determined in its sole discretion that Granite or Chino had violated the Affiliate Code of Conduct. Yet, it is difficult to understand the relationship of any provision suggested by Staff to public health and safety. And Staff agreed that there have been "no allegations in this case of providing unsafe water or inadequate water or anything of that nature."[28]

Further, Staff's request is not supported by the evidence in this case.[29] The Companies have been transparent and open in their dealings with Commission. There is no evidence of any willful violation of Commission rules or accounting standards. The Companies have cooperated in accepting Staff's recommendations and otherwise correcting any accounting irregularities.

Staff's request is also premature. Staff agreed that "the appointment of an interim manager would be related to violations of the yet-to-be finalized code of conduct."[30] There is no need at all to address this issue at this time.

Staff's request would also set dangerous precedent.[31] Small water companies do not have and cannot afford the staffing or expertise necessary to understand and comply with every nuance of utility accounting and the Commission's rate-making requirements. Mistakes are made; they happen even at the large water companies that have extensive staff dedicated to

[27] This paragraph, Granite Exhibit A-1 at 26-27; Chino Exhibit A-1 at 19.
[28] Granite transcript at 96:20-23.
[29] This paragraph, Granite Exhibit A-1 at 27; Chino Exhibit A-1 at 20.
[30] Granite transcript at 96:15-19.
[31] This paragraph, Granite Exhibit A-1 at 27; Chino Exhibit A-1 at 20.

accounting and regulatory compliance. A continuing threat of confiscation of a small water company from its owner does not serve the public interest and would only make the already difficult business of operating a small water company even more difficult.

Finally, delegating this authority to Staff would violate the Companies' due-process rights guaranteed by the United States Constitution. The 14th Amendment of the United States Constitution requires that a party receive notice and a fair hearing before being deprived of personal or property rights.

> [D]ue process of law under the Fourteenth Amendment of the Constitution of the United States requires that there be notice of hearing, a hearing, the right to produce witnesses, examine adverse witnesses and to have a full consideration and determination according to evidence before the body with whom the hearing is held.

Southern Pac. Co. v. Arizona Corp. Commission, 98 Ariz. 339, 347; 404 P.2d 692, 697 (Ariz. 1965).

The 14th Amendment applies equally to corporations and natural persons. "[A] corporation is a "person" within the meaning of the due process clause." *Arizona Public Service Co. v. Arizona Corp. Com'n*, 155 Ariz. 263, 371; 746 P.2d 4, 12 (App. 1987).[32]

A corporation certainly has the right to determine who manages that corporation. In fact, the Commission ordinarily cannot interfere with that right:

> [T]he commission has no authority or jurisdiction to control the internal affairs of the corporation. It cannot dictate who its officers shall be, whom it shall employ, who may invest money in it, nor what provisions it shall make for the recognition of its shareholders, nor the manner of transferring shares of stock upon its books.

Corp Com'n v. Consolidated Stage Co., 63 Ariz. 257, 263; 161 P.2d 110, 112 (1945).

When the Commission considers abridging a public service corporation's rights, such as its management rights, it acts in a quasi-judicial manner and must afford the affected party its due process rights guaranteed by the Constitution.

> We note, however, a common thread running through the statutes and the case law: in each, the Commission is acting in a judicial or quasi-judicial manner, that

[32] Approved in relevant part, *Arizona Public Service Co. v. Arizona Corp. Com'n*, 157 Ariz. 532, 760 P.2d 532 (Ariz.,1988).

> is, the Commission is resolving a conflict between a public service corporation and the public or is ruling on rate changes or property valuations of a public service corporation that will directly affect the public. In such instances, due process requires that the Commission give the affected parties notice and an opportunity to be heard.

Arizona Public Service Co. v. Arizona Corp. Com'n, 155 Ariz. 263 at 271, 746 P.2d at 12.

The Commission has heretofore justified appointment of an interim manager only in extraordinary circumstances, where public health and safety is jeopardized. And in every case, the appointment followed a public hearing where the affected utility had notice, an opportunity to appear and present evidence, and the Commission issued an order containing findings of fact and conclusion of law. Staff would bypass these due-process safeguards by delegating to Staff the ability to appoint an interim manager if it determined in its sole discretion that Far West had failed to comply with any of nine listed conditions.

