ORIGINAL

0000170123

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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

RECEIVED

2016 MAY -5 P 2: 04

AZ CORP COMMISSION
DOCKET CONTROL

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

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

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

Respectfully submitted on May 5, 2016, by:

Craig A. Marks

Craig A. Marks
Craig A. Marks, PLC
10645 N. Tatum Blvd
Suite 200-676
Phoenix, Arizona 85028
(480) 367-1956
Craig.Marks@azbar.org
Attorney for Granite Mountain Water Co., Inc. and Granite Meadows II Water Co., Inc.

Arizona Corporation Commission
DOCKETED
MAY 05 2016

DOCKETED BY	th

Original and 13 copies filed
on May 5, 2016, with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Copies mailed and emailed on May 5, 2016, to:

Bridget A. Humphrey/Matthew Laudone
Staff Attorneys
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

BEFORE THE ARIZONA CORPORATION COMMISSION

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

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

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

I. INTRODUCTION

For the most part, the Companies' Initial Joint Brief adequately discussed the Companies' positions, the evidence supporting them, and why they should be adopted. In this Joint Reply Brief, the Companies will first summarize each position still in dispute with the Staff and then offer a short reply to Staff if needed. For simplicity, the Companies will organize the Joint Reply Brief in the same manner as their Initial Joint Brief.

II. COMMON ISSUES

The following issues are common to both rate cases:

A. <u>Allocation of Common Costs</u>

Granite and Chino are sister companies operated from a common office using common staff. The Companies have historically allocated costs based on customer counts, which are currently 88% Chino/12% Granite. Customer counts represent the simplest and most accurate way to allocate costs and should dominate any cost allocation model between Chino and Granite.

Staff 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, even though Granite has fewer customers, lower water sales, higher levels of plant investment and higher rates. Further, Chino is an established, mature company that provides 75% of the combined revenue of Chino and Granite. 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. Aggressive shifting of costs to Granite would increase revenue instability because Granite would under-collect its authorized revenue by a significant magnitude. This 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. 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. In its briefs, Staff never addressed, let alone justified why it would orphan these common expenses.

Staff's allocation factors are also unusual and inappropriate. 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. Staff did not address these points in its briefs

Finally, use of Staff's four atypical factors introduces needless complexity for a small organization that needs simplicity to be successful. 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 cost 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 objected to the deduction of 33% of total monthly hours for the Companies' president as proposed by Staff. 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. 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.[1] This amount is arrived at by taking the actual half-time salary paid to Mr. Levie of $37,700 and

[1] In its briefs, Staff incorrectly states that it is recommending a "total reduction of $17,444 to Mr. Levie's salary" to $21,266. Staff GM brief at 12:17-18; Staff CM brief at 9:21-22. Given the Companies' proposed salary of $33,027, the actual Staff reduction to Mr. Levie's salary is $11,761.

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.

To support its overblown deduction for Mr. Levie's salary Staff noted in its briefs that "due to recent health issues, Mr. Levie's family is taking over some business functions to relieve the stress on Mr. Levie.[2] Staff's observation actually undercuts Staff's position. The work clearly must be and has been getting done by unpaid family members. If a third-party were performing all of Mr. Levie's duties, it would include those being done by family members. And that third party would have to be paid a reasonable salary to serve as both the chief executive and legal counsel for the Companies, likely far more than $33,027.

C. <u>Arbitrary Fire-Related Plant Disallowances</u>

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. The increase to the Companies' CIAC balance in turn reduces depreciation expense. 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. The fire was an event not within the Companies' control and it has made all reasonable efforts to reconstruct its plant records.

Staff curiously states: "While Staff does not believe the Company should suffer the consequences of the loss of documentation due to the fire, neither should it benefit unduly."[3]

---

[2] Staff GM Brief at 11:26 – 12:1; Staff CM Brief at 9:4-5.
[3] Staff GM Brief at 6:11-12; Staff CM Brief at 7:23-25.

With all due respect, through its arbitrary 10% rate base penalty, Staff would clearly force the Companies to "suffer the consequences of the loss."

The Companies would also not "benefit unduly" from the loss if Staff's arbitrary disallowance were ignored. The Companies have in no way benefited from the fire. 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 disallowances should be rejected.

D. Income Tax Expense

The Parties largely agree on how to calculate income-tax expense. However, because the Parties disagree on their revenue and expense recommendations the recommend income taxes at proposed rates are different.[4]

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. 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.

[4] The Companies have reviewed Staff's most recent workpapers and it appears that Staff has incorrectly calculated Arizona income tax expense. The error is actually in the Companies' favor, but in fairness it should be corrected.

The Companies have nothing further to add on this subject.

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. 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.

The Companies have nothing further to add on this topic.

H. Annual Report of Corporate Cost Allocations

Staff recommends that the Companies be required to file annual reports concerning cost allocations. 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.

The Companies have nothing further to add on this topic.

I. Affiliate Receivables and Payables

As the Companies understand it, Staff makes the following recommendations:

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. 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 unregulated affiliates.

For the reasons set forth in their Initial Joint Brief, the Companies do not agree with parts 3 and 4 of the recommendation concerning transactions between the regulated affiliates and cannot support the recommendations. If Staff's recommendation is adopted, the Companies would be forced to adopt burdensome, formalized policies and potentially obtain approvals prior to transferring funds, which would not benefit customers

The Companies have nothing further to add on this topic.