None of the Staff's concerns in these cases even remotely implicated public health and safety. But, assuming *arguendo* that a concern did implicate public health and safety, the Commission still could not bypass due process in the name of expediency.

> The right to such a hearing is one of 'the rudiments of fair play' assured to every litigant by the Fourteenth Amendment as a minimal requirement. There can be no compromise on the footing of convenience or expediency, or because of a natural desire to be rid of harassing delay, when that minimal requirement has been neglected or ignored.

Southern Pac. Co. v. Arizona Corp. Commission, 98 Ariz. at 347; 404 P.2d at 697.

It may be expedient to delegate to Staff the <u>extraordinary</u> power to appoint an interim manager, but it is constitutionally prohibited. This is particularly true when a public service corporation has the right in Arizona to control its "internal affairs." *Corporation Commission v. Consolidated Stage Co., supra.*

Finally, as previously stated, Staff's request is premature. The Code of Conduct would have to be drafted and approved by the Commission before the Commission could reasonably consider Staff's request.

III. GRANITE ISSUES

The following issues are unique to the Granite rate case.

A. Well No. 6 Purchase and Easement Costs

Granite and Staff disagree on the value of the easement, structures and well purchased for Well No. 6. There is no dispute over whether the well and easement were needed but the parties dispute the value to be included in rate base.

Granite proposes a cost of $75,000, which is the actual cost paid for the easement. The amount is $5,000 less than the value established by an independent appraisal conducted by Huck Appraisal Office ("Appraisal").[33] A copy of the Executive Summary from the Appraisal was attached as ***Exhibit RLJ-RB4*** to Granite Exhibit A-1.

The appraisal values the easement, including the structures and improvements located within the easement property at a value of $80,000 as of May 29, 2014, the day the easement was recorded in the Yavapai County Recorder's office.[34]

The breakdown of the valuation is as follows:

Land Value	$46,000
Structures	34,705
Well	16,000
Depreciation	(16,344)
Indicated Value	$80,361
Rounded To:	$80,000

Granite allocated the purchase costs as follows:[35]

Account 303 – Land and Land Rights	$46,000
Account 304 – Structures and Improvements	13,000[36]
Account 307 – Wells and Springs	16,000
Total Cost	$75,000

Staff's valuation of the wellsite and easement is unreasonably low and fails to consider the specific circumstances of this well purchase.[37] Staff calculates a theoretical minimum

[33] This paragraph, Granite Exhibit A-1 at 9.
[34] This paragraph, Granite Exhibit A-1 at 9.
[35] This paragraph, Granite Exhibit A-1 at 9.
[36] $34,705 structure value, less $16,344 depreciation, less $361 rounding, less $5,000 paid below appraisal.
[37] This paragraph, Granite Exhibit A-2 at 4-5.

easement area without consideration of the need to drill a replacement well in the future.[38] Staff further discounts the value of the preexisting outbuildings that were on the property, of no use to the previous owners, and that Granite intends to use to support its operations. While Granite understands the need to assure that its customers are not subsidizing an affiliate, in this case Staff's approach vastly oversimplifies a very complex situation and fails to reflect the value that this well provides to Granite and its customers. Ultimately, Staff has valued an existing well—known to produce high-quality water in sufficient quantity to support Granite Mountain's needs— together with a well house and all required land rights for both the well and connecting water lines at an unrealistically low $29,432. This is less than just the $32,625 estimated cost to drill a new well (not including necessary hydrogeological studies and permitting) received from Drill Tech, which would not be guaranteed to provide adequate, high-quality water. Effectively, Staff has assigned a negative value to the total of three positive factors:

1. Unlike a new well in another location, the acquired well is known to produce sufficient quantities of high quality water;
2. To drill a new well, Granite would have to acquire land for the well and associated water lines. The actually-acquired land provides room for one well, with adequate room to drill additional or replacement wells (and to run water lines;
3. The existing buildings will be used to support Granite's operations.

Staff never explains why it deducted the value of these tangible benefits, to arrive at a valuation less than the base cost just to drill a well.

To understand Granite's position it is first necessary to understand the challenge facing Granite.[39] It is not easy to develop a new water supply in Granite's service area. The prospect of drilling a new well is daunting. First a suitable site must be located that is both likely to produce

[38] The Company intends to drill a replacement well for the Company's Well No. 5, which the Company refers to as a "grandfathered well", within the easement area when additional water supply is required for the service area. See further, Decision Nos. 71869, 72294 and 74384.
[39] This paragraph, Granite Exhibit A-2 at 5-6.

water and, to get a well drilling permit from ADWR, the proposed well cannot negatively impact any existing wells. Granite was not able to locate such a site at any price. Next a well must actually be drilled and there is no guarantee of success. Granite estimated the cost of drilling at $32,625, based on an estimate provided by Drill Tech. This cost could easily escalate, potentially doubling or even tripling, if an initial effort was unsuccessful.

Ultimately, Granite became aware of the Well No. 6 property.[40] The property had gone through foreclosure and was listed by Federal National Mortgage Association for $185,000. Granite believed that the property could be purchased for $155,000. However Granite Mountain did not have $155,000 and could not borrow or otherwise secure $155,000 to purchase the property. But, a purchase had to be done quickly, because the property was "bank owned" and would not likely remain long on the market. Furthermore, Granite Mountain was not in a position to take the risk associated with purchasing a bank-owned property, which would be sold as-is and subject to liens, claims and damages without recourse to the seller, Federal National Mortgage Association.

Because Granite's need for the well was so great and because the time to acquire the property was short, as an accommodation to her father, Shauna Duke and her husband, Jonathan Duke, purchased the property from the Federal National Mortgage Association for $155,000.[41] The Duke's purchased the property solely to allow Granite Mountain to use the well and to provide a site for a replacement well to be drilled in the future.

The Duke's and Granite placed a value of $75,000 on an easement that would allow Granite to permanently use the well, the well house and portions of the property for water utility purposes.[42] In agreeing to the $75,000 purchase price, Granite took into consideration the following factors:

[40] This paragraph, Granite Exhibit A-2 at 6.
[41] This paragraph, Granite Exhibit A-2 at 6.
[42] This paragraph, Granite Exhibit A-2 at 6-7

- The difficulty in finding suitable sites within Granite's service area to drill potable wells that will produce an adequate quantity and quality of water.
- The fact that Well No. 6 is known to provide water of suitable quantity and quality for use as a potable water supply.
- The lack of other suitable and available parcels within Granite's service area with an existing well of suitable quantity and quality for use as a potable water supply.
- Granite's inability to finance the purchase a well or well site in advance of placing the well into service and obtaining regulatory recovery.
- Granite's inability to finance the full purchase price of the property on which Well No. 6 was located, particularly in the short time frame available to close a purchase of the bank owned property.
- The willingness of the Duke's to purchase the bank owned property containing the existing Well No. 6 and grant an easement to Granite Mountain that substantially devalues the underlying property.
- The willingness of the Dukes to grant the easement at a significant discount to the full purchase price and market value of the property.
- The willingness of the Dukes to accept deferred payment terms for the value of the easement more closely aligned with Granite's ability to finance and recover the costs of the easement.
- The comparable cost of drilling and developing a new well.
- The price paid by the Duke's for the underlying property.
- The market value of the property, including the existing well.

Due to the inherent value of the well and the significant encumbrance to the property, it is very unlikely that any property owner, other than a relative, would ever grant an easement such as was given to Granite by the Dukes for less than the full market value of the property.[43] In this case, transacting with an affiliate provided substantial benefits to the regulated utility.

Granite's reference to a "significant discount to the full purchase price" compares the $75,000 to be paid for the easement in the affiliate transaction, *which no unrelated third party would likely accept*, to the $155,000 purchase price for the property paid by the Dukes.[44] The Dukes did a favor for Granite which no third party would have granted.

Effectively, Granite saved $80,000 over the minimum price that Granite would have needed to pay even if it could have raised $155,000.[45] This was clearly in its customers' interest. Another reason that the purchase was in the customers' interest is that the purchase allowed use of a badly needed well that could not have been otherwise constructed. If a third party had purchased the property, it may have been impossible to obtain the well site at any price.