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. Staff offered no reasons in its testimony or briefs why the Commission should adopt such an unprecedented, unjustified remedy. 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 and 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."

Further, Staff's request is not supported by the evidence in this case and it is premature. There is no evidence of any willful violation of Commission rules or accounting standards. It is premature because Staff proposes to include this extraordinary remedy for violations of the yet undrafted code of conduct.

Staff's request would also set dangerous precedent. 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. 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, as discussed in detail in the Initial Joint Brief, delegating this authority to Staff would violate the Companies' due-process rights guaranteed by the United States Constitution.

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 a producing well, structures, and sufficient land to allow drilling of an additional well. The amount is $5,000 less than the value established by an independent appraisal conducted by Huck Appraisal Office ("Appraisal").

Staff's unreasonably low valuation of the wellsite and easement simply ignores business realities by failing to consider the specific circumstances of this well purchase. 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 the $32,625 estimated cost just to drill a new well (not including necessary hydrogeological studies and permitting), which would not be guaranteed to provide adequate, high-quality water.

Granite saved $80,000 over the minimum price that Granite would have needed to pay even if it could have raised $155,000. This was clearly in its customers' interest.

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. 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.*"[5] He was extremely qualified to testify as to the reasonableness of the $75,000 cost for the well and easement.

By contrast, 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.[6]

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 successfully 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.

[5] Granite transcript at 19:19-22.
[6] Granite transcript at 76:17-23; 95:19-23.

B. Storage Tank No. 3

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.

Staff raised no new issues in its brief. 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. Staff has not made this deduction, which caused accumulated depreciation and depreciation expense to be overstated.

Staff did not address this issue in its brief.

D. Income Tax Expense

The parties largely agree on how to calculate income-tax expense. 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. Granite did not include a deduction for synchronized interest expense, but has no issue with its propriety.

Income Tax Expense is also 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.

Staff did not address this issue in its brief

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. 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 has fully complied with Decision No. 74384. Staff reviewed Granite Exhibit A-4 and agreed that Granite was in compliance with Decision No. 74834.

In its brief, Staff inexplicably argues that Granite should be fined in connection with past WIFA issues. This would be inappropriate for several reasons. First, as Staff agreed, Granite has fully complied with Decision No. 74384, which considered all WIFA issues as of that date. Second, to resolve these and other accounting issues, Granite employed Ray Jones at significant expense to analyze past practices, review outstanding Commission Orders, recommend corrections to current practices, and finally explain to the Commission how these issues have been resolved. It is certainly fair to say that Granite is now far better prepared to comply with NARUC requirements and Commission practices than the vast majority of Class E water companies. Perhaps a fine might be warranted if Granite had not hired Mr. Jones and was not in compliance with Decision No. 74384. However, its resulting actions in this docket clearly demonstrate that Granite is sincerely and successfully striving to put the past behind it. Fines would be punitive and are unwarranted.

F. Rate Design

Staff's rate design would decrease the percentage of revenue collected from the base charge from 46.8% to 41.0%. 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%. This would 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.

Granite Mountain has nothing further to add on this topic.

G. **Penalties**

Again, neither penalties nor fines are appropriate.[7]

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. Chino 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.

Staff demonstrated that its use of traditional rate making would result in an Operating Margin of only 4.52%, assuming a 10.0% return on rate base.[8] This is well below the Operating Margins the Commission typically provides companies with small or negative rate bases. Therefore, Chino Meadows calculated a revenue requirement based on an Operating Margin of 15.0%, consistent with the California Public Utilities Commission's 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 bases.

---

[7] See Section III(E), above.
[8] Staff CM brief at 6:14-17

For reasons never explained, Staff has been determined to allow no rate increase for Chino.[9] As a result, even after Staff reallocated $10,634 in additional common expenses to Chino, it held rates flat, which reduced Chino's Operating Margin and guaranteed that neither Chino nor Granite would have no reasonable opportunity to recover these costs in rates.

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). 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.

Staff did not address this issue in its brief.

V. SUMMARY AND CONCLUSION

The Companies' allocation 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 would be offset by a very small rate increase for Chino. The public interest and the ratemaking principle of gradualism support the Companies' allocation proposal. 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.

[9] Staff CM brief at 6:3-4.

Further, a larger cost allocation preserves Chino's recommended 15% operating margin and provides Chino with additional 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.[10]

The Companies have shown that Staff's rate-base and expense disallowances are unwarranted and should be rejected.

Staff has not demonstrated any need for its extreme penalties or for its punitive recommendations for inclusion in a code of conduct.

The Companies' positions in these dockets are reasonable and should be adopted by the Commission.

[10] Staff seems to take issue with proposition that Chino's plant is older and costs more to maintain. "[T]he Company has provided no details about the age or condition of the plant, nor quantified the costs associated with the age of the plant." Staff CM brief at 3:14-16. In fact, the Companies' depreciation records detail the age of the plant. Also, it is axiomatic that plant wears out over time. For this reason, depreciation expense generates funds to replace aging plant. Further, based on his vast experience as an engineer for, manager of, and consultant to Arizona water utilities, Mr. Jones' stated that older plant requires more costly maintenance. Exhibit A-1 at 15:6-7. This expert opinion is reasonable, consistent with everyday experience (things wear down over time, the Second Law of Thermodynamics), and not contradicted by any other evidence.