Based on the foregoing, the $75,000 paid by Granite for the easement and well is an extremely fair price for an existing well with proven water production of drinking water quality.[46] The amount paid is supported by a real estate appraisal of $80,000. Further, Mr. Jones, who supported Granite's $75,000 request, has extensive first-hand experience in what is required to acquire well sites for water utilities. *"I have throughout my career worked on many water supply projects where we have had to identify well sites, acquire either existing wells or sites for wells to be drilled."*[47] He was extremely qualified to testify as to the reasonableness of the $75,000 cost for the well and easement.

By contrast, Staff's position is arbitrary. Further, in contrast to Companies witness Jones, Staff's valuation was supported by witnesses with <u>no qualifications</u> in real-estate appraisals and <u>no experience</u> acquiring property rights for well drilling.[48]

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[43] This paragraph, Granite Exhibit A-2 at 8.
[44] This paragraph, Granite Exhibit A-2 at 8.
[45] This paragraph, Granite Exhibit A-2 at 8.
[46] This paragraph, Granite Exhibit A-2 at 8.
[47] Granite transcript at 19:19-22.
[48] Granite transcript at 76:17-23; 95:19-23.

The Commission certainly must understand that it would be impossible for any water utility to acquire a well site that was large enough for an initial well and a replacement well, and then drill and equip the well for a cost remotely close to $29,432. The requested $75,000 cost is reasonable, supported by overwhelming evidence, and should be included in Granite's rate base.

B. <u>Storage Tank No. 3</u>

Granite thanks the Staff and Hearing Division for agreeing to allow the record to stay open long enough for Granite to complete Storage Tank No. 3 and to provide the documentation needed to support inclusion of its costs in rate base.

Granite completed construction of the tank, including disinfection and receipt of satisfactory bacteriological test results on November 16, 2015.[49] On December 3, 2015, the Arizona Department of Environmental Quality issued an Approval to Construct ("AOC") for Storage Tank No. 3. A copy of the AOC was attached as Exhibit A to Exhibit A-5. On December 5, 2015, Granite placed Storage Tank No. 3 into service.

The final cost of Storage Tank No. 3 was $106,043.13.[50] A full summary of the costs, together with supporting invoices, was attached as Exhibit B to Chino Exhibit A-5. As indicated on Exhibit B, Granite was able to obtain a refund in the amount of $18,925 from the original contractor for unfinished work and their failure to complete the tank in a timely manner. With the inclusion of this credit, most, if not all, of the unnecessary or duplicate costs of constructing the tank were eliminated.

However, in order to be certain there are no duplicate costs and to address Staff's concern regarding this issue, Granite reduced the cost of the tank by $3,820.45, as shown on Exhibit B to Granite Exhibit A-5.[51] The $3,820.45 reduction lowered the tank construction costs to the original bid of $93,650.00, eliminating any possibility of duplicate costs. After the cost

[49] This paragraph, Granite Exhibit A-5 at 4.
[50] This paragraph, Granite Exhibit A-5 at 4-5.
[51] This paragraph, Granite Exhibit A-5 at 5.

reduction, the cost of Storage Tank No. 3, including engineering, construction and miscellaneous items is $102,222.68, which Granite asks to be included in rate base.

Staff reviewed Granite's request concerning Storage Tank No. 3 and concluded: "Staff has determined that Granite's cost of $102,222.68, which include expenses of Engineering & Permitting, Tank Construction and Materials & Misc., was reasonable."[52] Further, "Staff concludes that the Tank is used and useful."[53]

Based on the evidence, the costs associated with Storage Tank No. 3 should be included in rate base.

C. Accumulated Depreciation and Depreciation Expense

Granite has deducted $4,680 from accumulated depreciation and the depreciable plant balance to reflect a post-test year retirement.[54] Staff has not made this deduction, which caused accumulated depreciation and depreciation expense to be overstated.

D. Income Tax Expense

The parties largely agree on how to calculate income-tax expense.[55] However, throughout much of the case, Staff used the wrong tax rate for Granite. Granite used personal tax rates in accordance with the Commission's policy pertaining to an income tax allowance for S-Corps. Staff instead utilized corporate income tax rates. In Staff's response to Granite's Supplemental Direct Testimony, Staff appears to have updated the tax rates used. However, the Company is still unable to replicate Staff's Arizona income tax calculation using personal tax rates. To account for the effects of the Water Infrastructure Financing Authority ("WIFA") debt incurred to fund construction of Storage Tank No. 3, Staff deducted synchronized interest expense in making its income tax calculation.[56] Granite did not include a deduction for synchronized interest expense, but has no issue with its propriety. Income Tax Expense is also

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[52] Staff Exhibit S-8 at 2:4-5.
[53] Staff Exhibit S-8 at 2:8.
[54] This paragraph, Granite Exhibit A-1 at 8.
[55] This paragraph, Granite Exhibit A-1 at 17-18.
[56] This paragraph, Granite Transcript at 143.

included in the Gross Revenue Conversion Factor. Since Chino and Staff disagree on their revenue and expense recommendations the recommend income taxes at proposed rates are different.

E. WIFA Payments

To ensure compliance with Decision No. 74384, Granite prepared Exhibit A-4, a report that shows all transactions related to a bank account used for payments on Granite's WIFA loan to fund construction of Storage Tank No. 3.[57] The report shows that Granite began making regular monthly deposits in November of 2014, as required by Decision No. 74384. In September of 2015, Granite made a deposit for amounts required for the period May 2014 through October 2014. As of the date of the report, Granite had made the required deposits for the period from May 2014 through October 2015. All withdrawals from the account are for WIFA loan payment or for fees charged by the bank. Granite is in compliance with Decision No. 74384.

Staff reviewed Granite Exhibit A-4 and agreed that Granite was in compliance with Decision No. 74834:

> The Company-provided Exhibit A-4 provided the accounting records for the WIFA Loan Account, payment history, and deposits to WIFA Loan Bank Account as required by Decision No. 74384. <u>The report indicates that the Company began making regular deposits into the separate bank account on September 25, 2015, in accordance with Decision No. 74384</u>.[58]

F. Rate Design

Granite's proposed rate design is presented on Schedule RLJ-4 attached to Granite Exhibit A-1.[59] The rate design keeps the current split of revenue from the base charge and the commodity charges essentially unchanged. The percentage collected from the third tier is reduced from 18.3% to 16.1%, moving incrementally toward industry recommendations and to address revenue stability concerns related to the large increase. Although Granite expects that it

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[57] This paragraph, Granite Exhibit A-5 at 3-4.
[58] Staff Exhibit S-9 at 5:9-13 (emphasis added).
[59] This paragraph, Granite Exhibit A-1 at 18.

will not be able to fully collect its authorized revenue due to declining sales, this rate design will promote revenue stability while encouraging conservation. Granite has adopted the break-over points recommend by Staff in their direct testimony for all meter sizes. Lastly, to avoid unnecessary complexity, Granite has not proposed separate rates for small commercial meters.

Staff's rate design would decrease the percentage of revenue collected from the base charge from 46.8% to 41.0%.[60] This revenue is shifted to both the second and third tier rates with the third tier percentage of revenue collected increasing from 18.3% to 20.8%. The primary concern with Staff's rate design is that it will promote revenue instability and impair Granite's ability to collect its authorized revenue. This shift of revenue from base charges to third tier revenue will undoubtedly exacerbate expected declining sales and cause Granite to collect less than its authorized revenue.

G. <u>Penalties</u>

Staff initially recommended that the Commission impose unspecified penalties on Granite for improperly providing free water to failure to collect bills from affiliates.[61] Staff claimed that Granite had failed to comply with Decision No. 71869.[62] Staff did not recommend any particular amount for the penalty.[63]

Granite disagreed with Staff's recommendation and testified that it provided no free water during the test year.[64] Further, the affiliate receivables were a process issue, different than those identified in Decision No. 71869.[65] Granite in fact brought the new issues to Staff's attention and corrected them as of the end of the test year.[66] And Granite Exhibit A-3 demonstrated that all receivables from the three non-water company affiliates have been paid in full.[67]

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[60] This paragraph, Granite Exhibit A-1 at 18-19.
[61] Staff Exhibit S-3 at 50-51.
[62] *Id.*
[63] Granite transcript at 92-93.
[64] Granite Exhibit A-1 at 19-20.
[65] Granite Exhibit A-1 at 20.
[66] *Id.*
[67] Granite Exhibit A-5 at 2.

It certainly seems clear that no penalties in any amount are warranted. Staff seems to have dropped this issue, as it was not discussed in subsequent testimony. If Staff does address this issue in its Initial Brief, Granite will respond further in its Reply Brief.

IV. CHINO ISSUES

The following issues are unique to the Chino rate case.

A. Operating Margin

Chino's revenue requirement should be set using a 15% operating margin.[68] As explained in Chino's application:

> Chino Meadows has a small and declining rate base due to the age of plant facilities, and the above-discussed mismatch between historically recorded depreciation expense and actual plant depletion. For a company with a very small rate bases, traditional ratemaking may yield inadequate Operating Income, which provides a dangerously small margin over expenses. A company with inadequate Operating Income may find it difficult or even impossible to cover increasing or fluctuating costs, to deal with emergencies or other contingencies, and to attract new capital for system improvements.
>
> In Chino Meadow's case, traditional rate making would result in an Operating Margin of only 4.16%, assuming a 10.0% return on rate base. This is well below the Operating Margins the Commission typically provides companies with small or negative rate bases. Therefore, Chino Meadows has calculated a revenue requirement based on an Operating Margin of 15.0%, consistent with the California PUC policy for small water utilities (less than 2,000 customers). This approach is also consistent with past Commission Decisions for small companies with small or negative rate base.

Staff's initial recommendation, including shifting $49,006 in costs and related revenue from Chino to Granite, allowed for no increase in rates with a resulting 15.85% operating margin. In its surrebuttal recommendation, Staff increased the cost allocation to Chino by $10,634 but maintained it recommendation for no increase in rates. This recommendation reduced the resulting operating margin to13.38%.

As noted previously, because Staff failed to maintain a consistent recommend operating margin and increase Chino's revenue requirement to recover these additional expenses, Chino will not be able to recover these expenses. If the operating margin is not held at 15%, Chino will

[68] Chino Exhibit A-2 at 3-4.

be unable to recover any costs related to any contested issues decided in Chino's favor. So instead of Granite being unlikely to recover $10,634 in common expenses and any other costs determined to be appropriately borne by Chino, Staff's recommendation for no increase in rates and the resulting decreasing operating margin, would instead guarantee that Chino will not recover those costs and expense. The effect of Staff's recommendation would be to make Chino worse off.

B. CIAC Amortization

Staff appears to have made a minor mistake in the calculation of the off-setting CIAC amortization by using the wrong amortization period (0.5 years instead of 1.5 years).[69] Additionally, Chino's Rebuttal CIAC amortization adjustment is calculated on a composite basis and takes into account the impact of Staff's other plant adjustments on the amortization rate. Although the differences are minor, Chino's Rebuttal CIAC amortization adjustment supported by Schedule RLJ-2 Rebuttal, Pages 5.1 and 5.2 is more comprehensive and should be adopted.

V. SUMMARY AND CONCLUSION

The Parties have significantly narrowed the issues between them. Concerning the remaining issues, the Companies' proposal is far more balanced than Staff's, which seems to have been calculated in isolation without considering the overall effects on the Companies. The Companies actually recommend a smaller rate increase for Granite than does Staff. This is offset by a very small increase for Chino. Given that Chino's rates have only increased by 0.61% in the past 20 years, and that there are far more Chino customers to bear allocated costs, the public interest, and the ratemaking principle of gradualism support the Companies' proposal.

Further, a larger cost allocation, while preserving the recommended 15% operating margin, would provide Chino funds needed to address an aging water system in need of improvements. It only makes sense that an older system that has had flat rates for 20 years would need a reasonable rate increase.

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[69] This paragraph, Chino Exhibit A-1 at 8.